IN THE CALIFORNIA SUPREME COURT

No. S206874

MARIA AYALA, et al.,

Plaintiffs and Appellants,

v.

ANTELOPE VALLEY NEWSPAPERS, INC.,

Defendant and Respondent.

After a Decision by the California Court of Appeal,
Second Appellate District, Division Four
Case No. B235484

Appeal from the California Superior Court, Los Angeles County
Case No. BC403405 (Judge Carl J. West)

DECLARATION OF MICHAEL J. WRIGHT IN SUPPORT OF MOTION FOR JUDICIAL NOTICE VOL. II OF II EXHIBITS 5 -13

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DECLARATION OF MICHAEL J. WRIGHT

1. I am an attorney duly admitted to practice law before the Courts of this state, and am an attorney at Callahan and Blaine, attorneys of record for Plaintiffs and Appellants. I have personal knowledge of the facts set forth in this declaration and, if called as a witness, would competently testify to their truth.

2. Attached hereto as Exhibit 1 is a true and correct copy of Notice of Motion and Motion to Decertify the Class; Memorandum of Points and Authorities in Support filed in San Diego Superior Court case *Espejo et al., v. The Copley Press, et al* SDSC case number 37-2009-00082322-CU-OE0CTL on December 6, 2012.

3. Attached hereto as Exhibit 2 is a certified copy of Memorandum of Points and Authorities in Support of Defendants The McClatchy Company and McClatchy Newspapers, Inc.'s Motion for Decertification filed in Sacramento Superior Court case *Sawin, et al., v. The McClatchy Company, et al.,* SCSC case number 34-2009-00033950-CU-OE-GDS on January 7, 2013.

4. Attached hereto as Exhibit 3 is a true and correct copy of *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*, (February 2000) Planmatics, Inc.'s report for the US

Department of Labor, which I personally downloaded and printed from the Department of Labor, Employment and Training Administration website: www.doleta.gov.

5. Attached hereto as Exhibit 4 is a true and correct copy of U.S. Government Accountability Office Report to the Ranking Minority Member, Committee on Health, Education, Labor, and Pensions, U.S. Senate (July 2006) *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-09-717, which I personally downloaded and printed from U.S. Government Accountability Office website: www.gao.gov.

6. Attached hereto as Exhibit 5 is a true and correct copy of U.S. Government Accountability Office Report to Congressional Requesters (August 2009) *Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention,* GAO-09-717, which I personally downloaded and printed from the U.S. Government Accountability Office website: www.gao.gov.

7. *Attached hereto as* Exhibit 6 is a true and correct copy of Annual Report of the White House Task Force on the Middle Class (February 2010), which I personally downloaded and printed from The White House website: www.whitehouse.gov.

8. Attached hereto as Exhibit 7 is a true and correct copy of California Employment Development Department Annual Report *Fraud Deterrence and Detection Activities* (June 2007), which I personally downloaded and printed from the California Employment Development Department website: www.edd.ca.gov.

9. Attached hereto as Exhibit 8 is a true and correct copy of California Employment Development Department Annual Report *Fraud Deterrence and Detection Activities* (June 2011), which I personally downloaded and printed from the California Employment Development Department website: www.edd.ca.gov.

10. Attached hereto as Exhibit 9 is a true and correct copy of the transcript of radio broadcast *Texas Contractors Say Playing By The Rules Doesn't Pay* by Wade Goodwyn, first broadcast on NPR on April 11, 2013, which I personally downloaded and printed from the National Public Radio website: www.npr.org.

11. Attached hereto as Exhibit 10 is a true and correct copy of the California Employment Development Department ("EDD") website regarding Underground Economy Operations (2010) which I personally downloaded and printed from the EDD's website: www.edd.ca.gov.

12. Attached hereto as Exhibit 11 is a true and correct copy of the EDD's *Information Sheet* regarding Employment Enforcement Task Force (November 2009) which I personally downloaded and printed from the EDD's website: www.edd.ca.gov.

13. Attached hereto as Exhibit 12 is a true and correct copy of a February 9, 2012 News Release Number 12-0257-SAN from the U.S. Department of Labor's Wage and Hour Division and a true and correct copy of the Memorandum of Understanding to which it refers, both of which I personally downloaded and printed from the website: www.dol.gov/whd.

14. Attached hereto as Exhibit 13 is a true and correct copy of Defendants' Memorandum of Points and Authorities in Support of Motion to Strike Class Allegations filed in Sacramento Superior Court case *Sawin, et al., v. The McClatchy Company, et al.,* SCSC case number 34-2009-00033950-CU-OE-GDS on February 15, 2011.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed this 29th day of April, 2013, at Santa Ana, California.

MICHAEL J. WRIGHT

United States Government Accountability Office

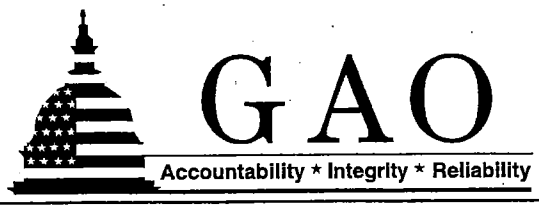
GAO

Report to Congressional Requesters

August 2009

EMPLOYEE MISCLASSIFICATION

Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention



GAO-09-717

August 2009

EMPLOYEE MISCLASSIFICATION

Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention

GAO Accountability · Integrity · Reliability

Highlights

Highlights of GAO-09-717, a report to congressional requesters

Why GAO Did This Study

When employers improperly classify workers as independent contractors instead of employees, those workers do not receive protections and benefits to which they are entitled, and the employers may fail to pay some taxes they would otherwise be required to pay. The Department of Labor (DOL) and Internal Revenue Service (IRS) are to ensure that employers comply with several labor and tax laws related to worker classification. GAO was asked to examine the extent of misclassification; actions DOL and IRS have taken to address misclassification, including the extent to which they collaborate with each other, states, and other agencies; and options that could help address misclassification. To meet its objectives, GAO reviewed DOL, IRS, and other studies on misclassification and DOL and IRS policies and activities related to classification; interviewed officials from these agencies as well as other stakeholders; analyzed data from DOL investigations involving misclassification; and surveyed states.

What GAO Recommends

This report includes various recommendations to DOL and IRS to enhance enforcement of proper worker classification, improve outreach to workers about classification, and improve interagency coordination in addressing misclassification. In commenting on a draft of this report, DOL and IRS generally agreed with our recommendations.

View GAO-09-717 or key components. For more information, contact Andrew Sherrill at (202) 512-7215 or sherrilla@gao.gov.

What GAO Found

The national extent of employee misclassification is unknown; however, earlier and more recent, though not as comprehensive, studies suggest that it could be a significant problem with adverse consequences. For example, for tax year 1984, IRS estimated that U.S. employers misclassified a total of 3.4 million employees, resulting in an estimated revenue loss of $1.6 billion (in 1984 dollars). DOL commissioned a study in 2000 that found that 10 percent to 30 percent of firms audited in 9 states misclassified at least some employees.

Although employee misclassification itself is not a violation of law, it is often associated with labor and tax law violations. DOL's detection of misclassification generally results from its investigations of alleged violations of federal labor law, particularly complaints involving nonpayment of overtime or minimum wages. Although outreach to workers could help reduce the incidence of misclassification, DOL's work in this area is limited, and the agency rarely uses penalties in cases of misclassification.

IRS enforces worker classification compliance primarily through examinations of employers but also offers settlements through which eligible employers under examination can reduce taxes they might owe if they maintain proper classification of their workers in the future. IRS provides general information on classification through its publications and fact sheets available on its Web site and targets outreach efforts to tax and payroll professionals, but generally not to workers. IRS faces challenges with these compliance efforts because of resource constraints and limits that the tax law places on IRS's classification enforcement and education activities.

DOL and IRS typically do not exchange the information they collect on misclassification, in part because of certain restrictions in the tax code on IRS's ability to share tax information with federal agencies. Also, DOL agencies do not share information internally on misclassification. Few states collaborate with DOL to address misclassification, however, IRS and 34 states share information on misclassification-related audits, as permitted under the tax code. Generally, IRS and states have found collaboration to be helpful, although some states believe information sharing practices could be improved. Some states have reported successful collaboration among their own agencies, including through task forces or joint interagency initiatives to detect misclassification. Although these initiatives are relatively recent, state officials told us that they have been effective in uncovering misclassification.

GAO identified various options that could help address the misclassification of employees as independent contractors. Stakeholders GAO surveyed, including labor and employer groups, did not unanimously support or oppose any of these options. However, some options received more support, including enhancing coordination between federal and state agencies, expanding outreach to workers on classification, and allowing employers to voluntarily enter IRS's settlement program.

Contents

Figure

Abbreviations

CSP	Classification Settlement Program
DOL	Department of Labor
ETA	Employment and Training Administration
ETEP	Employment Tax Examination Program
FLSA	Fair Labor Standards Act
IRS	Internal Revenue Service
OSHA	Occupational Safety and Health Administration
QETP	Questionable Employment Tax Practices
SB/SE	Small Business/Self Employed Division
TIN	taxpayer identification number
WHD	Wage and Hour Division

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

August 10, 2009

The Honorable Edward M. Kennedy
Chairman
Committee on Health, Education,
Labor, and Pensions
United States Senate

The Honorable Richard J. Durbin
Chairman
Subcommittee on Financial Services
and General Government
Committee on Appropriations
United States Senate

The Honorable Rob Andrews
Chairman
Subcommittee on Health, Employment,
Labor, and Pensions
Committee on Education and Labor
House of Representatives

The Honorable Lynn Woolsey
Chairwoman
Subcommittee on Workforce Protections
Committee on Education and Labor
House of Representatives

In fiscal year 2007, states uncovered at least 150,000 workers who may not have received protections and benefits to which they were entitled because their employers misclassified them as independent contractors when they should have been classified as employees. According to the Bureau of Labor Statistics, approximately 10.3 million workers, or 7.4 percent of the employed workforce, were classified as independent contractors in the United States in 2005, although it is not clear how many of these workers were misclassified. Misclassification can precipitate violations of labor and tax laws. Independent contractors are not covered by many of the labor laws that protect employees and are not eligible for many benefits to which employees are entitled. Misclassified employees may not know that they are improperly classified and may not be aware that they are being denied the protections and benefits to which they are entitled under federal and state laws. In addition, when employers

misclassify workers as independent contractors, they may fail to pay and withhold payroll taxes they would otherwise be required to pay and withhold, and the workers may not be aware of their tax obligations.

No single agency is directly responsible for ensuring proper worker classification. Several federal agencies have responsibility, however, for ensuring that workers receive the benefits and protections to which they are entitled as employees. The Department of Labor (DOL) is responsible for ensuring employer compliance with several labor laws, including the Fair Labor Standards Act of 1938 (FLSA). Other federal agencies responsible for enforcing laws that provide employees—but not independent contractors—with benefits and protections include the Equal Employment Opportunity Commission and the National Labor Relations Board. The Internal Revenue Service (IRS) is not responsible for ensuring that employee protections are provided, but is responsible for ensuring that employers and employees pay proper payroll tax amounts and that employers properly withhold taxes from workers' pay. IRS also seeks to provide general information to employers about worker classification.

In response to your request, this report provides information on the misclassification of employees as independent contractors, including (1) what is known about the extent of the misclassification of employees as independent contractors and its associated tax and labor implications; (2) what actions DOL has taken to address misclassification, if any; (3) what actions IRS has taken to address misclassification, if any; (4) the extent to which DOL and IRS collaborate with each other, states, and other relevant agencies to prevent and address cases of employee misclassification; and (5) options that could help address challenges in preventing and responding to misclassification.

To determine what is known about the extent of misclassification, we reviewed IRS's past estimates and its plans to update its estimates of the revenue losses associated with misclassification; analyzed the information from audits that states report to DOL on the number of employers they determined to have misclassified employees; and reviewed misclassification studies conducted by states, universities, and research institutes. To describe actions DOL has taken to address employee misclassification, we examined laws, regulations, and agency policies and documentation; examined summary data from DOL's Wage and Hour Division (WHD) on cases involving misclassification concluded during fiscal year 2008; reviewed select WHD misclassification case files; interviewed agency officials and investigators as well as employer and labor advocates; and surveyed states to obtain their perspectives on DOL's

education and outreach efforts. To describe actions IRS has taken to address employee misclassification, we reviewed IRS's strategy for enforcing rules and regulations related to employee misclassification, analyzed data from IRS's enforcement programs related to employee misclassification, reviewed IRS's education and outreach activities, and interviewed independent contractor and labor advocates. To understand how DOL and IRS cooperate with each other and with states and other relevant agencies, we examined agency policies and procedures for referring cases involving misclassification, interviewed agency and state officials, conducted a Web-based survey of states to determine how they coordinate with DOL and IRS, and reviewed information from IRS's Questionable Employment Tax Practices (QETP) initiative, a collaboration between IRS and states aimed at increasing tax compliance by employers. To describe options to help address misclassification, we reviewed GAO and other federal agency reports and recommendations and other organizations' studies on misclassification of employees. We also surveyed relevant stakeholders to help identify such options and summarize any related trade-offs.

We conducted this performance audit from August 2008 through August 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. For more information on our scope and methodology, see appendix I.

Background

In general, employee misclassification occurs when an employer improperly classifies a worker as an independent contractor instead of an employee.[1] As we reported in 2006, the tests used to determine whether a worker is an independent contractor or an employee are complex and differ from law to law.[2] While laws vary in their definitions of the

[1]In this report, we define the term employer as an entity that compensates employees, independent contractors, or both for services received in the course of a trade or business. Thus, the term does not include consumers or individuals who contract for services. While independent contractors may also be classified improperly as employees, this report focuses on the misclassification of employees as independent contractors.

[2]GAO, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-06-656 (Washington, D.C.: July 11, 2006).

conditions that make a worker an employee, in general, a person is considered an employee if he or she is subject to another's right to control the manner and means of performing the work. In contrast, independent contractors are individuals who obtain customers on their own to provide services (and who may have other employees working for them) and who are not subject to control over the manner by which they perform their services.

Many independent contractors are classified properly, and the independent contractor relationship can offer advantages to both businesses and workers. Businesses may choose to hire independent contractors for reasons such as being able to easily expand or contract their workforces to accommodate workload fluctuations or fill temporary absences. Workers may choose to become independent contractors to have greater control over their work schedules or when they pay taxes, rather than have employers withhold taxes from their paychecks.

However, employers have financial incentives to misclassify employees as independent contractors. While employers are generally responsible for matching the Social Security and Medicare tax payments their employees make and paying all federal unemployment taxes and a portion of or all state unemployment taxes, independent contractors are generally responsible for paying their own Social Security and Medicare tax liabilities and do not pay unemployment taxes because they are not eligible to receive unemployment insurance benefits.[8] In addition, businesses generally are not required to withhold the income, Social Security, or Medicare taxes from payments made to independent contractors that they are required to withhold for their employees. Independent contractors may also be responsible for making their own workers' compensation payments, depending on their state program. The differences, in general terms, between the tax responsibilities of employees and independent contractors are summarized in table 1.

[8]The Federal Unemployment Tax Act (26 U.S.C. §§ 3301–3311), in combination with 53 state-administered programs, provides for payments of unemployment compensation to workers who have lost their jobs. State-administered programs are subject to broad federal guidelines and oversight. States determine key elements of their programs, including who is eligible to receive state unemployment benefits and how much they receive. State unemployment tax revenues are held in trust by the U.S. Treasury and are used by the states to pay for regular, weekly unemployment benefits. Federal unemployment tax is used to administer the state and federal unemployment insurance programs, to administer the loan fund for state advances, to fund extended benefits when authorized by Congress, and to provide labor exchange services under the Wagner-Peyser Act.

Table 1: Differences between General Tax Responsibilities of Employees and Independent Contractors

	Individuals classified as employees		Individuals classified as independent contractors	
Type of tax	**Businesses' general responsibilities**	**Workers' general responsibilities**	**Businesses' general responsibilities**	**Workers' general responsibilities**
Federal income tax[a]	Withhold tax from employees' pay	Pay full amounts owed, generally through withholding	Generally, none[b]	Pay full amounts owed, generally through estimated tax payments[c]
Social Security and Medicare taxes[d]	Withhold one half of taxes from employees' pay and pay other half	Pay half of total amounts owed, generally through withholding	None	Pay full amounts owed, generally through estimated tax payments[c]
Federal unemployment tax[e]	Pay full amount	None	None	None
State unemployment tax	Pay full amount, except in certain states[f]	None, except pay partial amount in certain states[f]	None	None

Source: GAO analysis.

Note: There are various exceptions to the general responsibilities included in this table.

[a]Most states also require payment of state income taxes.

[b]Employers are generally required to withhold taxes at a rate of 28 percent from independent contractors who do not provide, or provide incorrect, taxpayer identification numbers (this practice is known as backup withholding).

[c]For estimated tax purposes, the year is divided into four payment periods.

[d]The overall tax rates for Social Security and Medicare for 2009 are 12.4 percent and 2.9 percent of income, respectively. Social Security taxes are to be paid for earnings up to the established wage base limit ($106,800 for 2009).

[e]Employers generally are required to pay federal unemployment insurance on the first $7,000 of employee pay at a rate of 6.2 percent, which can be offset by a credit of up to 5.4 percent for timely payment of state unemployment insurance taxes, resulting in an effective rate as low as 0.8 percent. The rate is set to decrease to 6.0 percent in 2010. 26 U.S.C. §§ 3301, 3302.

[f]According to DOL, these states are Alaska, New Jersey, and Pennsylvania.

While businesses may be confused about how to properly classify workers, some employers may misclassify employees to circumvent laws that restrict employers' hiring, retention, and other labor practices, and to avoid providing numerous rights and privileges provided to employees by federal workforce protection laws. These laws include

- FLSA, which establishes minimum wage, overtime, and child labor standards for employees;
- the Americans with Disabilities Act of 1990 and the Age Discrimination in Employment Act of 1967, which protect employees from discrimination based on disability or age;

- the Family and Medical Leave Act of 1993, which provides various protections for employees who need time off from their jobs because of medical problems or the birth or adoption of a child; and
- the National Labor Relations Act, which guarantees the right of employees to organize and bargain collectively.

Employers may also choose to misclassify their employees in order to avoid having to obtain proof that workers are U.S. citizens or obtain work visas for them. In addition, independent contractors generally do not qualify to participate in health and pension plans that employers may offer to employees. Finally, when employers misclassify employees, they may be able to undercut competitors because their costs are reduced.

While some workers may agree to be misclassified as independent contractors in order to be paid in cash, avoid withholding of taxes, or prevent having to provide proof of their immigration status, other workers may not realize that they have been misclassified. In addition, they may not realize that as independent contractors, they are not protected under many laws designed to protect employees, and that they have obligations for which employees are not responsible, such as payment of their own taxes over the course of the year.

Responsibility for enforcing laws that afford employee protections and administering programs that can be affected by employee misclassification issues is dispersed among a number of federal and state agencies, as shown in table 2.

Table 2: Key Federal and State Agencies Affected by Employee Misclassification

Agency	Areas potentially affected by employee misclassification
DOL	• Minimum wage, overtime, and child labor provisions • Job-protection and unpaid leave • Safety and health protections
IRS	• Federal income and employment (payroll) taxes
Department of Health and Human Services	• Medicare benefit payments
DOL, IRS, and the Pension Benefit Guaranty Corporation	• Pension, health, and other employee benefit plans
Equal Employment Opportunity Commission	• Prohibitions of employment discrimination based on factors such as race, gender, disability, or age
National Labor Relations Board	• The right to organize and bargain collectively
Social Security Administration	• Retirement and disability coverage and payments
State agencies	• Unemployment insurance benefit payments • State income and employment taxes • Workers' compensation benefit payments

Source: GAO analysis.

Misclassification itself is not a violation of any federal labor law, but it can result in violations of federal and state laws. For example, DOL's Wage and Hour Division (WHD) may cite employers that have misclassified their employees as independent contractors for violations of FLSA relating to recordkeeping (not keeping required records for these employees), nonpayment of the federal minimum wage, and nonpayment of overtime. It also assesses back wages owed to workers in cases where misclassification leads to nonpayment of overtime or minimum wage. IRS can also assess taxes and penalties on employers that it finds have misclassified employees.

However, some workers who would otherwise be considered employees are deemed not to be employees for tax purposes. With increased IRS enforcement of the employment tax laws beginning in the late 1960s, controversies developed over whether employers had correctly classified certain workers as independent contractors rather than as employees. In some instances when IRS prevailed in reclassifying workers as employees, the employers became liable for portions of employees' Social Security and income tax liabilities (that the employers had failed to withhold and remit), although the employees might have fully paid their liabilities for self-employment and income taxes.

In response to this problem, Congress enacted section 530 of the Revenue Act of 1978.[4] That provision generally allows employers to treat workers as not being employees for employment tax purposes regardless of the workers' actual status if the employers meet three tests.[5] The employers must have filed all federal tax returns in a manner consistent with not treating the workers as employees, consistently treated similarly situated workers as independent contractors, and had a reasonable basis for treating the workers as independent contractors. Under section 530, a reasonable basis exists if the employer reasonably relied on (1) past IRS examination practice with respect to the employer,[6] (2) published rulings or judicial precedent, (3) long-standing recognized practices in the industry of which the employer is a member, or (4) any other reasonable basis for treating a worker as an independent contractor. Section 530 also prohibits IRS from issuing regulations or Revenue Rulings with respect to the classification of any individual for the purposes of employment taxes. Congress intended that this moratorium to be temporary until more workable rules were established, but the moratorium continues to this day. The provision was extended indefinitely by the Tax Equity and Fiscal Responsibility Act of 1982.[7]

Federal agencies use different tests to determine whether a worker is an independent contractor or an employee. IRS uses the concepts of behavioral control and financial control and the relationship between the employer and the worker to determine whether a worker is an employee,[8]

[4]Pub. L. No. 95-600, 92 Stat. 2763 (Nov. 6, 1978).

[5]Section 530 does not apply in the case of certain technical workers (engineers, designers, drafters, computer programmers, systems analysts, or other similar skilled workers engaged in a similar line of work) who provide services for third parties pursuant to arrangements between the business for whom the technical worker works and the third party. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1706 (Oct. 22, 1986).

[6]In 1989, we stated that Congress may want to consider repealing the limitation on IRS prospectively reclassifying employees who may have been misclassified. See GAO, *Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers*, GAO/GGD-89-107 (Washington, D.C.: Sept. 25, 1989). Based in part on this report, Congress modified section 530 through the Small Business Job Protection Act of 1996 (Pub. L. No. 104-188, August 20, 1996) to limit the past examination practice reasonable basis to examinations for employment tax purposes of whether a worker should be treated as an employee.

[7]Pub. L. No. 97-248, 96 § 269(c)(1)(C)(2), 96 Stat. 324 (Sept. 3, 1982).

[8]See IRS Publication 1779, *Independent Contractor or Employee*, and Publication 15-A, *Employer's Supplemental Tax Guide*.

while WHD uses six factors identified by the United States Supreme Court to determine employee status during investigations of FLSA violations. The complexity and variety of worker classification tests may also complicate agencies' enforcement efforts. In addition, states use varying definitions of employee. For example, according to a report commissioned by DOL, at least 4 states follow IRS's test, and at least 10 states use their own definitions. The remaining states use various definitions that rely at least in part on whether the employer has the right to control the worker.

Decisions regarding employee status are sometimes determined through the courts. For example, in a recent decision, the United States Court of Appeals for the District of Columbia Circuit ruled that drivers for FedEx's small package delivery unit are independent contractors, and not employees, and therefore do not have the right to bargain collectively. FedEx had sought review of the determination by the National Labor Relations Board that the FedEx drivers were employees and that FedEx had committed an unfair labor practice by refusing to bargain with the union certified as the collective bargaining representative of its Wilmington, Massachusetts drivers. In ruling that the drivers are independent contractors, the court noted that because FedEx Ground drivers can operate multiple routes, hire extra drivers, and sell their routes without company permission, they were not like employees of traditional trucking companies.[9]

Legislation aimed at preventing employee misclassification has been introduced in previous sessions of Congress. At least four bills relating to employee misclassification were introduced in the 110th Congress. Two of the bills, both titled the Employee Misclassification Prevention Act (H.R. 6111 and S. 3648), were introduced in the House of Representatives and the Senate, respectively, to amend FLSA to require employers to keep records of independent contractors and to provide a special penalty for misclassification. Two other bills were aimed, in part, at amending the Internal Revenue Code to aid in proper classification. The Independent Contractor Proper Classification Act of 2007 (S. 2044) was introduced in the Senate to provide procedures for the proper classification of employees and independent contractors, including amending the tax code and requiring DOL and IRS to exchange information regarding cases involving employee misclassification. In the House of Representatives, the Taxpayer Responsibility, Accountability, and Consistency Act of 2008

[9]*FedEx Home Delivery v. National Labor Relations Board*, 563 F.3d 492 (D.C. Cir. 2009).

(H.R. 5804) sought to amend the Internal Revenue Code to modify the rules relating to the treatment of individuals as independent contractors or employees, including requiring IRS to inform DOL of cases involving employee misclassification. However, these bills were not enacted into law.

The Current Extent of Misclassification Is Unknown, but Misclassification Can Be a Significant Problem with Adverse Consequences

Although the national extent of employee misclassification is unknown, earlier national studies and more recent, though not comprehensive, studies suggest that employee misclassification could be a significant problem with adverse consequences.

In its last comprehensive estimate of misclassification, for tax year 1984, IRS estimated that nationally about 15 percent of employers misclassified a total of 3.4 million employees as independent contractors, resulting in an estimated revenue loss of $1.6 billion (in 1984 dollars).[10] Nearly 60 percent of the revenue loss was attributable to the misclassified individuals failing to report and pay income taxes on compensation they received as misclassified independent contractors. The remaining revenue loss stemmed from the failure of (1) employers and misclassified independent contractors to pay taxes for Social Security and Medicare and (2) employers to pay federal unemployment taxes.

For 84 percent of the workers misclassified as independent contractors in tax year 1984, employers reported the workers' compensation to IRS and the workers, as required, on the IRS Form 1099-MISC information return.[11] These workers subsequently reported most of their compensation (77 percent) on their tax returns. In contrast, workers misclassified as independent contractors for whom employers did not report

[10]The study did not include an estimate of the percentage of all independent contractors who were misclassified by their employers (that is, of all independent contractors, the percentage that should have been classified as employees).

[11]Employers are generally required to report payments of $600 or more in any given year made to independent contractors on Form 1099-MISC, unless the independent contractors are incorporated.

compensation on Form 1099-MISC reported only 29 percent of their compensation on their tax returns.[12]

Although IRS has not updated the information from its 1984 report, it plans to review the national extent of employee misclassification as part of a broader study of employment tax compliance.[13] However, IRS officials anticipate that the results of this study will not be available until 2013, at the earliest. As part of its National Research Program, IRS plans to examine a randomly selected sample of employers' tax returns for tax years 2008 to 2010. IRS employment tax officials told us they may need to extend the study if they have not collected sufficient data to provide reliable estimates. For the misclassification part of the employment tax compliance study, they said they hope to estimate the number of employers that misclassify employees, the number of employees who are misclassified, and the resulting loss of tax revenue. The officials also said they are uncertain whether IRS will be able to collect sufficient data to estimate the extent of misclassification within particular industries or geographic regions.

A study commissioned by DOL in 2000 found that from 10 percent to 30 percent of firms audited in nine selected states had misclassified employees as independent contractors.[14] The study also estimated that if

[12]In past reports, we identified various options to improve tax compliance among independent contractors and sole proprietors, who are included in a category of self-employed taxpayers along with independent contractors. In 1996, we identified two approaches to increase tax compliance of independent contractors: (1) require businesses to withhold taxes from payments to independent contractors and (2) improve information reporting on payments made to independent contractors. See GAO, *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors*, GAO/T-GGD-96-130 (Washington, D.C.: June 20, 1996). In 2007, we analyzed various options to address tax noncompliance among sole proprietors. See GAO, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2007). In 2009, we made various recommendations to improve compliance with filing Forms 1099-MISC. See GAO, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238 (Washington, D.C.: Jan. 28, 2009).

[13]We previously attempted to estimate the extent of misclassification and the extent of income tax losses using compliance data that existed in 1994, but these data were not sufficient to produce reliable estimates. See GAO, *Tax Administration: Estimates of the Tax Gap for Service Providers*, GAO/GGD-95-59 (Washington, D.C.: Dec. 28, 1994).

[14]Planmatics, Inc., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Program* (Rockville, Md: U.S. Department of Labor, February 2000).

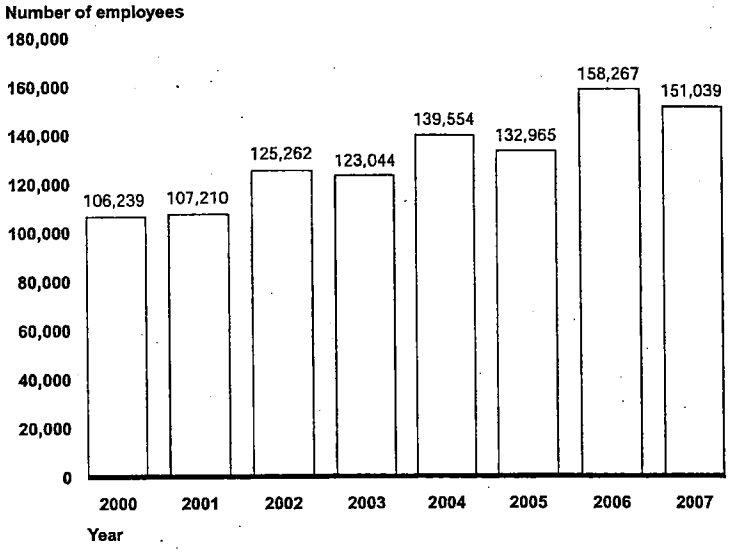
only 1 percent of all employees were misclassified nationally, the loss in overall unemployment insurance revenue because of employers' underreporting of unemployment taxes across all states would be nearly $200 million annually. In addition, the Bureau of Labor Statistics periodically conducts a survey of contingent workers (defined as workers holding jobs that are expected to last only a limited period of time), including independent contractors.[15] The most recent survey, conducted in 2005, revealed that 10.3 million U.S. workers were classified as independent contractors—approximately 7.4 percent of all workers. However, the survey did not indicate how many of these workers were misclassified.

State officials we interviewed told us that in their opinion, misclassification has generally increased over recent years. State activity in this area may support this view. For example, officials from New Hampshire's Department of Labor said the agency recently hired four new investigators to focus exclusively on investigations of employee misclassification. Summary data states reported to DOL's Employment and Training Administration, which oversees state administration of the unemployment insurance program, showed that from 2000 to 2007 the number of misclassified workers uncovered by state audits had increased from approximately 106,000 workers to over 150,000 workers, as shown in figure 1.[16] While these counts reveal an upward trend, they likely undercount the overall number of misclassified employees, since states generally audit less than 2 percent of employers each year.

[15]This survey, a supplement to the Current Population Survey, is a household survey in which workers are asked to self-report information about their jobs. It was conducted in February 1995, 1997, 1999, 2001, and 2005.

[16]States may uncover misclassification during their audits of employers' unemployment insurance tax payments. DOL requires states to report summary information related to misclassification from these audits on a quarterly basis, including the overall number of misclassified employees identified. We did not evaluate whether states changed their audit criteria over this period of time, which may explain the increase in some or all of the numbers of misclassified workers identified by the states. In addition, we note that during this period, the total number of employers audited by states increased from approximately 114,000 to about 117,000.

Figure 1: Number of Misclassified Employees Identified by State Audits of Employers, 2000 to 2007



Source: GAO analysis of DOL data.

State officials, however, told us that summary data they reported to DOL's Employment and Training Administration (ETA) did not include all misclassification identified by their investigations. For example, officials from one state said they did not report cases to DOL that did not meet ETA's prescriptive audit criteria that mandate, among other things, extensive testing of an employer's payroll records. Furthermore, the official pointed out that the data ETA collects do not include cases involving workers in the underground economy, where workers are paid in cash and income is not reported to states or IRS.

Studies conducted by states, universities, and research institutes have been generally limited in scope—for example, confined to one state or a specific industry within a state. However, some of these studies have noted that misclassification is especially prevalent in certain industries, such as construction. For example, a study conducted by Harvard University on the extent of misclassification in the construction industry in Maine estimated that approximately 14 percent of construction firms misclassified at least some of their employees each year from 1999 to

2002.[17] Maine state officials told us that following the study, they began targeting construction firms for their unemployment insurance audits and found higher levels of misclassification—up to 45 percent of the firms audited misclassified at least some of their employees.

Misclassification may undermine workers' access to protections, such as unemployment insurance and workers' compensation. For example, one group that advocates for workers cited an instance of a construction worker who fell three stories, was severely injured, and incurred hospital expenses of over $10,000 related to the injury. Because the worker was misclassified as an independent contractor, his employer did not provide workers' compensation coverage for the employee. Several union officials told us that misclassification of workers is especially prevalent in the construction industry where workers are often paid entirely in cash and, as a result, are not noted on the employers' records at all, either as employees or independent contractors. These officials told us they believe that some employers have been emboldened to begin operating on a cash basis by the ease with which they are able to misclassify their workers.

The WHD investigation case files we reviewed provided detail on several instances where misclassified employees did not receive minimum wages or overtime pay. For example, one case involved a medical transcription service that hired workers—whom WHD determined had been misclassified as independent contractors under FLSA—to work out of their homes transcribing medical files they downloaded from the company's computer system. When the system was not accessible, workers were not paid—although they were required to remain available until the system became operational—and, as a result, they were not paid the minimum wage required by FLSA.

[17]Construction Policy Research Center, Harvard University, *The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry* (Cambridge, Mass.: Apr. 25, 2005). This study was based on unemployment insurance audits conducted by the state of Maine. We did not assess the study to determine whether the methodology used was reliable.

DOL Has Taken Limited Steps to Detect and Address Misclassification

DOL's detection of employee misclassification is generally the indirect result of its investigations of alleged FLSA violations, particularly complaints involving nonpayment of overtime or minimum wages. WHD officials have stated to Congress that the misclassification of an employee as an independent contractor is not itself a violation of FLSA or other laws WHD enforces. Misclassification, however, is often associated with FLSA violations—in particular, recordkeeping violations and the failure to pay overtime or minimum wages. When WHD finds FLSA violations resulting from misclassification, it assesses back wages owed to workers as appropriate. In addition, although there is no penalty for recordkeeping violations, WHD requires businesses to place any workers the employer reclassifies as employees on the company payroll records, as per FLSA rules.

Our review of the case files also showed that WHD investigators, in the course of their investigations, did not consistently review documents that could indicate that employees had been misclassified. Specifically, investigators may ask employers about independent contractors or uncover misclassification through worker interviews, according to the information contained in the case files. However, they did not, as a matter of course, review employer records such as IRS Forms 1099-MISC that show payments made to independent contractors. Reviewing these records could aid WHD investigators in identifying workers who have been misclassified. Although one district director told us it is standard practice for investigators in his office to ask for this type of information during an investigation, it is not WHD policy to do so.

Many of the experts we interviewed said that targeted investigations of employers or industries could increase the detection of misclassification. Approximately 80 percent of the investigations WHD concluded in 2008 involving misclassification were initiated because of complaints from workers about possible labor violations. However, several experts we spoke with pointed out that some workers, such as immigrants or those in low-wage industries, are often less likely to file complaints with WHD.[18] Thus, a lack of targeted investigations coupled with the reluctance of misclassified workers to complain may result in less effective enforcement of proper classification. WHD officials told us that their ability to conduct

[18]Experts we spoke with explained that this reluctance sometimes stems from the fear of losing one's job, employer coercion, or, in the case of immigrant workers, apprehension about interacting with the federal government.

targeted investigations in recent years has been limited by reductions in agency resources combined with consistently high levels of worker complaints about possible labor law violations.[19] According to WHD policy, the first priority of the agency's enforcement is to respond to these complaints.[20]

WHD conducts few investigations targeted at misclassification, though it has begun to place a greater focus on misclassification within existing agency initiatives. WHD concluded over 24,500 FLSA cases in fiscal year 2008, and misclassification was the primary reason for the violation identified in 131 investigations. Most of these investigations (80 percent) were initiated by complaints from workers rather than being targeted by WHD. In the 26 investigations that were targeted by WHD,[21] the agency identified 341 misclassified employees who were owed back wages of over $88,000. In the 1990s, WHD implemented initiatives to conduct targeted investigations within low-wage industries with a history of FLSA violations, such as restaurants, hotels, and nursing homes. These initiatives enabled WHD to detect employee misclassification to the extent it was prevalent in those industries. WHD officials told us that in fiscal year 2007, in part because of heightened congressional interest in misclassification, they instructed their district directors to place a special emphasis on those low-wage industries within their districts with a history of misclassifying employees. During fiscal year 2009, for example, the New Orleans district office planned to conduct targeted investigations of the

[19]On March 25, 2009, the Secretary of Labor announced plans to hire 150 new investigators. WHD officials said they did not know whether this would enable them to target more employers for investigation.

[20]GAO has recently conducted evaluations of WHD's enforcement efforts and made recommendations for improvement. See GAO, *Fair Labor Standards Act: Better Use of Available Resources and Consistent Reporting Could Improve Compliance*, GAO-08-962T (Washington, D.C.: July 15, 2008); *Department of Labor: Wage and Hour Division's Complaint Intake and Investigative Processes Leave Low Wage Workers Vulnerable to Wage Theft*, GAO-09-458T (Washington, D.C.: Mar. 25, 2009); and *Department of Labor: Wage and Hour Division Needs Improved Investigative Processes and Ability to Suspend Statute of Limitations to Better Protect Workers Against Wage Theft*, GAO-09-629 (Washington, D.C.: July 23, 2009).

[21]Although WHD categorized nine of these cases as targeted investigations, they actually stemmed from investigations based on complaints from workers. In addition, targeted investigations that do not result in violations are not flagged as involving employee misclassification in WHD's database. Therefore, we were unable to determine the effectiveness of the agency's targeting strategy.

staffing and janitorial industries in its region, although it limited this effort to three investigations.

Examples of state efforts support the potential effect of targeted investigations aimed at detecting misclassification. New York's Department of Labor has created a task force that conducts investigations and audits aimed specifically at detecting misclassification. Among other activities, the task force conducts sweeps, or targeted investigations of businesses located within a certain area or within industries where misclassification is prevalent. In conducting investigations during 2007 and 2008 that targeted approximately 300 businesses in the retail and commercial industries, the task force found that 67 percent of the businesses were in violation of unemployment laws, labor standards, or workers' compensation laws. In addition, at the request of investigators, the task force scheduled follow-up audits of about half of these employers. As of December 2008, it had completed 54 of these audits and found in approximately 70 percent of them that employers had continued to misclassify at least some employees as independent contractors.

In addition, the task force conducted targeted investigations of over 600 businesses, primarily in the construction industry. It found labor violations in nearly half of these businesses and ordered follow-up investigations. Just over half of these investigations have been completed, resulting in nearly 7,800 employees being identified as misclassified. The state determined that the misclassification led to $2.2 million in unpaid wages, over $3.5 million in unpaid unemployment taxes and associated penalties, and over $1 million in penalties related to workers' compensation. As a result of all investigations conducted during a 16-month period ending December 31, 2008, the task force detected 12,300 instances of misclassification, with approximately $12 million in associated unpaid wages. In contrast, in fiscal year 2008, WHD identified 1,619 instances of misclassification nationwide during its investigations and assessed about $1 million in unpaid wages.

DOL has begun to track cases of misclassification in its WHD investigations database. However, although DOL's Occupational Safety and Health Administration (OSHA) may identify misclassification during its safety and health inspections, it does not record this information in its inspections database. In addition, in their responses to our survey, a majority of state workforce agencies noted that their states collect data on the occurrences of misclassification, but most of those states do not send this information to DOL. For example, an official in one state agency told us that in 2008 his state conducted investigations that led to the detection

of approximately 46,000 instances of misclassification, but that DOL collected no information associated with those cases. Since this information would likely include the names of employers that misclassified their employees, and the industries involved, collecting it could enable DOL to focus its investigations more effectively on certain employers or industries with a known history of misclassification.

DOL Makes Only Limited Use of Education or Penalties to Deter Misclassification

Although education and outreach to workers could help reduce the incidence of misclassification, DOL's work in this area is limited. The DOL Web site contains publications on the employment relationship under FLSA, some of which mention the use of independent contractors.[22] However, the Web site does not provide material that focuses specifically on the subject of employee misclassification. In addition to publications, the DOL Web site provides printable workplace posters, some of which employers are required to display in their workplaces. However, none of WHD's posters contain information on employment relationships or misclassification.

DOL employees sometimes hand out to workers pamphlets that contain general information on workers' rights. Also, DOL staff provides information materials at seminars and training sessions for employers. While these materials address what constitutes an employment relationship, they do not specifically mention misclassification. Similarly, WHD district directors we interviewed told us that their staffs do not conduct employer and worker outreach activities specifically on misclassification. However, some said their staffs may provide information about misclassification when answering questions from employers or workers. Finally, an OSHA official told us that the agency does not conduct any outreach or education directly related to misclassification, although officials in one region told us that workers were misclassified as independent contractors at over 80 percent of the construction sites they inspected.

[22]Department of Labor, Wage and Hour Division, *Employment Relationship Under the Fair Labor Standards Act*, WH Publication 1297 (Washington, D.C., August 1985); "Fact Sheet #13: Employment Relationship Under the Fair Labor Standards Act," http://www.dol.gov/esa/whd/fact-sheets-index.htm (accessed June 1, 2009); and "Fact Sheet #35: Joint Employment and Independent Contractors Under the Migrant and Seasonal Agricultural Worker Protection Act," http://www.dol.gov/esa/whd/fact-sheets-index.htm (accessed June 1, 2009).

According to our survey, few states regard DOL's efforts to educate workers and employers on employee misclassification to be effective. In fact, 16 states had no awareness of DOL education or outreach on the subject. Of the states that were aware of DOL's outreach activities, only 5 reported that they thought outreach for workers was effective, and only 6 stated that it was effective for employers. Further, some experts we interviewed also expressed the view that DOL's education and outreach efforts on misclassification are inadequate and that improvement is needed, especially for vulnerable populations. For example, some noted that immigrants are less likely to know their rights and are more likely to be misclassified than other types of workers.

WHD district directors we interviewed noted that there are challenges associated with reaching vulnerable populations, such as immigrant workers. Some noted that many noncitizens, whether documented or not, are wary of government and therefore reluctant to approach DOL officials or attend DOL-sponsored events. Despite this challenge, the directors told us that their offices coordinate with immigrant population communities in order to educate workers on labor issues. For instance, staff from the Boston and New Orleans district offices told us they participate in presentations, information sessions, and forums with the Hispanic communities in their districts in coordination with the Mexican consulates. These activities are generally broad in scope but may include specific information on misclassification.

When WHD identifies misclassification, the division does not use all available remedies—such as assessing financial penalties, pursuing back wages owed to workers who have been misclassified, and conducting follow-up investigations of employers that have misclassified workers—to penalize employers who have violated FLSA and help ensure future compliance. WHD levied penalties in less than 2 percent of the cases involving misclassification it completed in fiscal year 2008—2 of 131 investigations. In contrast, the division levied penalties in 6 percent of the cases involving FLSA violations from 2000 to 2007. WHD can only levy penalties for violations of the minimum wage or overtime pay provisions of FLSA when the violations are willful or repeated, though a WHD district director noted that it can be difficult to prove that employers are willfully misclassifying employees. In addition, although WHD determined that there were back wages to be paid in most of these cases, we found that investigators did not always follow up to ensure that employees were paid the back wages assessed. For example, in one case we reviewed, the employer did not provide documented proof that she paid back wages of over $5,000 owed to her employees, but WHD closed the case and

recorded the back wages as paid. Further, WHD officials told us that if the division uncovers violations caused by misclassification, it does not generally conduct follow-up investigations to ensure that the employees are properly classified.

IRS Has Several Enforcement and Education Efforts That Focus on Misclassification but Faces Challenges in Undertaking These Efforts

IRS's misclassification enforcement strategy relies on identifying and examining employers that have potentially misclassified employees. IRS primarily identifies employers to examine for potential misclassification through four sources:

- The Determination of Worker Status (Form SS-8) Program, in which workers or employers request that IRS determine whether a specific worker is an employee or an independent contractor for purposes of federal employment tax and income tax withholding through the submission of Form SS-8.[23] IRS examines some of the employers it determines to have misclassified workers through the SS-8 program.
- The Employment Tax Examination Program (ETEP), in which IRS uses specific criteria to identify for examination employers that have a high likelihood of having misclassified employees.
- General employment tax examinations, meaning examinations of tax returns that are started because of separate employment tax issue that lead to examinations of classification issues.
- The Questionable Employment Tax Practices (QETP) program, through which IRS and states share information on worker classification-related examinations and other questionable employment tax issues. IRS examines some employers that states have determined to have misclassified employees.

IRS's Small Business/Self Employed Division (SB/SE) conducts the majority of IRS's misclassification-related examinations. It made applicable assessments (taxes and penalties) in 71 percent of such examinations that it closed during fiscal year 2008, resulting in a total of almost $64 million in assessments, as shown in table 3. A description of the four programs though which IRS primarily generates misclassification-related examinations follows table 3. Also following table 3 is a description of IRS's Classification Settlement Program (CSP), which

[23]IRS Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

enables qualifying employers under examination for misclassification-related issues to lower their misclassification-related tax liabilities if they agree to properly classify their workers in the future.

Table 3: SB/SE Misclassification Examination Results by Examination Source, Fiscal Year 2008

	Examination source				
	SS-8	ETEP	General examinations	QETP	All programs
Number of closed examinations[a]	38	221	690	232	1,181
Percentage of all closed examinations by referral source	3	19	58	20	100
Number of closed examinations with assessments	30	127	522	165	844
Percentage of closed examinations with assessments[b]	79	57	76	71	71
Total assessments (dollars in millions)[c]	$1.1	$11.8	$40.9	$9.8	$63.5
Average assessment per examination	$28,191	$53,378	$59,225	$42,314	$53,810

Source: GAO analysis of IRS data.

Notes: We could not isolate the assessments made for taxpayers with CSP agreements because before fiscal year 2009, IRS did not separately track the outcomes of such examinations. For a qualifying taxpayer who enters into a CSP agreement, IRS records the dollar amount of the settlement as the assessment amount, not the dollar amount that would otherwise have been assessed for the taxpayer. IRS conducts examinations of taxpayers who do not comply with the terms of their CSP agreements, and assessments from such cases are included in table 3.

[a]In fiscal year 2008, SB/SE conducted all of IRS's examinations based on ETEP and QETP, all but one of IRS's examinations based on SS-8 referrals, and the majority of IRS's misclassification-related examinations based on general examinations. Examinations completed in fiscal year 2008 cover tax returns from previous tax years.

[b]A portion of the examinations that resulted in no assessments were closed because the taxpayers in question qualified for protection under section 530 of the Revenue Act of 1978, but IRS does not track the number of cases that are closed for this reason.

[c]Total assessments for each examination source do not sum to the total assessments for all programs because of rounding. Assessment amounts may include tax liabilities related to other employment tax issues that were assessed to the same taxpayer concurrently, as well as any penalties. Total assessments reflect the amounts that examiners recommended rather than the amounts collected by IRS. Taxpayers may challenge IRS's recommended assessments.

Through its SS-8 program, IRS provides workers or employers that file Forms SS-8 with its determination on the correct classification of the workers in question. IRS also uses the program to identify employers that may have misclassified employees and therefore would be fruitful to examine. In fiscal year 2008, 72 percent of all Form SS-8 requests filed resulted in IRS determinations that the workers in question were employees, 25 percent were closed without any advice given, and 3 percent resulted in determinations that the workers in question were

independent contractors or had other results.[24] IRS's SS-8 unit makes these determinations, in part, using information workers or employers provide on Forms SS-8.[25] After making classification determinations, IRS sends letters to employers to provide them with guidance on how to voluntarily amend their tax returns to comply with the determinations. IRS's SS-8 unit then uses specific criteria to determine which cases it should refer for examination, including the amount of compensation the worker in question earned, the number of similar workers hired by the employer, and whether the case likely involves fraud. The majority of employers the SS-8 unit determined to have misclassified employees are very small businesses, which generally are not referred because examining such businesses is generally not cost effective. As a result, IRS officials estimated that for recent tax years, only an average of 2 percent to 3 percent of employers it identified to have misclassified employees through SS-8 determinations were referred for examination, and an even smaller percentage resulted in examinations.[26]

For ETEP, IRS uses a computer matching program to identify annually employers that potentially misclassified employees. The match criteria include employers that reported paying compensation to workers (on Form 1099-MISC), the amount of compensation the workers reported on their tax returns, and the portion of the workers' total income that was

[24]According to IRS employment tax officials, the SS-8 unit closes about 20 percent of cases it receives each year without a determination for various reasons. For example, IRS may need to contact employers in order to make a determination for Form SS-8 requests filed by workers, and some workers withdraw their SS-8 requests because of fear of retaliation from their employers. To avoid duplication, the SS-8 unit does not make a determination in cases where IRS is examining the employer. In addition, a case is closed if the associated Form SS-8 is incomplete and IRS is unable to contact the applicant.

[25]About 90 percent of Form SS-8 requests are filed by workers.

[26]IRS examines an even smaller percentage of all Forms SS-8 filed. For example, IRS closed 39 examinations of employers that it identified through SS-8 determinations in fiscal year 2008 out of the almost 12,000 such requests filed. This amount was an increase from the average of 6,000 Form SS-8 requests that were filed annually for fiscal years 2005 through 2007. This increase was prompted, in part, by a new IRS form (Form 8919) that informs workers who think they may have been misclassified that they can file a Form SS-8 to obtain a determination from IRS.

paid by the employers.[27] IRS uses these criteria to identify employers to examine with the greatest potential for tax assessments. IRS officials told us that generally IRS examines about 1 percent to 3 percent of the employers it identifies annually through ETEP to have potentially misclassified employees. IRS does not examine some employers that it determines based on the ETEP match to have potentially misclassified employees, such as those that no longer appear to be in business; appear to have legitimate reasons for meeting the ETEP selection criteria, such as employers who compensate real estate agents, who are statutorily defined as independent contractors; or are protected by section 530. For tax year 2006, IRS identified over 33,000 employers through ETEP.[28] In fiscal year 2008, IRS examined 221 employers it identified through ETEP, as reflected in table 3.

Over half (58 percent) of the misclassification-related examinations of employers that SB/SE conducted in fiscal year 2008 arose through the course of IRS examining employers for other types of employment tax noncompliance. IRS examiners in all divisions are trained about misclassification issues, but the depth of training depends upon the division and group in which the examiners work.

According to IRS employment tax officials, QETP, initiated in December 2007, has proven to be a useful source of timely leads on potential misclassification cases. QETP is a collaborative initiative between IRS and, currently, 34 participating states through which IRS and state workforce agencies share information on misclassification examinations. IRS employment tax officials told us that the examination information that states provide through QETP is especially useful to the agency because it

[27]In a 1989 report, we recommended that IRS match independent contractors' information returns with their tax returns to more systematically identify employers that are misclassifying employees as independent contractors. One scenario we discussed in the report involved identifying independent contractors with incomes of more than $10,000 to identify contractors who received all of their income from one employer. See GAO/GGD-89-107. IRS's use of this matching process during the review led it to assess $9.9 million in additional taxes and penalties against 67 employers found to have misclassified workers.

[28]ETEP match data for tax year 2006 were the most recent data available at the time that we did our work.

is timely, making it easier for IRS to contact and collect money from noncompliant employers.[29]

In addition to its programs that generate misclassification examinations, IRS uses CSP to offer settlements to employers that it is examining for misclassification. Through CSP, which IRS initiated in 1996, employers under examination that meet certain criteria can lower their misclassification-related assessments if they agree to correctly classify their workers in the future and pay proper employment taxes.[30] As of November 2008, IRS had entered into about 2,800 settlement agreements, of which about 2,500 involved SB/SE. Employment tax officials in this IRS division estimated that their CSP agreements signed through the end of 2006 have resulted in at least approximately $76 million in taxes voluntarily reported by participating employers without further IRS intervention.[31] Of employers that entered into agreements through the end of 2006, IRS determined that 64 percent appear to be in compliance with their agreements. IRS has not been able to determine, through a review of filing histories, whether the remaining 36 percent of employers have complied with their CSP agreements. IRS would need to examine these employers to determine if they are in compliance with their agreements.

IRS Uses Various Methods to Educate Taxpayers about Proper Classification

IRS provides extensive general information on its Web site on worker classification issues for employers and workers, including flyers, IRS forms, fact sheets, a Web cast, and a training manual providing in-depth information on how IRS examiners determine a worker's correct classification. IRS also held a national phone forum on worker classification determinations in May 2009 targeted at tax professionals and small business employers and organizations. IRS officials noted that a key IRS worker classification Web page was recently linked to IRS's main page and was viewed nearly 800,000 times in fiscal year 2008.

[29]IRS officials reported that some QETP audit referrals it receives contain extraneous information or are provided in a format that is difficult to use. However, IRS officials have worked with at least one state workforce agency to help the state tailor the information it forwards to IRS.

[30]For example, employers must have filed all required information returns for their workers to be eligible to participate in CSP.

[31]IRS calculated this figure by first noting the dollar amount of each CSP agreement, multiplying the dollar amount for each agreement by the number of tax years since the taxpayer signed the agreement, and summing the values of all CSP agreements that had been signed since CSP was initiated.

IRS's outreach strategies include the use of handouts, e-mail lists, and industry newsletters. In 2008, IRS began conducting worker classification workshops. IRS employment tax officials said that IRS targets these workshops toward persons working as payroll professionals, who are most likely to handle workers' pay paperwork, and paid tax return preparers. IRS does not generally conduct outreach on classification issues for workers.

IRS Faces Challenges in Enforcing Compliance with and Educating Taxpayers about Classification Regulations

IRS's programs aimed at enforcing proper worker classification and educating taxpayers about this issue face three main challenges. First, because misclassification is a complex issue, addressing proper classification can be labor intensive for the IRS officials involved. For example, in determining whether workers are employees or independent contractors, IRS examiners must look to the common law, which can be a complex process.[32] The examiners must collect and weigh evidence on the related common law factors to determine what is relevant for classifying each relationship between the respective businesses and the workers in question.

Second, given competing agency priorities, IRS has limited resources to allocate to these programs. With regard to enforcement, it has resources to examine only a small percentage of the potential misclassification cases it detects. As shown in table 3, SB/SE completed examinations of less than 1,200 employers in 2008, a very small number when compared to the millions of small business and self-employed taxpayers in the United States. IRS focuses its examinations on employers with potential for large assessments or cases that likely affect a number of workers. To encourage voluntary compliance, IRS sends SS-8 determination letters to employers, and has also sent "soft notices" to employers it determined had not reclassified their workers after receiving these letters. However, IRS officials told us that SS-8 determination letters and soft notices can be

[32]For employment tax purposes, the Internal Revenue Code incorporates the common law definition of an employee. 26 U.S.C. § 3121(d)(2). The Department of the Treasury's regulations state that an employee-employer relationship generally exists when the business has a right to control and direct the worker not only as to the result to be accomplished but also as to the details and means by which that result is accomplished. 26 C.F.R. §§ 31.3121(d)-1(c); 31.3306(i)-1; 31.3401(c)-1. IRS's Revenue Ruling 87-41 contains a list of 20 factors or elements that IRS examiners can use to determine whether a worker is an employee under the common law. IRS examination training materials characterize these 20 factors as being based on three concepts: behavioral control, financial control, and the relationship between the employer and the worker.

ineffective if the letter or the notice signals that IRS will not further pursue the noncompliant employers. For example, according to these officials, only about 20 percent of employers that are sent SS-8 determination letters but that are not selected for examination voluntarily comply with IRS's classification determination. With regard to education, IRS uses indirect methods to reach the millions of businesses across the United States, such as sending correspondence to a large list of contacts in various industries and posting information in industry newsletters. According to IRS employment tax officials, information on misclassification is generally passed down two or three levels in order to reach employers.

Third, according to IRS officials we interviewed, section 530 is both a major reason that it cannot examine many of the suspected cases of misclassification it identifies and an impediment to its ability to educate taxpayers on misclassification issues, as discussed below.

- Before examining each potential misclassification case, IRS examiners must verify whether the employer in question qualifies for section 530 protection.[33] This verification process can be time and labor intensive, because examiners must determine whether the employers in question meet the three tests for section 530 protection.[34]

- Section 530 also restricts IRS's ability to issue regulations and Revenue Rulings with respect to the classification of any individual for purposes of employment taxes. Because of this limitation, IRS restricts the educational information it issues to informal general guidance and SS-8 determinations and rulings, which provide recommendations on how to classify specific workers. However, as noted previously, applying the classification rules can be complex. IRS employment tax officials told us that businesses regularly request IRS's guidance on how to classify workers. In accordance with section 530, IRS officials do not answer such inquiries but instead recommend that the businesses file Form SS-8 requests, which take time for the businesses to file and for IRS to process. Representatives

[33]IRS has interpreted the Small Business Job Protection Act of 1996, which added subsection (e) to section 530, as requiring the first step in examining any case involving employment tax obligations of an employer with respect to workers to be determining whether the business meets the requirements of section 530. Pub. L. No. 104-188, § 1122, 110 Stat. 1755, 1766 (Aug. 20, 1996), *codified at* 26 U.S.C. § 3401 note.

[34]As previously mentioned, in order to receive section 530 protection, employers must have filed all federal tax returns in a manner consistent with not treating the workers in question as employees, consistently treated similarly situated workers as independent contractors, and had a reasonable basis for treating the workers as independent contractors.

of worker, business, and paid tax return preparer groups pointed to a great deal of confusion about proper worker classification. In an interview, representatives of IRS's Taxpayer Advocate Service told us that IRS should have the ability to issue guidance on the rules it enforces, in the interest of effective tax administration.

Collaboration among Federal Agencies Is Limited, but States Report Successful Collaboration to Address Misclassification among Their Agencies and with IRS

DOL and IRS typically do not exchange the information they collect on misclassification, and DOL does not share information internally. However, when an employee is misclassified there is a potential for violations of both tax and labor laws, and sharing information could enable multiple agencies to address the consequences of misclassification. For example, WHD does not always send information on cases involving misclassification to other federal and state agencies, although WHD's policies and procedures direct it to share such information with other federal and state agencies. WHD officials said they may not provide referrals to states or other federal agencies because the definition of an employee varies by statute and the division does not want its investigators to interpret statutes outside its jurisdiction. WHD officials told us there were no legal limitations on sharing information from an investigation, although they said they were reluctant to share information on open cases because they did not want to compromise their investigations.

Although WHD has a memorandum of understanding stating that it will share information with IRS, WHD officials said they are concerned about referring cases to IRS because they fear that employers would be reluctant to cooperate with the division if they knew that it refers cases to IRS. However, in these cases, WHD could obtain a subpoena to compel the employer to provide WHD with records. Similarly, WHD depends on complaints from workers to drive much of its workload and locate employers that are in violation of the laws under its purview. According to these officials, if workers who were not paying taxes properly knew that WHD shared information with IRS about its investigations, they might be less likely to file complaints or cooperate during investigations.

In cases where WHD refers a case involving misclassification to states or other federal agencies, or to other divisions within DOL, it does not track these referrals centrally. Therefore, officials do not know how often or to whom cases are referred. In addition, officials are not able to ensure that cases are referred consistently across offices. Some district offices, however, keep track of the forms used to make such referrals. The referrals are usually made by the district offices, which maintain records

of the referrals in their files and send the originals to the agencies to which WHD has referred the cases.

OSHA may uncover misclassification during its inspections of potential health and safety violations but generally does not refer these cases to WHD or IRS. OSHA officials told us that although they have a number of memorandums of understanding with other agencies and divisions within DOL, these pertain to issues such as child labor and migrant workers and not to misclassification. However, we found that OSHA has a memorandum of understanding with WHD dating from 1990 that states that, in order to secure the highest level of compliance with labor laws, the agencies will exchange information and referrals where appropriate. This agreement also states that both agencies will report the results of any referrals to the other agency and will establish a system to monitor the progress of actions taken on referrals. However, while OSHA tracks referrals and results in its database, WHD has not established such a system.

ETA, which oversees unemployment insurance, collects only summary data from states on the number of employees they have found to be misclassified during unemployment insurance audits. While DOL funds the administration of state unemployment insurance programs, states are responsible for all tax collection, benefit payment, and investigations and audits. Therefore, officials told us that detailed employer or employee-specific information is available only at the state level, and ETA is unable to refer potential misclassification cases to WHD. Moreover, since state agencies are administrators of their own programs, officials told us that ETA does not investigate instances of misclassification that occur in state unemployment insurance programs.

Other federal agencies with jurisdiction over laws affected by misclassification told us that they do not work with DOL or track cases involving misclassification. Officials from the National Labor Relations Board, which enforces the right of employees to bargain collectively, told us that the agency does not work with DOL. Equal Employment Opportunity Commission officials said that they have not worked with DOL in any substantial way, although they do have a memorandum of understanding with DOL.

According to officials, IRS does not share misclassification-related information with DOL and shares only limited information with other federal agencies. In general, IRS is prohibited from sharing taxpayer information with other agencies per section 6103 of the Internal Revenue

Code.[35] IRS and the Social Security Administration have memorandums of understanding in place to facilitate information sharing on employment tax cases and issues, but they do not regularly share information on misclassification, according to IRS employment tax officials. However, the officials told us that the two agencies are creating a joint employment tax task team, and noted that the Social Security Administration can use IRS employment tax information to ensure that misclassified workers are given Social Security credit for wages earned. Contracting officers from several federal agencies we interviewed said that they saw relatively high volumes of potential misclassification among workers on federal construction contracts, and that the payroll information they collect could be of value to IRS. However, many of these agencies did not have information sharing relationships with IRS.

DOL Generally Does Not Work with States, but IRS Shares Information with Them

Less than 25 percent of states collaborate with DOL to identify employee misclassification. In responding to our survey, 12 states said that they have some type of collaborative arrangement with DOL in this area. These arrangements may include sending information to DOL, receiving information from DOL, and conducting joint investigations with DOL of cases involving potential misclassification. Approximately 56 percent of states we surveyed said that they collect data on misclassification beyond the summary unemployment insurance audit data they are required to report to DOL's ETA on a quarterly basis. Although this information could be useful to DOL in pursuing potential FLSA violations stemming from misclassification, state officials we interviewed said that they are not required to report it to DOL. For example, officials told us that they do not report information on employees who were misclassified but paid in cash and whose wages were not reported to IRS or state revenue agencies. DOL could use information on these employees to target investigations of possible FLSA violations, such as improper payment of overtime.

IRS and state workforce agencies share information on misclassification as part of QETP. IRS, DOL, and state workforce agencies collaborated to create QETP in September 2005. In its first year, 5 states participated and additional states have been added over time. Currently, IRS and workforce

[35]26 U.S.C. § 6103. The protection of taxpayer information is commonly thought to be critical to voluntary compliance with the tax code and necessary to protect taxpayer privacy. There are statutory exceptions to the general prohibition, such as those permitting the sharing of certain information with state tax officials and the Social Security Administration. 26 U.S.C. § 6102(d),(*l*)(1).

agencies from 34 states share information on audits involving misclassification as part of QETP.[36] IRS employment tax officials remarked that QETP sends an important message to employers and workers that IRS and states are working together on compliance issues. According to the IRS officials, the state agencies audit employers to determine whether they have classified workers correctly and paid state unemployment taxes as appropriate. We surveyed participating state agencies, and most respondents reported that audit information IRS provided was helpful.

In addition to sharing audit reports for employers that were found to have misclassified their employees, IRS also shares other types of misclassification-related data with some states. Nineteen of the state workforce agencies we surveyed reported that they receive Form 1099-MISC data from IRS.[37] The state agencies may use these data to identify potential cases of misclassification. According to IRS employment tax officials, IRS also shares the worker classification determinations it makes through its SS-8 program with some state agencies; IRS issues these determinations following employers' or workers' requests for determinations of employment status. Fourteen of the state workforce agencies we surveyed reported receiving this information from IRS.[38]

Some state workforce agencies surveyed noted that IRS's QETP information sharing and communication practices could be improved. For example, two states commented that the information they receive from IRS is somewhat dated. Some states that participated in our survey reported frustration over not receiving requested information from IRS or difficulty contacting IRS officials. IRS officials with whom we spoke were aware that some states were not receiving QETP referrals, and stated that IRS was in the process of centralizing its QETP administration in order to rectify the problem. They also said that IRS is in the process of clearing out a backlog of referrals from states. According to IRS employment tax officials, IRS has completed the centralization of QETP administration and taken steps to clear the backlog of referrals from states. Finally, some

[36]Seven additional state agencies reported that they were working with IRS to become QETP members.

[37]According to IRS officials, as of April 2009, 22 state workforce agencies were enrolled in the process to receive Form 1099-MISC data extracts.

[38]According to IRS officials, as of May 2009, 31 states were enrolled in a process to receive information from classification determinations.

states we surveyed also reported several key barriers to effectively using information provided by IRS. These included resource limitations within their own agencies, data system incompatibilities, and difficulties complying with IRS's legal requirements for safeguarding taxpayer data.

Some States Are Identifying Misclassification through Collaborative Initiatives Involving Their Revenue, Labor, and Enforcement Agencies

Some states have made efforts to address misclassification and have reported successful collaboration among their own agencies. States are particularly concerned because of misclassification's impact on workers' compensation programs and unemployment tax revenue, among other programs. In addition, states may incur additional costs, such as the cost of providing health care to uninsured workers, as a result of misclassification. Some states have passed legislation related to misclassification. For example, Massachusetts passed legislation that standardizes the definition of an employee and penalizes employers for misclassification, regardless of whether it was intentional. The statute authorizes the state Attorney General to impose substantial civil and criminal penalties and, in certain circumstances, to ban violators from obtaining state public works contracts.

Several states have recently created interagency initiatives or joint task forces aimed at detecting misclassification, often by executive order of the states' governors. These task forces share information across revenue, labor, and enforcement agencies. For example, the New York State Joint Enforcement Task Force on Employee Misclassification, which was formed in September 2007, is led by the New York Department of Labor and includes revenue agencies, other enforcement agencies, and the Attorney General's office. Since its inception, the task force has engaged in joint enforcement sweeps, coordinated assignments, and systematic referrals and data sharing between state agencies. New York state officials told us that they now consider it customary to use a multiagency approach and cross-agency coordination to deal with misclassification.

However, some of these state task forces have encountered challenges, particularly in coordination among state agencies. The agencies must overcome or ease restrictions on sharing information outside their jurisdictions, which may require state legislative action. State officials we interviewed cited other challenges, such as the fact that the lead agency does not have oversight authority over task force members, which makes it difficult to direct their efforts; the limited resources of many state agencies; and dealing with the added layers of bureaucracy involved in tracking cases and enforcing compliance together.

While these task forces are relatively recent innovations, state officials told us that they have already been effective in uncovering misclassification. New York state officials told us that the state uncovers many more misclassified employees through task force activities than solely through the unemployment insurance audits required by DOL. The state estimated that in just over a year's time, its misclassification task force uncovered 12,300 instances of employee misclassification and, as noted earlier, $157 million in unreported wages. The task force's enforcement activities also resulted in over $12 million in workers' back wages being assessed against employers.

Various Options Could Help Address Misclassification Challenges

As far back as 1977, we have analyzed options for addressing tax noncompliance arising from employee misclassification. In 1977, we recommended a specific definition to clarify who should be considered an independent contractor, and in 1979, we concluded that some form of tax withholding could be warranted to reduce tax noncompliance among self-employed workers.[39] In 1992, we offered options to improve independent contractor tax compliance, such as ensuring that their taxpayer identification numbers (TIN) are valid, informing them of their classification status and tax obligations, and closing gaps in the payments that are required to be reported on Form 1099-MISC.[40] For this report, we explored current options to address the challenges raised by employee misclassification, some of which are similar to the options we analyzed in these prior reports.

We identified 19 options to address the challenges raised by employee misclassification by reviewing literature and speaking with various groups, including those representing (1) labor and advocacy, (2) independent contractors and small businesses, and (3) tax professionals.[41] These

[39]GAO, *Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions*, GAO/GGD-77-88 (Washington, D.C.: Nov. 21, 1977) and *Compliance Problems of Independent Contractors*, Testimony 109909 (Washington, D.C.: July 17, 1979).

[40]GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108 (Washington, D.C.: July 23, 1992). Other options dealt with improving information reporting on payments made for services to independent contractors, including incentives to file Form 1099-MISC, and requiring more information to be reported on tax returns about the payments made for services.

[41]For a more detailed discussion of our methodology in selecting options to include in this report, see app. I.

options would require either legislative or administrative actions. Table 4 lists the 19 options. The list is not ranked in any order, but rather is grouped in seven broad categories.[42]

Table 4: Options for Addressing Employee Misclassification

A. Clarify the employee/independent contractor definition and expand worker rights	
1.	Clarify the distinction between employees and independent contractors under federal law
2.	Allow workers to challenge a classification determination in U.S. Tax Court
3.	Ensure that workers have adequate legal protection against retaliation from filing a Form SS-8
4.	Define misclassification as a violation under FLSA
B. Revise section 530 of the Revenue Act of 1978	
5.	Narrow the definition of "a long-standing recognized practice of a significant segment of the industry" so that fewer firms qualify for this reasonable basis for the section 530 safe harbor provision
6.	Lift the ban on IRS/Treasury issuing regulations or revenue rulings clarifying the employment status of individuals for purposes of employment taxes
C. Provide additional education and outreach	
7.	Require service recipients[a] to provide standardized documents to workers that explain their classification rights and tax obligations
8.	Expand IRS outreach to service recipient, worker, and tax advisor groups to educate them about classification rules and related tax obligations, targeting groups IRS deems to be "at risk"
9.	Create an online classification system, using factors similar to those used in the SS-8 determination process, to guide service recipients and workers on classification determinations
10.	Increase the use of IRS notices to service recipients in industries with a potentially high incidence of misclassification to educate them about classification rules and ask them to review their classification practices

[42]The list also does not include options that we have recently analyzed or recommended in prior reports that are indirectly related to worker misclassification, such as information reporting on payments made to independent contractors. For example, in GAO-09-238 we made various recommendations to improve compliance with filing Forms 1099-MISC, and in GAO-07-1014 we analyzed various options to address tax noncompliance among sole proprietors, a group of taxpayers that includes independent contractors.

D. Withhold taxes for independent contractors
11. Require service recipients to withhold taxes for independent contractors whose TINs IRS cannot verify or who IRS has determined are not fully tax compliant
12. Require universal tax withholding for payments made to independent contractors, using tax rates that are relatively low (e.g., 1 percent to 5 percent of payment amounts)
13. Require service recipients to withhold taxes from payments made to independent contractors who request withholding in writing
E. Collect data on misclassification and independent contractors
14. Measure the extent of misclassification and related impacts on tax revenues at the national level
15. Require each independent contractor to apply for a separate business TIN
F. Enhance IRS compliance programs
16. Expand IRS's CSP to include service recipients that voluntarily contact IRS about their misclassified workers
17. Require service recipients to submit Forms SS-8 for all newly retained independent contractors
G. Enhance coordination and information sharing
18. Enhance coordination between IRS, DOL, and other federal agencies to share data and address misclassification
19. Enhance coordination between IRS, states, and selected local governments to share data and address misclassification

Source: GAO analysis of literature reviews and interviews with affected stakeholders.

[a]By "service recipients," we mean businesses and other entities that receive services from independent contractors or employees in the course of a trade or business, not including consumers or individuals who seek services for their homes or personal use.

We asked 11 external stakeholders to provide input on these 19 options, including (1) the extent to which they supported or opposed each option and (2) the benefits and drawbacks of each option (see app. II for a summary of these benefits and drawbacks for each option).[43] These stakeholders included 4 groups that represent the views of small businesses, independent contractors, and those who hire them (i.e., independent contractor groups); 4 groups that represent the views of organized labor (i.e., labor groups); 2 groups that represent the tax

[43]We identified these 11 stakeholder groups from the original 19 that we interviewed early in our study. We selected the 11 based on those that provided specific ideas and comments on the options in our first round of interviews and that expressed willingness to respond to our written data collection instrument.

preparation and advice community; and 1 federal agency that uses contractors. We received responses from 9 of these groups.[44]

No Option Had Unanimous Support or Opposition

Stakeholders did not unanimously support or oppose any of the 19 options. Although views were mixed, stakeholders generally expressed support for the options more frequently than they expressed opposition. For example, at least seven of the nine responding stakeholders supported three options (see table 5).

Table 5: Options for Addressing Employee Misclassification with the Greatest Level of Stakeholder Support

Ensure that workers have adequate legal protection against retaliation from filing a Form SS-8 (option 3)
Require service recipients to provide standardized documents to workers that explain their classification rights and tax obligations (option 7)
Increase the use of IRS notices to service recipients in industries with a potentially high incidence of misclassification to educate them about classification rules and ask them to review their classification practices (option 10)

Source: GAO analyses of stakeholder responses to questions about 19 options.

Note: Options included in this table were supported by seven or eight stakeholders out of the nine from which we received input on the 19 options.

In contrast, five of nine stakeholders opposed one option—narrowing the definition of "a long-standing recognized practice of a significant segment of the industry" under section 530 of the Revenue Act (option 5). While all three independent contractor groups opposed this idea on the grounds that the protection was important, two labor groups that opposed the option did so because it only narrowed rather than eliminated this protection.

Labor Groups and Others Were Generally More Supportive of Options Than Independent Contractor Groups

In general, labor groups, a group representing tax preparers, and a federal agency that hires contractors tended to be more supportive of the 19 options than independent contractor groups. We analyzed whether the majority of stakeholders in each group—that is, over half of them—stated that they supported, opposed, or were neutral on the 19 options. Table 6 shows that a majority of the labor group respondents (i.e., at least 3 of the 4) supported 9 options and opposed none. Similarly, the tax professional group and the federal

[44]We did not receive responses from one of the paid tax return preparer groups and one of the independent contractor groups.

agency both supported 10 options and opposed none. In contrast, a majority of the independent contractor respondents (i.e., at least 2 of the 3) supported 7 options and opposed 8. A blank cell in the table indicates that the stakeholders for the group lacked a majority view on the option.

Table 6: Options to Address Misclassification by Expressed Support, Opposition, or Neutrality by a Majority of Stakeholder Group

Options	Labor groups	Independent contractor groups	Other groups[a]
1. Clarify the distinction between employees and independent contractors within federal law		Support	Support
2. Allow workers to challenge determinations in Tax Court	Support	Oppose	Support
3. Ensure that workers have protection for filing a Form SS-8	Support	Support	Support
4. Define misclassification as a violation under FLSA	Support	Oppose	
5. Narrow the definition of "a long-standing recognized practice of a significant segment of the industry"		Oppose	Support
6. Lift the ban on IRS clarifying employment status	Support	Oppose	
7. Require service recipients to give workers documents that explain classification	Support	Support	
8. Expand IRS outreach		Support	Support
9. Create an online classification system		Oppose	Support
10. Increase the use of IRS notices	Support	Support	Support
11. Require service recipients to withhold taxes for certain independent contractors	Neutral	Oppose	Support
12. Require universal tax withholding for payments made to independent contractors		Oppose	
13. Require service recipients to withhold taxes at independent contractor request		Neutral	Support
14. Measure the extent of misclassification at the national level	Support	Neutral	
15. Require each independent contractor to apply for a separate business TIN		Support	
16. Expand IRS's CSP		Support	
17. Require service recipients to submit Forms SS-8 for newly retained independent contractors		Oppose	Support
18. Enhance coordination between IRS, DOL, and other federal agencies	Support	Neutral	
19. Enhance coordination between IRS, states, and selected local governments	Support	Neutral	

Source: GAO analyses of stakeholder responses to questions about 19 options.

Note: "Support" indicates that over half of the respondents in the group generally or strongly supported the option. "Oppose" indicates that over half of the respondents in the group generally or strongly opposed the option. "Neutral" indicates that over half the group was neutral on the option or had no opinion. A blank cell indicates that the option lacked a consensus opinion by a majority of stakeholders.

[a]Other groups included a group representing tax professionals and a federal agency that hires contractors.

Stakeholders Identified Various Benefits and Drawbacks to the Options

We asked stakeholders what they perceived to be the benefits and drawbacks of each option. We did not follow up on these responses to clarify and understand the basis for the stakeholders' perceptions on benefits and drawbacks. As a result, absent other relevant data, these responses did not allow us to uniformly assess whether the benefits outweighed the drawbacks for each option, or vice versa. Table 7 lists examples of types of benefits and drawbacks identified across all the options.

Table 7: Types of Benefits and Drawbacks Stakeholders Identified across the 19 Options

Examples of types of benefits identified	Examples of types of drawbacks identified
Improved tax compliance	Higher financial costs/burdens for businesses
Greater equity/justice for workers	Inequities among those using independent contractors
More consistency/uniformity in classifying	Economic disruption/upheaval
More education/understanding	More litigation
More attention/visibility	Political opposition
More worker protection	Less freedom of choice
Less misclassification	Deter use of independent contractors
Less manipulation of classification rules	More manipulation of classification rules

Source: GAO analyses of stakeholder responses to questions about 19 options.

We found that some of the stakeholders had different perceptions of whether an outcome for an option would be beneficial. For example, some respondents said that creating an online classification system could help reduce confusion over classification rules and unintentional misclassification. However, other respondents stated that such a system would produce inconsistent determinations and could be manipulated to achieve desired classification determinations. Similarly, some stakeholders said that requiring a separate TIN for independent contractors could increase voluntary tax compliance or help facilitate IRS compliance and enforcement efforts. However, others expressed the opinion that a separate TIN could be conducive to tax fraud or manipulation of the classification system. Finally, some perceived that expanding CSP to include employers that volunteer to disclose their misclassified employees would benefit such employers by reducing their financial exposure while others viewed this same outcome as allowing

them to escape financial sanctions for misclassifying. (See app. II for summaries of the types of benefits and drawbacks for each option.)

We also asked IRS officials to share their insights on the benefits and drawbacks of the options from a tax administration perspective. Some of their insights included the following:

- Expanding CSP to include employers that voluntarily ask to participate could help reduce employee misclassification, although allowing voluntary participation raises issues of equity and may create a safe harbor from examination. For example, this expansion could bring into compliance employers that voluntarily disclose that they have misclassified employees but would reduce the financial sanctions they face for having done so. IRS employment tax officials said that they recently created a team to explore these and other issues related to such an expansion and that they hope to start soliciting comments on a proposal from across IRS starting in summer 2009.

- "Soft" (i.e., non enforcement) notices to educate employers that appear to be misclassifying employees and to encourage them to correct their classifications might not be effective unless IRS is able to follow up with employers that do not change their classification behavior. Notices also are more effective if they are sent strategically rather than using a "shotgun" approach. Furthermore, sending notices to employers in certain industries without sufficient justification for targeting them likely would create a backlash that IRS would have to manage.

- Expanded information sharing with other federal agencies generally can help IRS to be more effective at enforcing proper worker classification. However, section 6103 protections against improper disclosure of tax data generally hamper such sharing and one-way information sharing can create resentment among other agencies.

- Creating standardized documents on worker rights and tax obligations can impose burdens on businesses, although such burdens could be reduced by requiring employers to provide such documents only to newly hired or retained workers rather than to all workers. Also, IRS may not currently have the authority to require employers to provide such documents to workers.

- Requiring a separate TIN for each independent contractor could help compliance but would impose some costs on businesses and IRS to reprogram its computers.

- Requiring Forms SS-8 for all newly retained independent contractors would create tremendous costs for IRS, and it may not be able to review the forms quickly enough to affect some independent contractors who employers retain on a short-term basis.

- An online classification system that uses factors like those that IRS uses to make Form SS-8 determinations could provide guidance to those unsure about classifying workers. However, the system should not be used to make classification determinations because those entering the data could manipulate their entries to receive a desired outcome.

Some of the identified options relate to goals, objectives, and strategies in IRS's Strategic Plan for 2009-2013. For example, IRS's plan envisions placing more emphasis on providing more targeted and timely guidance and outreach on how to voluntarily comply and creating opportunities for taxpayers to proactively resolve tax disputes as soon as possible as part of its goal to improve service to make voluntary compliance easier. To enforce the law to ensure that everyone meets their tax obligations, IRS plans to strengthen its partnerships with other government agencies to leverage resources in a way that allows quick identification and pursuit of emerging tax schemes through education as well as enforcement. IRS also seeks to expand its enforcement approaches by allowing for alternative treatment of potential noncompliance. These approaches include expanding the use of soft notices to educate taxpayers and to encourage them to self-correct to avoid traditional enforcement contacts, such as examinations, as well as expanding incentives and opportunities for taxpayers to voluntarily self-correct noncompliant behavior.

Conclusions

Misclassification can have a significant impact on federal and state programs, businesses, and misclassified employees. It can reduce revenue that supports such programs as Social Security, Medicare, unemployment insurance, and workers' compensation. Further, employers with responsible business practices may be undercut by competitors who misclassify employees to reduce their costs, for example, by not paying payroll taxes or providing benefits to workers. Employers may also exploit vulnerable workers, including low-wage workers and immigrants, who are unfamiliar with laws pertaining to employment relationships, including laws designed to protect workers. For example, misclassified workers may not be paid properly for overtime or may not know that their employers are not paying worker's compensation premiums.

Although misclassification is a predictor of labor law violations, and although state examples show that targeting misclassification is an effective way to uncover violations, DOL is not taking advantage of this opportunity by looking for misclassification in its targeted investigations. As a result, employers may continue to misclassify employees without consequences and workers may remain unprotected by labor laws and not receive benefits to which they are entitled. Furthermore, because DOL conducts limited education and outreach on misclassification, many workers have insufficient information on employment relationships and may not understand their employment status and rights. In addition, vulnerable populations, including low-wage workers and immigrants, may not know they are misclassified and, as result, may not receive the protections and benefits to which they are entitled. By not regularly sharing information on cases involving misclassification, federal and state agencies are also losing opportunities to protect workers and to make the most effective use of their resources. Also, because DOL is not working with states active in this area to identify misclassification, it is not using its resources most effectively by establishing a collaborative effort between federal and state agencies to address misclassification.

Many of the IRS-related options we analyzed to address misclassification were generally perceived to have merit as means to address misclassification, but all have some drawbacks, according to those stakeholders we surveyed. Although several options had support from many of those who provided input, we had no reliable measure of the extent of misclassification and did not have sufficient information to weigh the benefits compared to the drawbacks of the options given the scope of our work. Even so, qualitative information provided by the stakeholders can help policymakers and tax administrators judge whether any of the options merit pursuit.

Likewise, some actions have potential to address misclassification in a cost-effective manner while also adhering to IRS's strategic vision for the next few years. For example, IRS and DOL can do more to educate employers and workers. Given that most complaints come from workers, further educating them about the consequences of misclassification may be especially useful. Developing a standard document on classification rights and related tax obligations that all new workers would either be given by employers or referred to on agencies' Web sites would be particularly well targeted. Similarly, IRS could build on its existing state contacts to resolve current concerns with the QETP initiative, which mutually benefits both federal and state parties. Regularly collaborating with participating states can help ensure that issues are addressed by both

IRS and states in a timely manner. Finally, expanding CSP to allow for voluntary self-correction of classification decisions could prompt compliance among employers that IRS is unlikely to pursue through enforcement because of limited resources. Soft notices targeted to employers that appear to be misclassifying would give them a chance to self correct before IRS decides whether to examine them and should be tested to determine their effectiveness.

Recommendations for Executive Action

We are making six recommendations to the Secretary of Labor and the Commissioner of Internal Revenue to assist in preventing and responding to employee misclassification.

- To increase its detection of FLSA and other labor law violations, we recommend that the Secretary of Labor direct the WHD Administrator to increase the division's focus on misclassification of employees as independent contractors during targeted investigations.

- To enhance efforts to protect workers and make the most effective use of their resources, we recommend that the Secretary of Labor direct the WHD Administrator and the Assistant Secretary for OSHA to ensure that information on cases involving the misclassification of employees as independent contractors is shared between the two entities and that cases outside their jurisdiction are referred to states and other relevant agencies, as required.

- To identify promising practices in addressing misclassification and use agency resources most effectively, we recommend that the Secretary of Labor and the Commissioner of Internal Revenue establish a joint interagency effort with other federal and state agencies to address the misclassification of employees as independent contractors. Because tax data may provide useful leads on noncompliance, the task force should determine to what extent tax information would assist other agencies and, if it would be sufficiently helpful, seek a legislative change through the Department of the Treasury to allow for sharing of tax information with appropriate privacy protections.

- To enhance understanding of classification issues by workers—especially those in low-wage industries—we recommend that the Secretary of Labor collaborate with the Commissioner of Internal Revenue to offer education and outreach to workers on classification rules and implications and related tax obligations. Such collaboration should include developing a standardized document on classification that DOL would require employers to provide to new workers.

- To maximize the effectiveness of the relatively new QETP initiative, we recommend that the Commissioner of Internal Revenue create a forum for regularly collaborating with participating states to identify and address data sharing issues, such as ensuring clear points of contact within IRS for states and expeditious sharing of data.

- To increase proper worker classification, we recommend that the Commissioner of Internal Revenue extend the CSP to include employers that volunteer to prospectively reclassify their misclassified employees, and as part of this extension test whether sending notices describing the program to potentially noncompliant employers would be cost effective. Employers to which IRS would send notices could include those referred for examination but who may not be examined because of higher priorities, resource limitations, or other reasons.

Agency Comments and Our Evaluation

In their comments on a draft of this report, both DOL and IRS generally agreed with our recommendations, and either agreed to implement or to take steps consistent with our recommendations, such as exploring their implementation. WHD, OSHA, and IRS provided written comments on the draft, which are reprinted in their entirety in appendixes III (DOL comments from WHD and OSHA) and IV (IRS comments). In addition, ETA provided technical comments, which we incorporated.

DOL agreed with our recommendation to increase WHD's focus on misclassification of employees as independent contractors during targeted investigations. WHD commented that it would reexamine its training documents and field guidance to ensure that employee classification was addressed during all stages of an investigation. In addition, WHD agreed to focus on increasing compliance for workers in industries where misclassification is prevalent.

DOL also agreed that there is value in sharing information on cases involving the misclassification of employees as independent contractors between WHD and OSHA and with state agencies. WHD and OSHA stated that they are both committed to working closely together to exchange information and improve protections afforded workers. In addition, WHD said that it would assess its current referral processes to ensure that they adequately provided for referrals to other agencies in cases related to employee misclassification.

In their comments, the agencies expressed support for our recommendation to establish a joint interagency effort to address

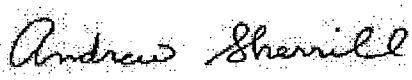
misclassification. DOL stated that a joint effort between DOL and IRS may prove useful in WHD's efforts to enforce wage and hour laws, and that WHD would participate in any such interdepartmental effort. Similarly, IRS stated that coordination between departments and agencies at the federal and state levels is an effective way to encourage voluntary compliance and agreed to work with the Secretary of Labor to explore developing a joint effort, subject to disclosure rules under section 6103 of the Internal Revenue Code and other privacy rules.

In addition, DOL and IRS agreed to explore opportunities to collaborate to offer education and outreach to workers on the topic of worker classification, including developing a standardized document that DOL would require employers to provide to new workers. WHD agreed to reach out to IRS to explore opportunities for joint outreach to workers, and IRS agreed to collaborate with the Secretary of Labor, make education and outreach materials available to DOL, and work with the Secretary of Labor to explore developing a standardized document on classification for DOL to provide to new workers.

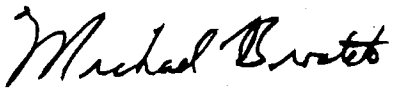
Finally, IRS agreed to work with state workforce agencies participating in QETP to establish a forum to identify and address data sharing and IRS points of contact issues using its Enterprise Wide Employment Tax Program. IRS also said it would consider expanding the CSP to employers not under examination and commented that if it decides to expand the program, it will consider all options, including issuing notices and soft letters and soliciting volunteers through outreach and education. We appreciate that IRS will consider these actions and continue to believe that extending the CSP to include employers that volunteer to prospectively reclassify their misclassified employees would be an effective way to increase proper worker classification and that it would be useful to test whether sending notices would be a cost-effective feature of an expanded program.

As we agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 30 days from the date of this letter. At that time, we will send copies of this report to the Secretary of Labor, the Commissioner of Internal Revenue, and relevant congressional committees. The report is also available at no charge on GAO's Web site at http://www.gao.gov.

Please contact Andrew Sherrill at (202) 512-7215 or sherrilla@gao.gov or Michael Brostek at (202) 512-9110 or brostekm@gao.gov if you or your staffs have any questions about this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix V.



Andrew Sherrill
Director, Education, Workforce
and Income Security



Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Scope and Methodology

To determine what is known about the extent of the misclassification of employees as independent contractors and its associated tax and labor implications, we reviewed studies on misclassification conducted by the Internal Revenue Service (IRS), the Department of Labor (DOL), and others. We reviewed IRS's estimate on the extent of misclassification and the associated revenue loss for tax year 1984. We also interviewed IRS officials responsible for planning an update to that estimate. From DOL, we reviewed a study it commissioned in 2000 on the extent of misclassification. We also analyzed the information states report to it regarding their findings of misclassification during their audits of employers.[1] We analyzed summary data that the states reported for the years 2000 to 2007. These data included the number of employers in each state, the number of audits completed, and the number of misclassified employees identified during these audits. We also reviewed misclassification studies conducted by states, universities, and research institutes. Finally, we interviewed officials from federal and state agencies to obtain their views on misclassification and its consequences for workers.

To describe actions taken by DOL to address employee misclassification, we examined DOL policies and documentation, including DOL's Wage and Hour Division's (WHD) *Field Operations Handbook* and the Occupational Safety and Health Administration's *Field Operations Manual.* We interviewed agency officials at the national and district levels, as well as several investigators from WHD, and spoke with employer and labor advocates to obtain their perspectives on DOL's efforts. In some cases, we relied on interviews conducted for a previous closely related GAO testimony, issued in July 2008.[2] We also obtained and analyzed WHD data on cases involving misclassification concluded during fiscal year 2008. We could not obtain data for other time periods because WHD did not flag cases to indicate whether they involved misclassification before fiscal year 2008. We assessed the reliability of the data and determined them to be sufficiently reliable for the purposes of this report. However, because DOL only flagged cases as involving misclassification when it was the primary reason for Fair Labor Standards Act (FLSA) violations, and because WHD officials told us that not all investigators understood how to properly flag these cases, this information may be incomplete.

[1]All states, the District of Columbia, and Puerto Rico are required to report information regarding their unemployment insurance audits to DOL on a quarterly basis.

[2]GAO-08-962T.

In total, we examined data for 131 cases involving 1,619 misclassified employees who were denied payment for overtime or were paid less than minimum wage. Using these data from the WHD database, we judgmentally selected 26 case files to review. We selected cases based on factors such as the number of employees misclassified, the total amount of back wages computed, whether a single employee was owed over $10,000 in back wages, whether civil money penalties were assessed, and whether the case resulted from a complaint or was directed by the agency. We conducted reviews of 13 case files in the WHD New Orleans and Boston offices and requested copies of the remaining selected case files from WHD. Because we judgmentally selected these files, our findings from the reviews of case files are not projectable to all WHD cases.

To obtain information on state coordination with DOL and IRS, state perspectives on DOL's education and outreach efforts, and whether states collect data on cases involving misclassification, we conducted a Web-based survey of unemployment insurance directors in all states, the District of Columbia, and Puerto Rico. We administered two versions of this survey: one for states participating in the Questionable Employment Tax Practices (QETP) program and one for states that do not participate in the QETP program. After we drafted the questionnaire, we asked for comments from a knowledgeable official at the National Association of State Workforce Agencies as well as from an independent GAO survey professional.

We conducted two pretests of the survey, one with a state participating in the QETP program and one with a state that does not participate in the QETP program, to check that (1) the questions were clear and unambiguous, (2) terminology was used correctly, (3) the questionnaire did not place an undue burden on agency officials, (4) the information could feasibly be obtained, and (5) the survey was comprehensive and unbiased. We received responses from all 32 states on the survey for QETP participants, for a response rate of 100 percent. We did not receive a response from 1 state on the survey for states that do not participate in QETP, for a response rate of 95 percent. We were unable to contact the official in Puerto Rico within the study's time period. Finally, we interviewed officials in 4 states to obtain more information about their efforts to address misclassification and, where applicable, reviewed documentation on these efforts.

To describe actions IRS takes to address employee misclassification, we interviewed officials from the employment tax group within IRS's Small Business/Self Employed Division (SB/SE), which conducts the majority of

IRS misclassification-related examinations. We also obtained data on SB/SE examinations of worker misclassification for tax year 2008 generated from four sources: (1) the Determination of Worker Status (Form SS-8) program, (2) the Employment Tax Examination Program (ETEP), (3) QETP, and (4) general IRS employment tax examinations, including cases referred from other divisions within IRS. SB/SE conducted all IRS misclassification examinations generated by ETEP and QETP, over 97 percent of the examinations generated by the SS-8 program, and the majority of general examinations IRS conducted during fiscal year 2008. We also obtained data from IRS's Classification Settlement Program. We assessed the reliability of these IRS data sources and found them to be sufficiently reliable for the purposes of this report. To obtain information on IRS's education and outreach activities that address misclassification, we interviewed officials from the employment tax group within SB/SE, interviewed independent contractor and labor advocates, and reviewed educational materials on classification IRS makes available on its Web site.

To understand how DOL and IRS cooperate with each other and with states and other relevant agencies, we examined agency policies and procedures for sharing information on misclassification and referring cases involving misclassification, and interviewed agency and state officials. We also reviewed information IRS provided on its arrangements with states through the QETP program.

To describe options that could help address challenges in preventing and responding to misclassification, we reviewed GAO and other federal agency reports and recommendations and other organizations' studies on misclassification of employees. We also interviewed 19 relevant stakeholders representing various groups, including (1) labor and advocacy groups, (2) groups that represent small businesses and independent contractors, (3) groups that represent tax professionals, (4) authors who have published on misclassification issues, and (5) federal agencies, to help identify options and summarize any associated trade-offs. Based on those discussions, we identified 19 options to include in this report. We originally identified over 100 options but reduced the list to 19 options that directly addressed misclassification challenges and issues, were not already being implemented, and were distinct from each other. In addition, we did not include other options that we have recently analyzed or recommended in prior reports on misclassification or that are indirectly related to worker misclassification, such as for information reporting on payments made to independent contractors.

We surveyed 11 stakeholders for their views on the 19 options we identified, asking them to state their level of support or opposition to the options and what they perceived to be the strengths and drawbacks of each option. These stakeholders included 4 groups that represent the views of small businesses, independent contractors, and those who hire them (i.e., independent contractor groups); 4 groups that represent the views of organized labor (i.e., labor groups); 2 groups that represented the tax preparation and advice community; and 1 federal agency that uses contractors. We received responses from 9 of these groups.[3] We analyzed the responses we received in order to present summary information in the report.

We conducted this performance audit from August 2008 through July 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[3]We did not receive survey responses from one of the groups representing the tax preparation and advice community and one of the independent contractor groups.

Appendix II: Stakeholder Views on Options to Address Misclassification Challenges

We identified 19 options to address challenges involved with preventing and responding to worker misclassification by reviewing related literature and interviewing knowledgeable persons about misclassification. As we identified these options, we asked these stakeholders for their views on the options, including what they considered to be the benefits and drawbacks of each. These stakeholders included IRS officials and representatives of organizations representing workers, independent contractors, tax professionals, and a federal agency that hires contractors.

The following is a summary of the options and their perceived associated benefits and drawbacks. Neither the list of options nor the list of their perceived associated benefits and drawbacks is exhaustive. Some of the options are concepts rather than fully developed proposals with details of how they would be implemented. Additional detail could bring more benefits and drawbacks to light. The benefits and drawbacks are not weighted and are not listed in order of importance or by frequency of mention. Options should not be judged by the number of benefits and drawbacks. Some of the options overlap, covering more than one problem, while other options only deal with specific aspects of a problem.

A. Clarify the employee/independent contractor definition and expand worker rights

1. Clarify the distinction between employees and independent contractors under federal law by unifying multiple definitions, limiting the number of factors used to make determinations, and making the factors more conclusive

Benefits:

- Could reduce manipulation of classification rules
- Could improve equity and efficiency of classification rules
- Could improve worker protection if an expansive definition is adopted
- Could improve objectivity of rules/reduce confusion

Drawbacks:

- Lobbying and political compromises could weaken the definition
- Lobbying and political compromises could lead to a more restrictive definition
- Could lead to increased litigation if a new definition has no history or precedent
- Could create transitional costs and upheavals in working relationships
- Could deter use of independent contractors
- A "one-size-fits-all" approach may cause imbalances and more problems than it solves in certain industries
- IRS and government agencies could incur costs to administer a new definition
- Could sidetrack key anti-abuse reforms
- No need to harmonize definitions since courts work well in doing so
- Could encourage more employers to engage in fraud

2. Allow workers to challenge classification determinations in U.S. Tax Court

Benefits:

- Could increase equity and protections for workers
- Could reduce incentives for misclassification

Drawbacks:

- Could result in more or unnecessary litigation
- Would be unfair to businesses
- Could deter use of independent contractors
- Too narrow to limit challenges to just Tax Court and just workers

3. Ensure that workers have adequate legal protection from retaliation for filing a Form SS-8

Benefits:

- Could help reduce misclassification/improve misclassification compliance
- Could help improve worker protection and justice

Drawbacks:

- Could result in more litigation
- Limits ability of employers to end contractual relationships as needed
- Could reduce use of independent contactors
- Not necessary because retaliation is rare and independent contractors can protect themselves through a contract
- Does not include worker protection for other actions to challenge misclassification

4. Define misclassification as a violation under FLSA

Benefits:

- Could help increase voluntary compliance
- Would allow federal agencies, including DOL, to take greater enforcement actions

Drawbacks:

- Could increase costly lawsuits for businesses
- Could deter use of independent contractors
- Unfair to penalize businesses and contractors for confusing and subjective regulations

B. Revise section 530 of the Revenue Act of 1978

5. Narrow the definition of "a long-standing recognized practice of a significant segment of the industry" so that fewer firms qualify under this reasonable basis for the section 530 safe harbor

Benefits:

- Could reduce incentive to misclassify and increase voluntary compliance
- Could reduce confusion
- Could help reduce tax gap related to misclassification

Drawbacks:

- Opens the door to eroding the protection of section 530
- Could create inequities among those who use independent contactors
- Could lead to economic disruption or upheaval in some industries
- Ignores unique issues that some industries possess
- Unnecessary because current definition can be hard to meet
- Only narrows rather than eliminates "industry practice"

6. Lift the ban on IRS/Treasury regulations or revenue rulings clarifying the employment status of individuals for purposes of employment taxes

Benefits:

- Could reduce requests for individual classification determinations and associated costs
- More consistent application of the rules
- Could increase voluntary compliance
- Could allow IRS to more effectively prevent misclassification and enforce classification
- Could improve understanding and reduce confusion over classification

Drawbacks:

- No need because existing case law is sufficient
- IRS favors employee status
- Could erode section 530 protection
- Could increase litigation and lobbying costs
- IRS cannot fix the classification problem without congressional guidance
- A national standard would not affect state definitions
- Could disrupt working relationships
- Political influences could slant the new guidance

C. Provide additional education and outreach

7. Require service recipients to provide standardized documents to workers that explain their classification rights and tax obligations

Benefits:

- Could increase voluntary compliance
- Could help reduce misclassification by reducing errors
- Could help educate workers about classification

Drawbacks:

- Could discriminate against some independent contractors
- Relies on employers instead of IRS to inform workers
- Could be ineffective if workers cannot understand the documents
- Employers would incur costs and burdens

8. Expand IRS outreach to service recipient, worker, and tax advisor groups to educate them about classification rules and related tax obligations, targeting groups IRS deems to be "at risk"

Benefits:

- Could increase voluntary compliance
- Could improve uniformity of classifications
- Could reduce misclassification by reducing errors

Drawbacks:

- Could deter use of independent contractors
- Could divert IRS resources from enforcement
- Does not target tax advisors who facilitate misclassification
- Could lead to unfair targeting of business groups
- Could lead to independent contractors suing their clients

9. Create an online classification system, using factors similar to those used in the SS-8 determination process, to guide service recipients and workers on classification determinations

Benefits:

- Uses electronic instead of paper-based processes
- Could minimize the need for SS-8 determinations
- Could provide more information to workers and service recipients
- Could streamline decision making on classifications
- Could reduce confusion and unintentional misclassification

Drawbacks:

- IRS would incur costs to develop system
- Still relies on subjective weighting of evidence and is likely to produce inconsistent determinations
- Not all workers have access to computers
- Could be manipulated by employers to attain desired classification

10. Increase the use of IRS notices to service recipients in industries with a potentially high incidence of misclassification to educate them about the classification rules and ask them to review their classification practices

Benefits:

- Could increase voluntary compliance
- Could improve understanding of correct classification

Drawbacks:

- IRS would incur costs to develop and mail notices
- Could be ineffective if not combined with IRS enforcement
- Could expose employers to more litigation
- Could create adversarial relationships between employers and workers
- Could be unfair to targeted industries

D. Withhold taxes for independent contractors

11. Require service recipients to withhold taxes, with rates at an adequate level to induce compliance, for independent contractors whose taxpayer identification numbers (TIN) cannot be verified or if notified by IRS during the TIN verification process that the contractors are not fully tax compliant

Benefits:

- Could identify more misclassification
- Could help improve voluntary filing and tax compliance by having taxes paid up front

Drawbacks:

- Would impose costs and burdens on employers
- Does not hold employers financially accountable for misclassification
- TIN verification is not effective
- Could face political opposition
- Discriminates against independent contractors
- Could result in withholding errors

12. Require universal tax withholding for payments made to independent contractors using tax rates that are relatively low (e.g., 1 percent to 5 percent of payment amounts)

Benefits:

- Would make payments to workers more visible
- Could increase voluntary filing and tax compliance by having taxes paid up front
- Could help identify misclassification
- Such low rates would not be burdensome to independent contractors

Drawbacks:

- Would impose costs and burdens on employers and workers.
- Could expose employers to underwithholding penalties
- Does not hold employers financially accountable for misclassification
- Could deter use of independent contractors
- Does not recognize that profit margins vary widely across businesses
- Could be used to intimidate undocumented workers
- Withholding amounts could be too high or withholding rate could be too low
- Could lead to increased "off-the-books" payments for services

13. Require service recipients to withhold taxes from payments made to independent contractors who request withholding in writing

Benefits:

- Could increase voluntary filing and tax compliance by having taxes paid up front
- Would be practical because withholding is voluntary
- Could help independent contractors meet their tax obligations
- Could make misclassification easier to identify and less likely to occur

Drawbacks:

- Could increase employers' costs and exposure to penalties for withholding errors
- Could deter use of independent contractors
- Does not hold employers financially accountable for misclassification
- Would need additional remedies for workers if employer did not remit taxes to IRS

E. Collect data on misclassification and independent contractors

14. Measure the extent of misclassification and related impacts on tax revenues at the national level

Benefits:

- Could raise awareness of misclassification
- Would provide data to support any reform efforts
- Could help IRS more effectively address misclassification
- Could improve understanding of correct classification

Drawbacks:

- Timely estimates could be costly
- May not be successful
- Could take a while and delay needed reforms

15. Require each independent contractor to apply for a separate business TIN

Benefits:

- Could increase voluntary compliance
- Reinforces business status and obligations of independent contractors
- Could facilitate IRS compliance and enforcement efforts
- Could prompt workers to think about their desired status

Drawbacks:

- IRS would incur costs
- Would impose burdens on independent contractors to apply
- Could be harmful to some industries
- Employers could use it to force workers into independent contractor status or to justify their independent contractor classifications

F. Enhance IRS compliance programs

16. Expand IRS's Classification Settlement Program (CSP) to allow for CSP treatment for service recipients that voluntarily contact IRS about their misclassified workers before any contact from IRS about potential misclassification

Benefits:

- Would reduce the financial exposure of participating employers
- Could increase voluntary compliance
- Would not unnecessarily burden employers

Drawbacks:

- IRS would incur costs to expand program
- Unfairly rewards intentional misclassification
- Could create section 530 protection or allow other manipulation of classification rules for some employers

17. Require service recipients to submit Forms SS-8 for all newly retained independent contractors

Benefits:

- Could increase voluntary compliance/reduce misclassification
- Shifts burden of proof to the independent contractor
- Provides IRS more information about independent contractors for compliance and enforcement

Drawbacks:

- Current SS-8 process does not sufficiently protect workers or investigate employers
- Would impose burdens and costs on employers and independent contractors
- Could severely slow down the contracting process
- Could deter use of independent contractors
- Could allow for more manipulation of classification rules unless the rules are clarified and IRS more vigorously investigates employers
- Does not address IRS's bias for employee status
- IRS's costs would be significant

G. Enhance coordination and information sharing

18. Enhance coordination between IRS, DOL, and other federal agencies to share data and address misclassification

Benefits:

- Could increase voluntary compliance
- Could deter intentional misclassification
- Could make federal enforcement more efficient
- Could improve consistency across federal agencies

Drawbacks:

- IRS may not be able to use all the information that it receives
- Could deter some workers from reporting misclassification, especially if it leads to questions about their immigration status
- Could result in loss of privacy for individuals affected by the information sharing
- Could be hampered by differences in agency definitions of employee status

19. Enhance coordination between IRS, states, and selected local governments to share data and address misclassification

Benefits:

- Could help increase voluntary compliance
- Could improve federal agency efficiency and effectiveness

Drawbacks:

- IRS may not be able to use all the information it receives
- Could deter some workers from reporting misclassification
- Could result in loss of privacy for individuals affected by the information sharing
- Could be hampered by different definitions of employee status
- Having too many government agencies involved could hamper action and allow employers to manipulate rules

Appendix III: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employment Standards
Washington, D.C. 20210

JUL 14 2009

Mr. Andrew Sherrill
Director
Education, Workforce, and
Income Security Issues
U. S. Government Accountability Office
Washington, D. C. 20548

Dear Mr. Sherrill:

Thank you for the opportunity to comment on the Government Accountability Office's (GAO) draft report entitled *"Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention"* (GAO-09-717).

The draft report provides four recommendations to the Secretary of Labor, two of which directly cite the Employment Standards Administration's Wage and Hour Division (WHD). Our comments follow the restated recommendations.

Recommendation 1

To increase its detection of FLSA and other labor law violations, we recommend that the Secretary of Labor direct the Wage and Hour Division Administrator to increase the division's focus on misclassification of employees as independent contractors during targeted investigations.

Response

WHD agrees with this recommendation. WHD investigators must establish an employment relationship to pursue remedies on behalf of workers under most of the statutes that the agency enforces, including the Fair Labor Standards Act and the Family and Medical Leave Act. To reinforce this position, the agency will reexamine its training materials and field guidance documents to ensure that all investigative staff is aware of the potential for employer misclassification of workers as independent contractors, that procedures are clearly articulated, and that investigators address employers' classification practices during all stages of an investigation. In addition, WHD's future performance planning priorities will focus on increasing compliance on behalf of workers employed in industries that are characterized by frequent incidences of independent contractor misclassification.

Recommendation 2

To enhance efforts to protect workers and make the most effective use of their resources, we recommend that the Secretary of Labor direct the Wage and Hour Division Administrator and the Assistant Secretary for OSHA to ensure that information on cases involving misclassification of employees as independent contractors is shared between the two divisions and that cases outside their jurisdiction are referred to states and other relevant agencies, as required.

Response

WHD agrees that there is value in sharing information about misclassification with the Occupational Safety and Health Administration (OSHA) and with state agencies, as appropriate. To this end, WHD and OSHA are committed to working together to improve coordination between the two agencies and to institutionalize the exchange of information on this issue. WHD will also assess its current referral processes to ensure that they adequately provide for referrals of potential violations of other laws outside WHD's jurisdiction that may be related to the misclassification of workers as independent contractors.

Recommendation 3

To identify promising practices in addressing misclassification and use agency resources most effectively, we recommend that the Secretary of Labor and the Commissioner of Internal Revenue establish a joint interagency effort with other federal and state agencies to address the misclassification of employees as independent contractors. Because tax data may provide useful leads on noncompliance, the task force should determine to what extent tax information would assist other agencies, and if it would be sufficiently helpful, seek a legislative change through the Department of Treasury to allow for sharing of tax information with appropriate privacy protections.

Response

WHD agrees that a joint effort between the Department of Labor and the Internal Revenue Service may prove useful in its efforts to enforce wage and hour laws. WHD will actively participate in any such interdepartmental effort.

Recommendation 4

To enhance understanding of classification issues by workers—especially those in low-wages industries—we recommend that the Secretary of Labor collaborate with the Commissioner of Internal Revenue to offer education and outreach to workers on classification rules and implications and related tax obligations. Such collaboration should include developing a standardized document on classifications that DOL would require employers to provide to new workers.

Response

WHD will reach out to the Internal Revenue Service to explore opportunities for joint outreach to workers.

WHD appreciates the seriousness of the adverse consequences to workers who are misclassified as independent contractors. Again, thank you for the opportunity to comment on the draft report.

Sincerely,

Shelby Hallmark
Acting Assistant Secretary

U.S. Department of Labor

Assistant Secretary for
Occupational Safety and Health
Washington, D.C. 20210

JUL 14 2009

Mr. Andrew Sherrill, Director
Education, Workforce
and Income Security

Mr. Michael Brostek, Director
Tax Issues
Strategic Issues Team

United States Government Accountability Office
441 G Street, N. W.
Washington, D.C. 20548

Dear Messrs. Sherrill and Brostek:

The Occupational Safety and Health Administration (OSHA) appreciates the opportunity to review and comment on your draft report entitled *Employee Misclassification: Improved Coordination, Outreach and Targeting Could Better Ensure Detection and Prevention.*

The OSH Act requires all employers to maintain a safe and healthful workplace. It is the employer's responsibility to ensure the health and safety of the workers as the employer has direct control of the workplace and the actions of the employees who work there. Consequently, misclassification of employees as contingent workers generally will not result in an employer responsible for OSHA violations escaping citation.

Nonetheless, OSHA understands the serious ramifications workers face in lost protections and benefits due to misclassification. OSHA is committed to working closely with the Administrator of the Wage and Hour Division to enhance the exchange of information on this issue and improve protections afforded workers.

Again, thank you for the opportunity to respond to GAO's draft report.

Sincerely,

Jordan Barab
Acting Assistant Secretary

Appendix IV: Comments from the Internal Revenue Service

DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 10, 2009

Mr. Michael Brostek
Director, Strategic Issues
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Brostek:

Thank you for the opportunity to review the Government Accountability Office's (GAO) draft report entitled, "Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention (Job Code GAO-09-717)."

We recognize that when employers improperly classify workers as independent contractors instead of employees, those workers do not receive protections and benefits to which they are entitled, and the employers may fail to pay taxes they would otherwise be required to pay. We agree that coordination between the departments and agencies at the federal and state levels is an effective way to encourage voluntary compliance and help address employee misclassification.

The IRS enforces worker classification compliance primarily through administration of our SS-8 program and through employment tax examinations. IRS offers a classification settlement program where employers may be eligible to reduce audit assessments if they agree to prospectively treat their workers as employees in the future. IRS also provides general information on worker classification through publications and fact sheets available on our Web site and through outreach targeted to tax and payroll professionals and employers. However, IRS faces challenges with these compliance efforts because of resource constraints and legal limits placed on IRS in providing guidance under Section 530 of the Revenue Act of 1978.

Your report identifies various options that could help address the misclassification of employees as independent contractors. We appreciate the suggestions and will carefully consider them as we work with the Secretary of Labor and others to explore those options.

The enclosed response addresses each recommendation separately.

If you have questions or concerns, please contact Christopher Wagner, Commissioner, Small Business/Self-Employed Division at (202) 622-0600.

Sincerely,

Linda E. Stiff

Enclosure

Enclosure

Recommendation

To identify promising practices in addressing misclassification and use agency resources most effectively, we recommend that the Secretary of Labor and the Commissioner of Internal Revenue establish a joint interagency effort with other federal and state agencies to address the misclassification of employees as independent contractors. Because tax data may provide useful leads on noncompliance, the task force should determine to what extent tax information would assist other agencies, and if it would be sufficiently helpful, seek a legislative change through the Department of the Treasury to allow for sharing of tax information with appropriate privacy protections.

Comment

We agree that coordination between departments and agencies at the federal and state levels is an effective way to encourage voluntary compliance. We agree to work with the Secretary of Labor to explore developing a joint effort subject to disclosure rules under IRC Section 6103, as well as privacy rules under 5 U.S.C. 552a.

Recommendation

To enhance understanding of classification issues by workers – especially those in low-wage industries - we recommend that the Secretary of Labor collaborate with the Commissioner of Internal Revenue to offer education and outreach to workers on classification rules and implications and related tax obligations. Such collaboration should include developing a standardized document on classification that DOL would require employers to provide to new workers.

Comment

We agree to collaborate with the Secretary of Labor, and we will make education and outreach materials available to the DOL. We agree to work with the Secretary of Labor to explore developing a standardized document on classification for the DOL to provide to new workers.

Recommendation

To maximize the effectiveness of the relatively new QETP initiative, we recommend the Commissioner of Internal Revenue create a forum for regularly collaborating with participating states to identify and address data sharing issues, such as ensuring clear points of contact within IRS for states and expeditious sharing of data.

Comment

We agree to work with participating State Workforce Agencies (SWAs) in the Questionable Employment Tax Program (QETP) to establish a forum to identify and address data sharing and IRS points of contact issues. We will utilize the Enterprise Wide Employment Tax Program (EWETP) to achieve this.

Recommendation

To increase proper worker classification, we recommend that the Commissioner of Internal Revenue extend the Classification Settlement Program to include employers who volunteer to prospectively reclassify their misclassified employees, and as part of this extension test whether sending notices describing the program to potentially noncompliant employers would be cost effective. Employers to whom IRS would send notices could include those referred for examination but who may not be examined due to higher priorities, resource limitations, or other reasons.

Comment

We will review the existing Classification Settlement Program and consider the possibility of expanding to employers not under audit. If expansion of this program is appropriate, we will consider all options, including issuing notices and soft letters and soliciting volunteers through outreach and education.

Appendix V: GAO Contacts and Staff Acknowledgments

GAO Contacts

Andrew Sherrill, (202) 512-7215 or sherrilla@gao.gov

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Acknowledgments

In addition to the contacts named above, Revae Moran, Acting Director; Tom Short, Assistant Director; Amy Sweet, Analyst-in-Charge; Jeff Arkin, Analyst-in-Charge; Susan Bernstein; Jessica Bryant-Bertail; Scott Charlton; Doreen Feldman; Jennifer Gravelle; Maura Hardy; David Perkins; Ellen Phelps Ranen; Albert Sim; Andrew J. Stephens; and Gregory Wilmoth made key contributions to this report.

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ANNUAL REPORT OF THE WHITE HOUSE TASK FORCE ON THE MIDDLE CLASS

FEBRUARY 2010

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Mr. President,

I'm proud to present you with the annual report of the White House Task Force on the Middle Class.

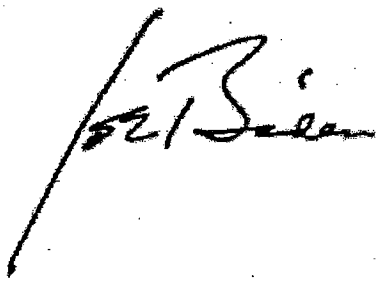
Shortly after we took office, you gave me the honor of chairing this Task Force, noting that "the strength of our economy can be measured by the strength of our middle class." Since that day, that simple yet powerful equation—a strong middle class equals a strong economy—has guided our work.

We report on those activities in the following pages. As you will see, the Task Force has been actively working on several of the issues that are most important to the aspirations and everyday lives of middle-class families, including access to higher education, balancing work and caregiving obligations, retirement security, and high-quality jobs for middle-class workers. This report will also discuss a number of important new initiatives in your Fiscal Year 2011 Budget that are designed to address these core middle-class issues, including the near-doubling of a tax credit to help middle-class families offset the rising costs of child care and a proposal to significantly lower student loan payments.

Our report examines the economic origins of the middle-class squeeze, including the growing gap between productivity and middle-class incomes, the dramatic rise in economic inequality, and the challenge of balancing work and family responsibilities as women's earnings have become increasingly important to middle-class families.

Mr. President, you have consistently stressed that we will be, and should be, judged by the extent to which our agenda lifts the living standards of hard-working, middle-class Americans. As you will see in these pages, our Task Force has worked diligently toward this goal over the past year, and we will continue to do so in the coming months.

Sincerely,



Executive Summary

The White House Task Force on the Middle Class, chaired by Vice President Joe Biden, was created by President Obama a little more than one year ago, shortly after the Administration took office. The mission of the Task Force, as stated in the Executive Order that created it, is to work with our member agencies and councils to ensure that the economic challenges facing the American middle class, challenges that predate the recession that was deepening as the Task Force was formed, always remain front and center in the work of the Administration.

Over the past year, this has been our singular focus. Of course, in the context of the deepest recession since the Great Depression, the Administration's first priority for the middle class has been restoring job growth by stabilizing an economy that was in freefall. This economic contraction has dealt a serious blow to middle-class families, with staggering losses to their jobs, their savings, and the value of their homes. The Vice President, in his role as the Administration's chief overseer of the Recovery Act, has played a critical role in this central part of our economic agenda. And of course, the President's health care reform agenda targets one of the most important—and too often most precarious—aspects of middle-class life.

But at the same time, the Task Force has worked to address some of the longer term challenges facing the middle class: balancing work and family responsibilities, college access and affordability, and retirement security. And while restarting the engine of job creation is the Administration's highest priority, the Task Force is working to ensure that the jobs that are created as the economy begins to recover are good jobs.

This report details our activities in pursuing policy solutions to these challenges over the past year. The report also highlights some of the key Administration initiatives supported by the Task Force, many of which are part of the President's Fiscal Year 2011 Budget, including:

Helping Middle-Class Families Balance Work and Caregiving Obligations. For the majority of middle-class families, it is no longer the case that one parent is the breadwinner while the other is the caregiver. The economic stability of middle-class families depends at least in part on policies that help families balance work and caregiving obligations. The Budget will:

Provide a Bigger Child Care Tax Credit for Middle-Class Families. Parents are working harder but with less to show for it after paying for child care, which keeps getting more expensive. The Budget nearly doubles the Child and Dependent Care Tax Credit for middle-class families making under $85,000 a year, and nearly every family that makes under $115,000 will see its credit increase.

Increase Child-Care Assistance to Help Working Families Move into the Middle Class. Many working parents cannot lift their families into the middle class without child-care assistance. The Budget provides a $1.6 billion increase in funding for the Child Care and Development Fund, which will fund services for approximately 235,000 children and improve quality.

Provide Help for Families Caring for Seniors and People with Disabilities. The Budget boosts funding for programs that support caregivers and allow seniors to live in the community for as long as possible.

Making College More Affordable and Accessible. For many middle-class parents, higher education means the chance for their children to realize their full potential. Unfortunately, families across the country are seeing rising costs and falling family incomes threaten the dream of sending their children to college. The Budget will:

Cap Student Loan Payments. The Budget strengthens the Income-Based Repayment plan for student loans by limiting a borrower's payments to 10 percent of his or her income above a basic living allowance and by forgiving all remaining debt after 10 years of payments for those in public service work and after 20 years for all others.

Reform Student Lending. The Budget supports pending legislation that would shift all Federal loans to the Direct Loan program, in which the Federal Government provides the capital for all new student loans, and chooses private and nonprofit companies to service the loans. This shift will eliminate tens of billions of dollars in wasteful subsidies to banks and the resulting savings will be used to expand Pell Grants and invest in community colleges.

Increase Pell Grants and Put Them on a Firm Financial Footing. The Recovery Act and the 2009 appropriations bill boosted the maximum Pell Grant award by more than $600, for a total award of $5,350, and the maximum award will increase to $5,550 in 2010. The Budget proposes to make that increase permanent and guarantee that Pell Grants grow faster than inflation in the future. The Budget would increase Pell Grants by a total of nearly $1,000 since the Administration took office, expand eligibility, and nearly double the total amount of Pell Grants available. It also proposes to make Pell Grant funding mandatory, rather than dependent on annual appropriations from Congress.

Extend the American Opportunity Tax Credit. The Recovery Act created the American Opportunity Tax Credit, which is worth up to $2,500 per year and can be claimed against tuition, fees, and textbook expenses for 4 years of college. The Budget proposes to make this temporary credit permanent, crediting families up to $10,000 over 4 years.

Make Historic Investments in Community Colleges. The Budget supports a new American Graduation Initiative that will offer competitive grants to help community colleges improve their outcomes and help meet the President's goal of graduating five million additional community college students by 2020.

Simplify Student Aid: The Administration is working to simplify the student aid application, making life easier for 18 million students and families a year and increasing the programs' effectiveness at boosting enrollment. We are tailoring the online form to skip unnecessary questions, working with Congress to eliminate dozens of questions that are currently statutorily required, and letting families fill out forms electronically with information transferred from tax returns they have already filed.

Enhancing Retirement Security. After a lifetime of employment, American workers deserve a secure retirement. Yet for middle-class workers today, especially in the wake of the historic losses to retirement savings and housing wealth in the financial crisis, retirement seems anything but secure. The Budget will:

Establish Automatic Individual Retirement Accounts. The Administration will require most employers who do not currently offer a retirement plan to enroll their employees in a payroll-deduction IRA unless the employee opts out.

Simplify and Expand the Saver's Credit. The Administration will help working families save for retirement by simplifying and expanding the Saver's Credit to provide a 50 percent match on the first $1,000 of retirement savings for families earning up to $65,000 and providing a partial credit to families up to $85,000. We will also make this credit fully refundable.

Update 401(k) Regulations to Improve Transparency and Reliability. A majority of American workers rely on 401(k)-style plans to finance their retirements. The Administration is proposing new regulations to improve the transparency and adequacy of 401(k) retirement savings.

Protecting Workers and Creating Middle-Class Jobs. Access to good quality jobs, with fair compensation and stable benefits, is a key factor in building a strong middle class. The Administration's most immediate imperative in this regard is to do all we can to jumpstart job creation. Building on some of the successes of the Recovery Act, the President has outlined a program to quickly generate job growth in small businesses, clean energy, and infrastructure. In addition, the Middle Class Task Force is focusing on the following initiatives to ensure that we create good jobs that can sustain a middle-class lifestyle and that workers are treated fairly:

Passing the Employee Free Choice Act. To level the playing field for workers who want to form unions, the Administration is committed to passing the Employee Free Choice Act. The loss of bargaining power has been a factor in both the stagnation of middle-class earnings and the divergence of wage growth from productivity growth. Restoring the right to pursue collective bargaining in a more balanced environment would help middle-class workers get their fair share of the gains as the American economy recovers.

Responsibility in Federal Contracting. The Federal Government spends over $500 billion dollars a year on contracts, generating jobs for tens of millions of workers, but there are inadequate controls in place to prevent government contracts from being awarded to employers that violate tax, labor and employment, fraud, or environmental laws. In addition, the quality of jobs on some of these contracts can be very low, which can have a negative impact of the quality of goods or services purchased by the government. For these reasons, the Task Force is looking at ways to improve the procurement process by making it less likely that irresponsible businesses will get Federal contracts and by allowing procurement officers to consider job quality when awarding contracts while not raising the quality-adjusted costs of contracts.

Protecting Benefits for Employees by Ensuring Proper Classification. As part of the Budget, the Department of Labor will launch a new initiative to prevent employees from being misclassified as independent contractors. Misclassification hurts workers by depriving them of benefits and protections to which they might be entitled and costs the government billions of dollars in unpaid taxes. The Department of Labor will increase enforcement using additional personnel and resources and will propose legislative changes that will require employers to properly classify their workers, provide for penalties when they do not, and restore protections for employees

who have been classified improperly. In addition, the Department of the Treasury is seeking legislation to allow it to better define and clarify worker classification standards—which benefits workers and firms by reducing uncertainty—and to prospectively reclassify misclassified workers.

Investing in Clean Energy Manufacturing. The Recovery Act provided $2.3 billion for the Section 48C Advanced Energy Manufacturing Tax Credit, but the credit was so popular that many qualified applications could not be accepted. The Administration will push to add $5 billion for the credit to create good, middle-class jobs and build a domestic clean energy sector.

I. Introduction

On January 30, 2009, ten days into his Administration, President Barack Obama signed an Executive Order creating the White House Task Force on the Middle Class, chaired by Vice President Joe Biden. On that day, the President stressed that "the strength of our economy can be measured by the strength of our middle class." Vice President Biden elaborated:

> "Quite simply, a strong middle class equals a strong America. We can't have one without the other. This Task Force will be an important vehicle to assess new and existing policies across the board and determine if they are helping or hurting the middle class. It is our charge to get the middle class—the backbone of this country—up and running again."

The new Administration did not develop these views overnight. During their campaign for office, then-candidates Obama and Biden observed the middle class struggling with a recession that began in December 2007. Moreover, this deep downturn came after an economic expansion that left too many middle-class families behind. As shown in the next section, productivity grew solidly over the 2000s expansion, but the real median income of working-age households actually fell between 2000 and 2007.

So when the Task Force was created, it was not intended simply to look out for the middle class over the course of the recession. The Task Force was created to keep a steady eye on a central goal of the Obama Administration's economic policy: making sure that the middle class does not get left behind again. As the President's Executive Order creating the Task Force puts it: "It is a high priority of my Administration to achieve a secure future for middle-class working families, one in which they share in prosperous times and are cushioned during hard times."[1] And importantly, as President Obama said that day, our mission extends not only to families who are currently in the middle class, but also to those who aspire to rise into the middle class.

This document describes the activities of the Task Force since our inception. It includes discussions of the subject areas in which we focused our efforts, the events and public meetings we held on those topics, links to reports and documents created along the way, and discussions of policies under consideration to help achieve the goal of renewed middle-class prosperity.

First, however, we will provide a brief description of the structure and membership of the Task Force.

The Task Force was born from the ideas and experiences noted above and from the input of many members of the public and supporters of the Obama/Biden campaign. Various labor unions, for example, have consistently fought for better economic conditions for middle-class families, and their imprint on the Task Force has been clear. This appreciation for the role that unions play in connecting middle-class prosperity with broader economic growth has been part of the Task Force's thinking since its creation, when the President stressed that "you cannot have a strong middle class without a strong labor movement."

[1] "Memorandum for the Heads of Executive Departments and Agencies," January 2009, http://www.whitehouse.gov/the_press_office/memorandum_for_the_heads_of_executive_departments_and_agencies/

Of course, the role of business in creating middle-class jobs is also central to the goals of the Task Force, and in his very next sentence, the President pointed out: "We know that strong, vibrant, growing unions can exist side by side with strong, vibrant and growing businesses." Taking our cue from the President, the Task Force has consistently stressed this balance, avoiding old arguments and false dichotomies while working together with all stakeholders interested in a strong American middle class.

The Vice President chairs the Task Force, and the Task Force's members are drawn from Administration agencies and councils, including the Secretaries of Labor, Health and Human Services, Education, Energy, the Treasury, Commerce, Housing and Urban Development, Transportation, and Agriculture, as well as the Administrator of the Environmental Protection Agency, the Directors of the National Economic Council, the Office of Management and Budget, and the Domestic Policy Council, and the Chair of the Council of Economic Advisers.

Our activities over the past year included:

> Meetings of Task Force members—both principals and their staffs—to assess progress, generate ideas for middle-class initiatives, and move those ideas through the policy process;
>
> Holding 13 public events across the country and at the White House to promote the Task Force's policy agenda and to engage with experts and members of the public;
>
> Working with our agency members to prepare seven white papers with policy analysis to accompany public events, which are available at www.astrongmiddleclass.gov;
>
> Using our website to keep the public informed about what this Administration is doing to help the middle class and to collect ideas and comments from the public;
>
> Outreach to external stakeholders in the labor, business, and advocacy communities to obtain information and hear their individual views.

Engaging with the public provides a way for the many stakeholders representing middle-class interests to learn from one another. But more importantly, it allows us to hear directly from ordinary middle-class Americans about their aspirations and the challenges they face.

We heard from people like the mother at our Task Force meeting in St. Louis, Missouri with two kids in college and two more at home, who wanted to get more training and education herself. She asked the Vice President, "How can I keep my son at Purdue and my daughter at Texas A&M, and two more still to go to college?"

Or people like Shannon from Pennsylvania, a single mom and veteran who is caring for two kids while working full-time. She wrote to tell us that her paycheck barely covers her bills, and she has already lost the "small luxuries" she works hard for.

Or people like the small-business owner we met in St. Cloud, Minnesota, who wants to grow his small engineering consulting company even during this recession, but was just looking for a little help tapping into the new clean energy economy.

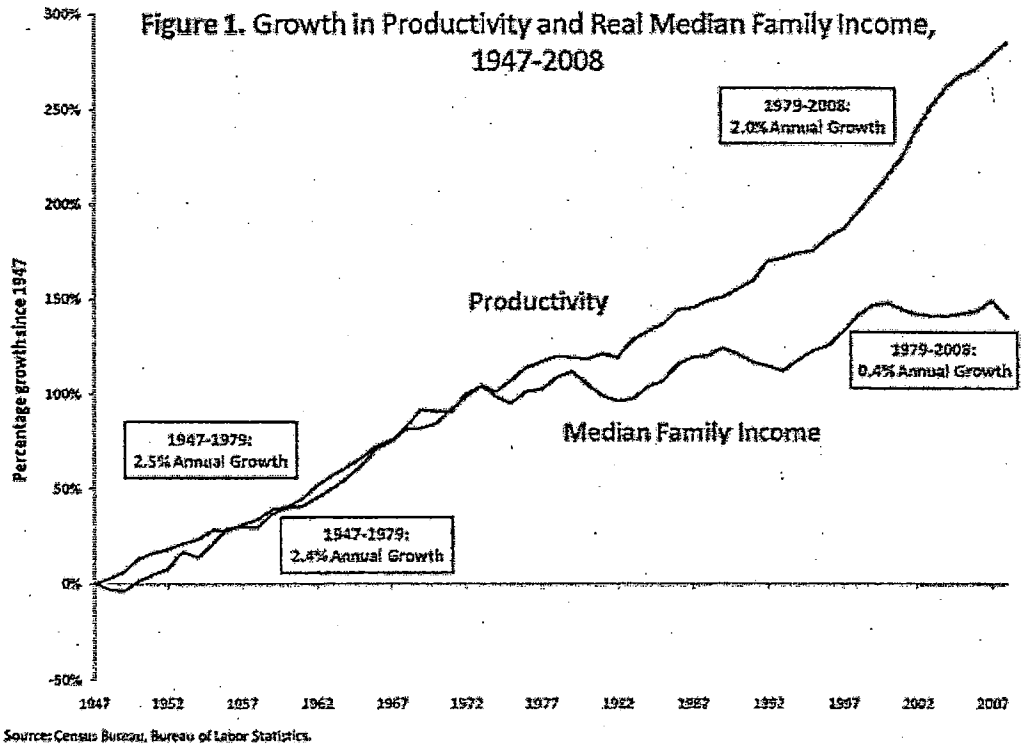
The input we have gotten from people like these across the country has guided the development of our policy agenda throughout the year.

The State of the American Middle Class

Understanding the economic challenges facing middle-class families is essential in crafting the policy agenda to help meet those challenges. In this section, we briefly examine some of the longer-term trends responsible for the middle-class squeeze, including the increased gap between productivity and wages; economic inequality and mobility; and shifts in gender roles and the need for work-life balance in today's economy.

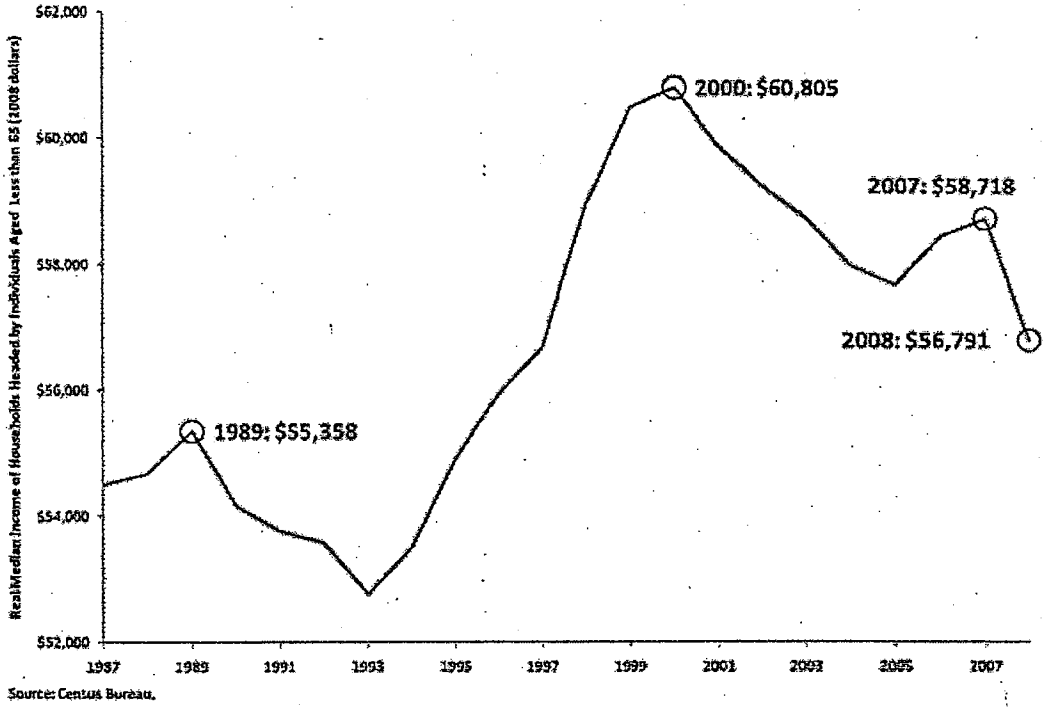
Figure 1 presents a long-term trend of middle-class income—in this case, the inflation-adjusted median income for all families, which is the longest time series of this type available. We plot productivity growth along with the income measure, to provide a broad benchmark against which to judge the relationship between economic output and middle-class income growth.

The figure makes two broad points. First, regarding family income, it shows that there have been two very different growth regimes over different periods of history. Between 1947 and 1979, for example, real median family income grew at an annual rate of 2.4 percent, which amounts to about a doubling of real income over this period. After 1979, however, this trend decelerated significantly, as real median family income grew only 0.4 percent per year, for a total increase of 14 percent. Second, as we will discuss in more depth below, it shows that in the latter regime, since 1979, the growth of family income has become increasingly disconnected from the broader growth of output and productivity. While productivity has continued to grow robustly, middle-class families are no longer getting their share of that growth.



Note also the poor performance of real median family income in the 2000s, when it was essentially flat, before declining 3.4 percent in the recession year of 2008 (it is typical in this research to measure income over peak years, separating out recessions).

Figure 2. Real Median Income of Working-Age Households, 1987-2008



Since we have more refined data for this recent time period, we can look at a more relevant group in the context of working families: working-age households, or those headed by someone less than 65. Figure 2 shows clearly that the economic expansion of the 2000s did not reach this group of households. As the weak labor market and anemic job growth of the 2000s reduced the upward pressure on workers' wages, the real median income for working-age households fell by about $2,100 between 2000 and 2007, or 3.4 percent, and fell another 3.3 percent in the recessionary year of 2008.[2]

The second point illustrated by Figure 1 involves the comparison of real median family income growth and productivity growth. The rationale behind this comparison is that as the rate of output per hour rises, living standards for middle-class families should also rise. After all, many of these families are responsible for generating that growth, and one view of the implicit social contract that has defined the American middle class is that as the economy expands, the living standards of middle-class families will improve.

And in fact, as the figure reveals, that contract was fully operative in the first few decades of the period shown. Family income and productivity grew at about the same annualized rate. However, in the last three decades, the relationship has broken down and middle-class incomes have diverged sharply from

[2] United States Census Bureau. All figures measured in real 2008 dollars.

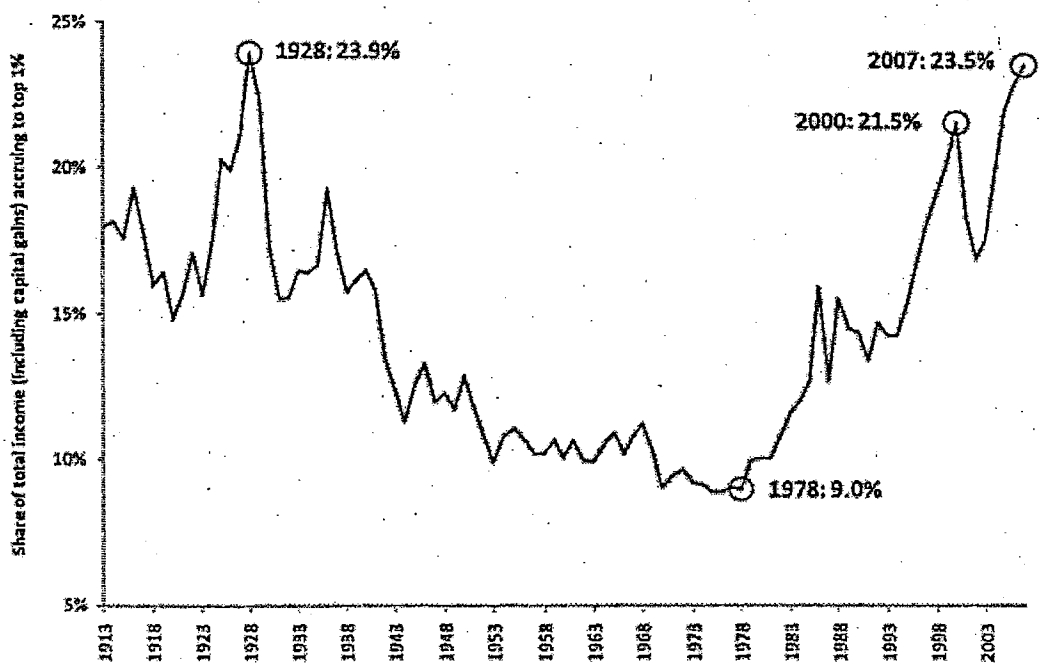
productivity, with a large, yawning gap developing by the end of the series. This divergence has become even more dramatic in recent years; half of the total increase in the gap occurred in the years between 2000 and 2008, a period of particularly weak middle-class income growth.

Of course, there are many dynamics at work behind this breakdown. The composition of families and the demographics of the country shifted as well. Some of these changes put downward pressure on income growth, such as the growth of single-parent families. But other trends pushed the other way, such as an older, more experienced, and more highly educated workforce, as well as much more labor supply in the paid labor market by working women. In sum, such trends fail to explain away this divergence between middle-class incomes and productivity. It is a solid symbol of the breakdown of an implicit social contract.

Where did the growth go, if not to middle or lower-income families? The well-documented increase in income inequality during these years suggests that much of it accrued to households in the top reaches of the income scale. Figure 3 shows the share of total income, including income from realized capital gains (like profits from selling stocks), going to the top one percent of households over a span of more than 90 years. In the most recent year of available data—2007—over 23 percent of income was held by the top 1 percent, the highest level of income concentration since 1928, the year before the market crash that began the Great Depression.

In other words, there is strong evidence that a major cause of the middle-class squeeze is the wedge of inequality: the fact that, at any given level of growth, a smaller share of the benefits of that growth is flowing to the middle on down.

Figure 3. Share of Total Income Going to Top 1% of Families, 1913-2007

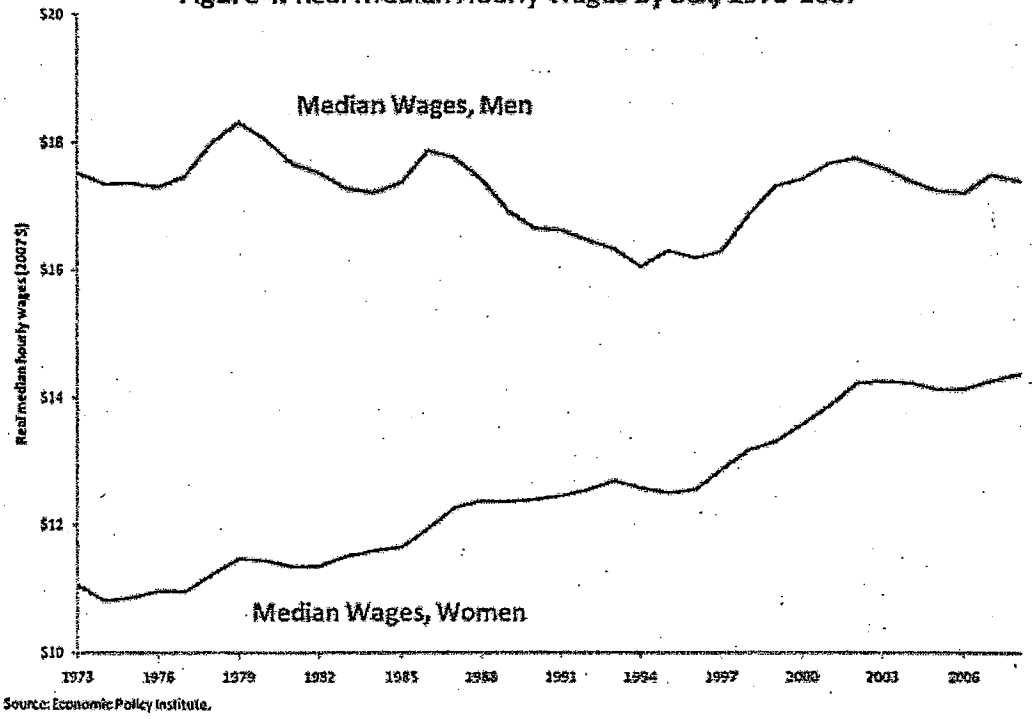


Source: 2007 update to Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *Quarterly Journal of Economics* 118:1, Feb. 2003.

A full elaboration of the factors behind the growth of inequality is beyond our scope in this report. Surely, technological changes, like the increased presence of computerization in the workplace, have boosted employers' skill demands, but this is actually a fairly smooth, ongoing process, and is by no means the only or even the most important factor boosting inequality. Globalization has played a role as well, as increased competition with lower-wage countries has raised competitive pressures, especially in our manufacturing sector. And a very important factor that tends to get less attention is the diminished bargaining power of many workers in the middle class, in part because there is less of a union presence in the workplace, and in part because the combined dynamics of technological change, trade, and the growth of the financial sector have tilted the bargaining scale against many mid-level workers.

The impact of these factors is evident in the historical trend of real median hourly wages, especially those of men. Figure 4 shows these trends, using data developed by the Economic Policy Institute. Note that even though the series undergoes a growth period in the 1990s, the median wage of men was at about the same level, in real terms, at the end of this series as it was at the beginning. This is a remarkable result underlying one dimension of the middle-class squeeze: the earnings of the typical or median male worker, while undergoing various ups and downs over the past generation, have not increased in real terms since 1973.

Figure 4. Real Median Hourly Wages by Sex, 1973-2007



For women, the trend in real median earnings has been more positive, though they too saw less progress in recent years. These relative wage trends raise another very important dynamic related to women and middle-class families, one that feeds directly into some of our policy discussions below regarding

work-family balance. Due both to the stagnation of men's earnings and to increased labor market opportunities, women's labor supply has increased significantly. Back in the 1960s, their labor market participation as a share of the working-age population was about 40 percent. In 2007, the most recent economic peak, it was almost 60 percent, compared to just over 70 percent for men.[3]

Particularly germane to our work is the increase in the number of working mothers, as their increased time in the paid labor market raises challenges for both men and women in balancing work and family responsibilities. Working wives in middle-income, married-couple families with children increased their labor supply by almost 500 hours between 1979 and 2006, the equivalent of 3 more months of full-time work.[4] Notably, over this same period, their husbands' hours were unchanged (they generally worked full-time, full-year throughout the period).

Also, single parent families with children, most headed by women, have become a much larger share of all families with kids, rising from 15 percent in the early 1970s to 25 percent in 2008.[5] These trends were discussed in detail at a November Task Force meeting at the Center for American Progress. As Heather Boushey, an economist who participated in that meeting, has shown, there has been a significant increase in the share of women whose income contributions are essential to their families' well being.[6] Clearly, this change underlies the time squeeze many families increasingly experience.

Figure 5 shows the median share of family income coming from wives' contributions over time. These earnings have become increasingly important over time, with the median share rising from around 20 percent to around 35 percent over the past few decades. According to a new Pew Research Center study exploring the shifting economics of marriage, the percentage of wives who bring home more income than their husbands shot up from 4 percent in 1970 to 22 percent in 2007.[7]

[3] Bureau of Labor Statistics.

[4] Lawrence Mishel, Jared Bernstein, and Heidi Shierholz. The State of Working America 2008/2009. An Economic Policy Institute Book. Ithaca, NY: ILR Press, an imprint of Cornell University Press, 2009.

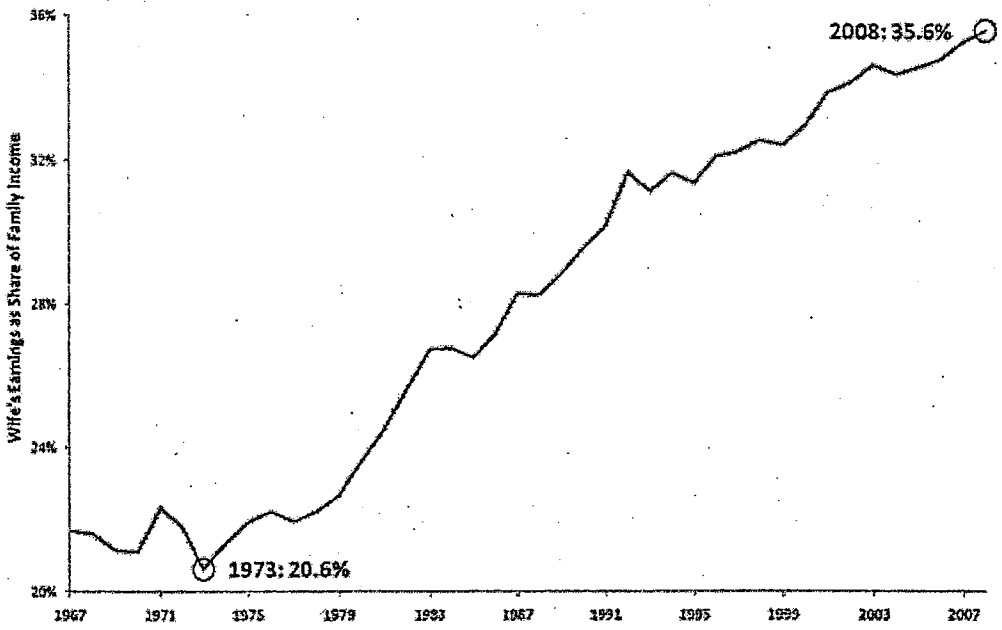
[5] United States Census Bureau.

[6] Heather Boushey, "The New Breadwinners," in "The Shriver Report: A Woman's Nation Changes Everything," October 2009, http://www.americanprogress.org/issues/2009/10/womans_nation.html/.

[7] Richard Fry and D'Vera Cohn, "Women, Men and the New Economics of Marriage," Pew Research Center, January 2010, http://pewsocialtrends.org/pubs/750/new-economics-of-marriage.

Figure 5. Median Share of Family Income Generated by Wife's Earnings

Working-Age Married Couples with Children and Working Wives, 1967-2008



Source: Center for American Progress analysis of Census Bureau data. Includes all married couples with children, with a working wife, spouses aged 25-64.

These data reveal some of the origins of the middle-class squeeze, including the divergence of growth and median incomes, inequality, wage stagnation, and the increased need to balance work and family responsibilities. They have also shaped the policy agenda of the Task Force, and of the Administration as a whole, over the past year.

Of course, first and foremost, our Administration's highest priority must be pulling the economy out of the deepest recession in decades, stabilizing housing and financial markets, and above all, creating jobs for middle-class workers. The Administration has always believed that regardless of the growth of gross domestic product or the proclamations of economists, this recession is not truly over until we have returned to robust job growth, which is why the President has proposed a targeted new package of job-creation initiatives. These proposals, which are discussed briefly in the next section, will create the conditions for the private sector to start hiring again by making key investments in infrastructure, incentivizing clean energy and energy efficiency, and giving tax cuts to the small businesses that are the engine of American job creation. But the figures above underscore the critically important reality of today's economy: a return to economic growth, or even robust job creation, is necessary but not sufficient to lift the living standards of middle-class families and loosen the squeeze.

One of the Administration's first actions after we took office was to take a first step towards addressing the middle-class squeeze by enacting the Making Work Pay tax credit, which immediately started putting money back in the pockets of 95 percent of working Americans. The Administration is proposing to extend this tax credit for another year and to permanently extend the tax cuts for middle-class families that were enacted in 2001 and 2003.

But in order to reconnect the growth of American prosperity and productivity with the growth of middle-class living standards, we also need to ensure that middle-class families have access to the things they need in order to succeed: affordable child and elder care, opportunities for higher education, secure retirement savings options, and of course, quality, affordable health care.

While not the focus of this report, the rising cost of health care and health insurance is one of the primary strains on middle-class family budgets. Increases in insurance premiums and out-of-pocket expenses have dramatically outpaced growth in family income over the past 20 years.[8] Furthermore, families are losing insurance at an alarming rate. In 2009, an average of 15,000 Americans lost their private health insurance each day, often because of job loss or because their employer dropped their coverage.[9] Between 1997 and 2006, half of Americans under the age of 65 found themselves without health insurance at some point, and current trends suggest that the fraction is likely to be even greater in the next decade.[10]

Health insurance reform has the potential to rein in costs, improving the financial stability of families nationwide. The Congressional Budget Office estimates that more than 30 million Americans will gain coverage by the end of the decade under current proposals for reform, which will have a significant impact in limiting out-of-pocket costs.[11] Reform will also lower the cost of premiums for many Americans who are already insured.[12] The creation of a new insurance exchange will increase employment flexibility for working Americans and lower health care costs. Economists estimate that by slowing the explosive growth in health care costs, comprehensive insurance reform will reduce average annual family premiums by up to $1,000 by 2019.[13]

Comprehensive health insurance reform remains one of the highest priorities of this Administration. While the Task Force believes passing reform is critical in order to ease the burden on middle-class families, we have primarily focused on other key needs of middle-class families.

In the sections that follow, we examine the different aspects of this middle-class agenda: protecting workers and creating middle-class jobs, retirement security, work-family balance, and pathways into the middle class. We discuss our activities in these areas, describe some of the key new policies and proposals that have been associated with the Task Force, and highlight other policies that we hope to explore further in the coming months.

[8] "Middle Class In America," U.S. Department of Commerce, Economics and Statistics Administration, January 2010, http://www.commerce.gov/s/groups/public/@doc/@os/@opa/documents/content/prod01_008833.pdf

[9] Drew Altman, "A Holiday Reminder on the Economy and Health Care," Kaiser Family Foundation, December 2009, http://www.kff.org/pullingittogether/120409_altman.cfm

[10] "The Risk of Losing Health Insurance Over a Decade: New Findings from Longitudinal Data," Department of the Treasury, September 2009. http://www.treas.gov/press/releases/docs/final-hc-report092009.pdf

[11] "Patient Protection and Affordable Care Act, Incorporating the Manager's Amendment," Congressional Budget Office, December 2009, http://www.cbo.gov/ftpdocs/108xx/doc10868/12-19-Reid_Letter_Managers_Correction_Noted.pdf

[12] "An Analysis of Health Insurance Premiums Under the Patient Protection and Affordable Care Act," Congressional Budget Office, November 2009, http://www.cbo.gov/ftpdocs/107xx/doc10781/11-30-Premiums.pdf

[13] Council of Economic Advisers, "The Economic Case for Health Care Reform: An Update," December 2009, http://www.whitehouse.gov/sites/default/files/microsites/091213-economic-case-health-care-reform.pdf

What Does It Mean To Be Middle Class?

Economists, policy makers, and just about everyone else talk about the middle class, but no standard definition exists. The Task Force asked one of our members, the U. S. Department of Commerce, to examine the literature on this question and to think about what it means to be middle-class and how middle-class aspirations can be achieved. Their report can be seen in full at the Department of Commerce's website.[14] The authors examine various definitions, discuss middle-class values and aspirations, and present hypothetical budgets showing how these aspirations might be achieved with different incomes. Finally, the report considers whether or not it is harder to be middle-class today than it was 20 years ago.

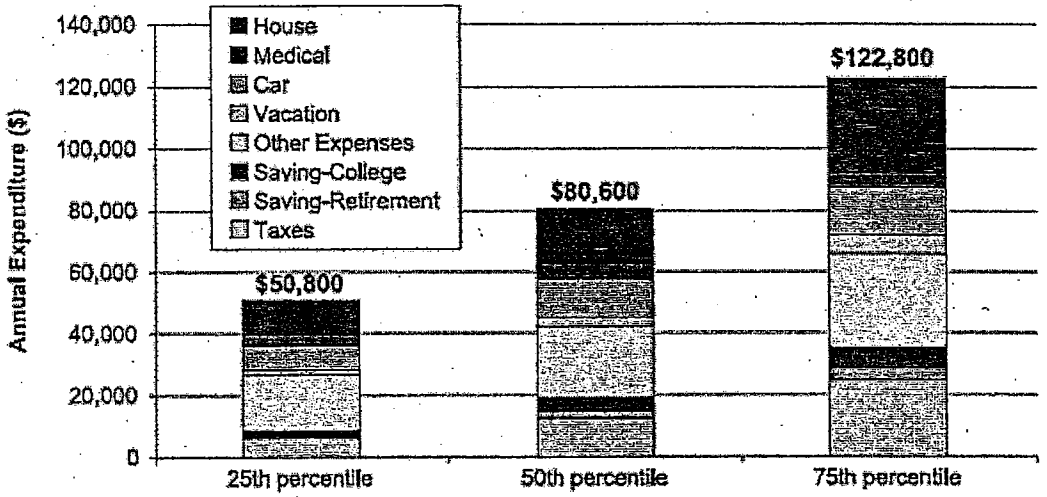
The principal findings of the report are:

> Middle-class families are defined by their aspirations more than their income. The Commerce report assumes that middle-class families aspire to home ownership, a car, college education for their children, health and retirement security and occasional family vacations.
>
> Families at a wide variety of income levels aspire to be middle class and under certain circumstances can put together budgets that allow them to obtain all six items above, which are assumed to be part of a middle-class lifestyle. Figure 6 shows Commerce's estimates of a middle-class family budget for married-couple families with two school-aged children. The estimates range from about $51,000 for this type of family at the 25th percentile of the income distribution to about $123,000 for those at the 75th percentile. The Figure breaks out the six components of the budget that relate to middle-class aspirations—homeownership, cars, savings for children's college education and parents' retirement, health care and vacations—and also shows the budget components that go to "non-aspirational" goods and services (such as utilities, food, and clothing) and taxes.

The technique used to construct Figure 6 adds all of these budget costs together except housing, and then assigns the residual—what's left in income at that percentile after netting out all these other costs—to housing. For example, the median family in this group, with annual income equal to about $81,000, could afford a mortgage on a home worth about $231,000; families at the 25th percentile could only afford a home worth about $144,000. The Commerce report then shows that the actual prices of median homes in different parts of the country range from $123,000 to over $400,000. Thus, depending on where they reside, even higher-end middle-class families will face a budget squeeze.

[14] "Middle Class in America," U.S. Department of Commerce, Economics and Statistics Administration, January 2010, http://www.commerce.gov/s/groups/public/@doc/@os/@opa/documents/content/prod01_008833.pdf

Hypothetical Budgets for Married-Couple Families with Two School-Age Children

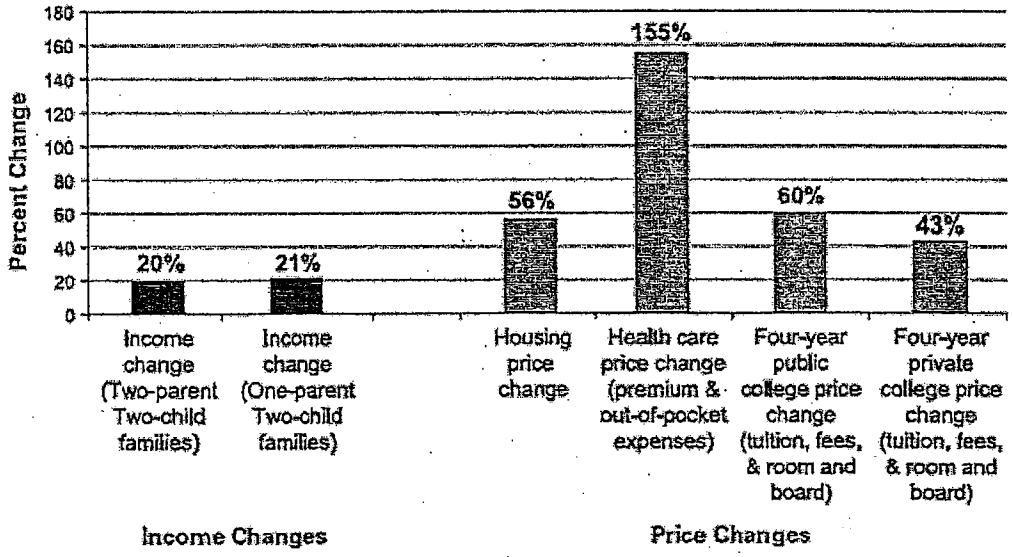


Planning and saving are critical elements in attaining a middle-class lifestyle for most families. Under the right circumstances, even lower-income families may be able to achieve many of their aspirations if they are willing to undertake present sacrifices and necessary saving.

However, many families, particularly those with less income, will find attaining a middle-class lifestyle difficult if not impossible. Areas with high housing costs can make even higher-income families feel pinched. Lack of employer-provided health insurance can confront a family with bankrupting health costs. And unforeseen expenses can ruin even the best-laid budget plans.

It is more difficult now than in the past for many people to achieve middle-class status because prices for certain key goods—health care, college and housing—have gone up faster than incomes. Figure 7 shows that between 1990 and 2008, real median income for two-family types—married couples and single parents, both with two children—grew about 20 percent, with virtually all that growth occurring in the 1990s, as incomes were virtually flat at best in the 2000s. However, prices of key budget components grew much faster (after adjusting for economy-wide inflation), led by health care—up 160 percent—followed by housing and college.

Changes in Median Real Family Income vs. Price Changes in Key Middle Class Items: 1990 - 2008



In the current economy, even with home prices falling, many middle-class families will be hard-pressed to meet the reasonable set of aspirations described. The fact that the prices of these aspirational goods have risen much faster than middle-class incomes over the last two decades reveals a longer-term challenge for these families. Thus, the report concludes that it is harder to attain a middle-class lifestyle now than it was in the recent past.

II. Protecting Workers and Creating Middle-Class Jobs

For middle-class families of working age, the main determinant of their living standards is their paycheck, not their stock portfolio. Therefore, access to good quality jobs—employment opportunities with fair compensation and stable benefits—is a key factor in solving the middle-class squeeze and building a stable middle class.

Of course, the Administration's most immediate imperative in this regard is to do all we can to jump-start job creation. This was a central theme in President Obama's State of the Union Address, and the President outlined a program to quickly generate job growth in small businesses, clean energy and energy efficiency, and infrastructure. Some of the key components of this proposed agenda include:

> Tax cuts targeted at small business to provide incentives to hire new workers, raise pay, and invest in new equipment;
>
> Proposals to create jobs weatherizing homes and buildings and expanding the production of clean energy equipment here in America (this latter policy is discussed in more detail below);
>
> Infrastructure investment that will create good jobs building and repairing roads, bridges, transit and aviation systems, and water systems.

While these initiatives are needed immediately to tackle unemployment, the Task Force is mindful of the longer-term need to ensure quality jobs, strong labor standards, and expanding opportunity for middle-class families well after the recession is over. Once again, our policy agenda is consistently guided by an awareness that the economic challenges facing today's middle class largely are structural, not cyclical, phenomena.

To this end, the Task Force has focused on green jobs, manufacturing employment, Project Labor Agreements, responsible Federal contracting, strong enforcement of labor standards and helping workers to build their voice at work, often through a fairer process in support of collective bargaining.

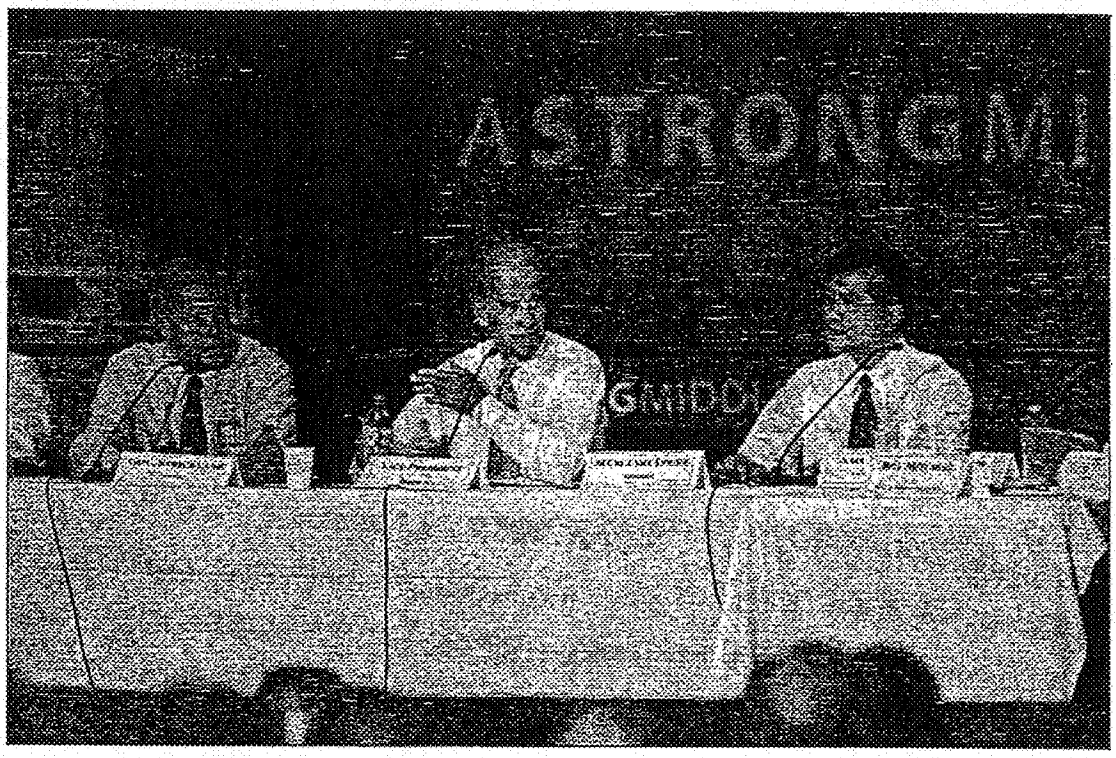
Supporting the Manufacturing Sector

President Obama has stressed the importance of a strong manufacturing sector, both for the good, middle-class jobs it creates and for the positive macroeconomic benefits it provides. Back in September, when the President appointed him as Senior Counselor for Manufacturing Policy, Ron Bloom described the Administration's position regarding manufacturing:

> A strong manufacturing sector is a cornerstone of American competitiveness and a critical part of President Obama's economic strategy. As we meet the challenges of globalization and technological change, it is vital to have a concerted effort across the Administration to support an innovative, vibrant manufacturing sector.

In keeping with this Administration's commitment to supporting American manufacturing, the Task Force has focused on manufacturing throughout the year, holding two manufacturing events since the Task Force's inception.

The first was an event in Perrysburg, Ohio at Willard and Kelsey Solar Group, a research, development and manufacturing facility that produces thin-film solar panels. Task Force members toured the innovative facility, after which they held a roundtable discussion with participants from industry, labor, government, and academia, as well as a town hall-style forum for the Vice President to get input and answer questions from members of the public.



Vice President Joe Biden at a Task Force meeting on American manufacturing at Willard and Kelsey Solar Group, a manufacturer of solar panels in Perrysburg, Ohio. Official White House Photograph by David Lienemann.

The event also provided an opportunity for the Vice President to highlight some of the Administration's actions and proposals to support the American manufacturing sector, including:

> The Administration's expanded commitment to Research & Development (R&D) targeted at new manufacturing, including doubling our R&D investment in key science agencies; expanding the Technology Innovation Program, which supports innovation in the U.S. through high-risk, high-reward research in areas of critical national need; and making permanent the research and experimentation tax credit, another important boost for manufacturing R&D.

The expansion of the Hollings Manufacturing Extension Partnership (MEP), which is positioned to play a helpful role in meeting the challenges facing our manufacturers. This Commerce Department program exists to enhance the competitiveness of small- and medium-sized U.S. manufacturers by helping firms transition to expanding sectors, adapt new technologies, and provide the best possible training to their staff. Recognizing MEP's importance, especially given the unique challenges and opportunities facing the manufacturing sector, the Vice President used this event with Secretary Locke to highlight the role played by the MEP and support the doubling of the program's resources in the President's budget by 2015.

The manufacturing programs in the American Recovery and Reinvestment Act (ARRA), ranging from new tax credits for advanced energy manufacturing, to safety net and training measures, to the Act's purchase of over 17,000 domestic vehicles, to new high-speed and commuter rail and smart grid investments.

The Task Force's focus on the manufacturing sector continued with its second manufacturing event, held in Washington, DC on December 16. At this event, the Vice President announced the Administration's support for a significant expansion of the 48C Advanced Energy Manufacturing Tax Credit, a new Recovery Act credit "for qualified investments in advanced energy projects, to support new, expanded, or re-equipped domestic manufacturing facilities." This event also featured the release of "A Framework for Revitalizing American Manufacturing" a detailed presentation of the Administration's approach to the sector.[15]

While the Recovery Act included a number of programs designed to help lift the manufacturing sector out of recession, one of the most forward-looking was the Advanced Energy Manufacturing Tax Credit (Section 48C in the IRS code). This credit is run through the Department of Energy and the Department of the Treasury to encourage investment in facilities to manufacture the machinery of the clean energy economy right here in America. As Leo Gerard, President of the United Steelworkers, said at our first Task Force event, "we need to make sure that the green economy is an American economy. We need to make sure that it's made in America. We need to make sure that what we're going to be exporting is our ideas and our vision and our values and our science—not our jobs."

The Recovery Act provided $2.3 billion for the tax credit, but the credit was so popular that we received many more qualified applications than we were able to accept. As part of this Task Force event, the Vice President announced the Administration's support for an additional $5 billion to build on this credit's success.

The 48C tax credit is unique in that while many tax credits and loans have long incentivized the production of renewable energy, the 48C credit promotes the domestic manufacture of the components that are used to produce that energy. The tax credit is available for advanced energy manufacturing facilities, such as investments in:

Technologies that create energy from renewable resources (sun, wind, geothermal and other renewable resources)

[15] "A Framework for Revitalizing American Manufacturing," Executive Office of the President, December 2009, http://www.whitehouse.gov/sites/default/files/microsites/20091216-maunfacturing-framework.pdf

Energy storage technologies (fuel cells, microturbines or other energy storage systems used in electric vehicles)

Advanced transmission technologies that support renewable generation (including storage)

Renewable fuel refining or blending technologies

Energy conservation technologies (advanced lighting, smart grid)

Plug-in electric vehicles & vehicle components (motors, generators)

Property to capture and sequester carbon dioxide

Other property designed to reduce greenhouse gas emissions

The 48C program provides a 30 percent credit against tax liabilities that can be used to offset the costs of investments in these areas. Following its introduction in the Recovery Act, the credit generated three times more acceptable applications than the $2.3 billion initial funding level could support. Given the dual need for good, middle-class jobs and for seed capital to help build a new, domestic clean energy sector, providing additional funding for this successful tax credit is a high priority of the Task Force, and one we will work on moving forward.

Looking ahead, the Vice President and Task Force intend to work with the agencies and with Senior Counselor Bloom to continue to promote the Administration's manufacturing agenda. Policies in this space may include: export promotion, transitional assistance to supply chains (especially former auto suppliers), public/private partnerships (especially in green manufacturing), and continuing to build off of the ARRA investments noted above.

Green Jobs

Connecting the American middle class to opportunities in the clean energy sector is a critical component of this Administration's economic strategy. The extension of the Section 48C Advanced Energy Manufacturing Tax Credit discussed above is only one piece of our agenda in this area; the Administration's commitment to green jobs also includes the other historic investments in clean energy that we made in the American Recovery and Reinvestment Act, as well as an unprecedented inter-agency commitment to working together to remove barriers to the growth of green industries.

This commitment is reflected in the three events that the Task Force has held on the subject of green jobs. Our very first meeting, held in Philadelphia, Pennsylvania in February 2009, discussed the potential of green jobs as a pathway into the middle class. The green sector will grow rapidly as we transform the way that we produce and consume energy—and this growth is good news for working families.

At the request of the Task Force, the White House Council of Economic Advisers (CEA) conducted an analysis of green jobs in advance of our first Task Force meeting. The CEA found that green jobs typically pay more than comparable jobs outside of the green sector. The wage premium for workers in occupations that are concentrated in green industries ranges from about 10 to 20 percent compared

to similarly qualified workers in comparable jobs. And even among workers with the same occupation, those in green industries tend to receive significantly higher wages. For example, welders in the turbine manufacturing and power generation sectors make 13.5 percent more than the average for welders across all industries.[16] It is no surprise that these higher-paying jobs are also more likely to be union jobs. A more complete analysis of green jobs, along with a description of several local green jobs initiatives, including efforts to open up green job opportunities for disadvantaged workers, can be found in our first Middle Class Task Force Staff Report.[17]

As our economy recovers, millions of Americans will rejoin the workforce or transition to new jobs in growing sectors of the economy. If the coming recovery is to truly lift the middle class, these Americans must be connected to career-track jobs that offer real opportunities for advancement and wages and benefits that can support a family. That is why this Administration's unprecedented investments in catalyzing the clean energy economy and creating more good green jobs are so important.

Clean Energy Jobs in the Recovery Act

The Recovery Act included the largest single investment in clean energy in American history – $90 billion. This money will leverage private investment to produce a total of up to $150 billion in clean energy projects. For a detailed analysis, please see Vice President Biden's memorandum to President Obama on America's transformation to a clean energy economy.[18] Among the key investments are:

$23 billion for renewable energy generation and advanced energy manufacturing, which will likely create over 250,000 jobs and leverage over $43 billion in additional investment that could support up to 469,000 more jobs.[19] These investments put us on track to double our renewable energy generation in 3 years and double our capacity to manufacture wind turbines, solar panels and other renewable energy components by 2012.

$2.7 billion in federal investments, which will leverage an additional $3 billion of private capital for projects designed to transform the transportation sector, including the production of advanced batteries, plug-in hybrid electric vehicles, and all-electric vehicles.

$4 billion in smart grid investments that will increase reliability, reduce electricity usage and save businesses and consumers billions of dollars. These smart grid investments will likely result in 43,000 new jobs and leverage enough private capital to support up to 61,000 additional jobs.

$5 billion for the Weatherization Assistance Program, so states can weatherize hundreds of thousands of homes by the end of next year, delivering energy savings to low-income families and creating green jobs in the process. The Recovery Act also expanded tax credits for energy efficiency home upgrades.

[16] "Green Jobs: A Pathway to a Strong Middle Class," Middle Class Task Force Staff Report, http://www.whitehouse.gov/assets/documents/mctf_one_staff_report_final.pdf.

[17] Ibid.

[18] Memorandum for the President from the Vice President, "Progress Report: the Transformation to a Clean Energy Economy," December 2009, http://www.whitehouse.gov/sites/default/files/administration-official/vice_president_memo_on_clean_energy_economy.pdf.

[19] All job estimates correspond to jobs that last for one year. Some jobs could last longer, which would proportionately reduce the number of distinct jobs.

$500 million in competitive grants administered by the Department of Labor for projects that train workers for green jobs.

The Vice President and other members of the Task Force are deeply engaged in the continuing implementation of Recovery Act programs in the clean energy sector.

Agency Partnerships on Green Jobs Facilitated by the Middle Class Task Force

At the first meeting of the Task Force in Philadelphia in February, Task Force members and outside experts discussed ways to expand the demand for green jobs. As the renewable energy and energy efficiency sectors grow, training will become even more critical. We need to equip workers with the skills they need to perform these new middle-class jobs. This need was the focus of our second Task Force meeting on green jobs, which was held on May 26th in Denver, Colorado. The Vice President and Secretaries Solis, Donovan, and Vilsack were joined by representatives from several model training programs, including programs operated by community colleges and labor unions.[20] Secretary Solis officially announced the availability of $500 million in Recovery Act grants for green jobs training, funds that have since been distributed to grantees around the nation.

Vice President Joe Biden at a Task Force meeting on green jobs in Denver, Colorado.
Official White House Photograph by David Lienemann.

[20] For more information on the model programs, see "Middle Class Task Force: Green Jobs Update," http://www.whitehouse.gov/assets/documents/Middle_Class_Task_Force_Green_Jobs_Update.pdf.

In Denver, we announced two new agency partnerships, facilitated by the Task Force, which will make it easier for people to find green jobs and connect to the training they need to fill them. First, the Secretaries of Labor and Housing and Urban Development (HUD) announced a partnership aimed at building on Recovery Act investments to create green employment opportunities for residents of HUD housing. Secretaries Solis and Donovan encouraged local Workforce Investment Boards (WIBs) and Public Housing Agencies (PHAs) to work together to train and place public housing residents into Recovery Act-funded jobs improving public housing. They also called on PHAs and WIBs to engage in joint outreach to inform public housing residents of these opportunities and collaboratively ensure that quality work supports are in place.[21]

Secondly, the Secretaries of Education, Labor, and Energy announced a new agreement to advance the development of a skilled clean energy and energy efficiency workforce by collaborating to link American workers to jobs, training and educational opportunities funded by the Recovery Act and future Federal investments. The Departments will share information and work together to develop mutually supportive programs that create career pathways for green jobs. The terms of the agreement are laid out in a Memorandum of Understanding between the three agencies.[22] Both of these partnerships represent the kind of interagency collaboration and communication that the Task Force seeks to promote. As Secretary Donovan said, "in these challenging economic times, it is crucial for government agencies to collaborate to find innovative ways to create jobs and get Americans working again."

The Middle Class Task Force Recovery Through Retro t Report

At the second Task Force meeting on green jobs in May, the Vice President asked the White House Council on Environmental Quality to develop a plan that lays the groundwork for a self-sustaining home energy efficiency retrofit industry that supports good, green jobs long after the Recovery Act investments in energy efficiency are gone. In response, the Council on Environmental Quality convened a policy process that included 11 departments and agencies and 6 White House offices. The result was the Recovery Through Retrofit Report, which was released at another Task Force meeting in October.[23]

The report identifies three barriers that stand in the way of a robust national home retrofit market. First, consumers do not have access to reliable information about retrofits. Second, the upfront costs of home retrofits can be high but consumers do not have access to financing. Finally, there are not enough workers with sufficient training to serve a robust national retrofit market.

The report then lays out steps that the Federal Government will take, using existing authority and funding, to address each of the barriers. First, to address the information barrier, we will develop a standardized home energy performance measure applicable to every home in America, and an energy performance label that energy auditors, retrofitters, lenders, realtors, and consumers can use to identify

[21] U.S. Department of Labor, U.S. Department of Housing and Urban Development, http://portal.hud.gov/portal/page/portal/RECOVERY/transparency_resources/DOL%20-%20HUD%20WIB%20PHA%20Letter%20Final.pdf.

[22] "Memorandum of Understanding Among the United States Departments of Education, Energy, and Labor," http://www.dol.gov/recovery/green-jobs-mou.pdf.

[23] "Recovery Through Retrofit," Middle Class Task Force, Council on Environmental Quality, October 2009, http://www.whitehouse.gov/assets/documents/Recovery_Through_Retrofit_Final_Report.pdf

the most energy efficient homes. Second, we will make it easier for homeowners to pay for retrofits by promoting accessible and affordable financing options. Finally, we will develop voluntary, nationally recognized standards for worker training and certification so that workers receive the skills needed to assure that retrofit jobs are done well.

The Council on Environmental Quality is convening an interagency working group chaired by the Departments of Energy, Housing and Urban Development, Labor and Agriculture as well as the Environmental Protection Agency, to implement the recommendations. The participating Agencies are reporting back to the Task Force on a regular basis.

Project Labor Agreements and Other Executive Orders

One of the first actions taken on behalf of the Middle-Class Task Force was President Obama's signing of Executive Order (EO) 13502 encouraging executive agencies to consider using project labor agreements (PLAs) when they engage in large-scale construction projects. Project labor agreements are pre-hire collective bargaining agreements with one or more labor organizations that establish the terms and conditions of employment for a specific construction project. The use of a project labor agreement can provide structure and stability to large-scale construction projects. PLAs also help ensure compliance with laws and regulations governing safety and health, equal employment opportunity, and labor and employment standards. The coordination achieved through PLAs can significantly enhance the economy and efficiency of Federal construction projects.

Along with assisting the preparation and signing of the EO, the Task Force recognized that it was not enough simply to sign the EO encouraging the use of PLAs; we needed to help promote their appropriate use by agency contracting offices, most of whom had little knowledge of, or experience with, PLAs. To boost implementation of the President's order, the Task Force convened an inter-agency PLA Working Group to provide technical assistance to agencies on PLAs. The working group currently includes the Department of Energy, the Department of Labor, the Department of Commerce, the Department of Justice, the Department of Housing and Urban Development, the Department of Agriculture, the Department of Transportation, the Department of the Interior, the Tennessee Valley Authority, the National Aeronautics and Space Administration, the General Services Administration, and the Office of Management and Budget.

Building on the Department of Energy's successful use of PLAs to effectively coordinate large construction projects, other agencies are investigating the benefits of PLAs, and we expect to see increased utilization of Project Labor Agreements in the future.

As part of the Administration's commitment to protecting workers on government contracts while promoting economy and efficiency in government contracting, the President also signed three other Executive Orders:

> Economy in Government Contracting (EO 13494) requires the Federal Government to remain impartial concerning any labor-management dispute involving government contracts and, to this end, prevents Federal contractors from being reimbursed by the Federal Government for activities undertaken to persuade or influence employees' decisions whether or not to form or

join unions and engage in collective bargaining. However, the Executive Order permits reimbursement for costs related to maintaining satisfactory labor relations between the government contractor and its employees.

Notification of Employee Rights under Federal Labor Laws (EO 13496) requires that Federal contractors post notices of workers' rights under Federal labor laws.

Nondisplacement of Qualified Workers under Service Contracts (EO 13495) provides that, when a Federal service contract expires and the Federal Government awards the follow-on contract to a successor contractor, the employees of the predecessor have a right of first refusal under the new contract for positions for which they are qualified.

Enforcing Labor Standards and Preventing Misclassification

Strong enforcement of employment and labor laws is critical to ensuring that, as the economy begins to recover, the jobs we create are good jobs that can support a middle-class family. If labor standards are not enforced, too many workers will be poorly positioned to improve their economic status. Working men and women in many low-wage jobs will never earn enough to support themselves and their families. Noncompliant employers will be able to avoid responsibility for providing fair wages and safe workplaces by improperly relegating many employees to independent contractor status, which also unfairly puts the vast majority of employers—those who play by the rules—at a competitive disadvantage.

The enforcement agencies at the Department of Labor, including the Wage and Hour Division, the Office of Federal Contract Compliance Programs, the Occupational Safety and Health Administration (OSHA), the Mine Safety and Health Administration, and the Employee Benefits Security Administration, are charged with protecting 135 million workers against these kinds of abuses at more than seven million establishments throughout the United States.

This Administration has worked vigorously to defend and protect workers, beginning by restoring worker protection agencies' enforcement staff to 2001 levels. Significant progress was made in achieving this goal. The proof is in the numbers:

710 new enforcement personnel were hired in worker protection agencies.

OSHA inspected workplaces employing 5.4 million people, provided on-site assistance to over 30,000 small businesses that employ 3.7 million workers, and provided 34,000 individuals with assistance and information. These enforcement activities included over 1,900 inspections of workplaces receiving Recovery Act funding to ensure that workers involved in these projects were adequately protected.

Since the beginning of 2009, the Wage and Hour Division recovered more than $171 million in back wages for approximately 214,000 workers.

The Office of the Solicitor received a jury verdict against one of the nation's largest poultry producers and filed a consent judgment against the nation's largest chicken processing company for violating the Fair Labor Standards Act, resulting in back wage awards.

The Office of Federal Contract Compliance Programs helped recover more than $9 million in back pay for more than 21,000 affected workers.

In addition, the Office of Labor-Management Standards issued a final rule that preserved union members' access to meaningful financial information about their union while eliminating unnecessary paperwork requirements. And the Mine Safety and Health Administration announced a comprehensive strategy to end new cases of black lung among the nation's coal miners.

This year, the Wage and Hour Division will launch a multilingual campaign titled "We Can Help" targeting worker populations and industries in which workers are reluctant to report violations, and OSHA is holding a major worker safety and health summit to address the concerns of vulnerable Latino workers in low-wage, high hazard industries.

Yet there is considerably more that can be done to help workers. The Administration is undertaking efforts that will build on the progress we have already made, including a new focus on misclassification, which has been a key issue for the Task Force. Currently, workers wrongly classified as independent contractors are denied access to critical benefits and protections to which they may be entitled as employees, including overtime, health and workers' compensation coverage, family and medical leave, equal employment protections, safe and healthy workplaces, and unemployment insurance. In addition to denying workers the protections and benefits of the Nation's most important employment laws, misclassification gives unfair advantages in the marketplace to employers who misclassify their workers and generates billions of dollars of losses to the government through unpaid taxes.

An August 2009 Government Accountability Office report noted that the precise extent of misclassification is unknown, but studies suggest that it may affect 10 to 30 percent of firms. A number of recent studies suggest that misclassification—while it occurs in many industries—is most prevalent in several high-risk industries: construction, janitorial, home health care, child care, transportation and warehousing, meat and poultry processing, and other professional and personnel service industries. The construction industry, in particular, is cited in each of the studies as rife with employee misclassification.

As part of the FY 2011 Budget, the Department of Labor will propose legislative changes that will require employers to properly classify their workers, provide for penalties when they do not, and restore protections for employees who have been classified improperly. The Budget also includes $25 million to hire additional enforcement personnel targeted at misclassification and to fund competitive grants to boost states' incentives and capacity to address this problem.

In addition, the Department of the Treasury is seeking legislation to allow it to better define and clarify worker classification standards—which benefits workers and firms by reducing uncertainty—and to prospectively reclassify misclassified workers. The Budget estimates that this would increase Treasury receipts by more than $7 billion over 10 years, much of it consisting of unpaid taxes.

The Departments of the Treasury and Labor will explore avenues of collaboration with respect to worker classification.

Responsible Federal Contracting

The Federal Government spends over half a trillion dollars a year on contracts for goods and services, generating employment for tens of millions of workers. However, there are inadequate controls on the records of firms who get these contracts and on the quality of the jobs these contracts create. Ignoring these factors has negative implications, not only for the workers on these contracts, but for the quality and efficiency of services rendered. For these reasons, the Task Force has participated in a review process to identify ways to reform the procurement process to increase the quality of both the services procured and the jobs created under Federal contracts.

The Task Force recognizes that contracts should not be awarded to irresponsible sources with unsatisfactory records of business ethics, including noncompliance with labor and employment, tax, fraud, and consumer protection laws. We also recognize that substandard wages and benefits can have negative impacts on employees' productivity and stability, which in turn can reduce the quality of performance on Federal contracts.

We expect to produce shortly some new recommendations to bring these ideas into practice.

National Equal Pay Enforcement Task Force

With more women in the labor force than ever before, the earnings of women are essential to the economic well-being of American families. But too often, women are paid less than men for doing the same job. The first bill President Obama signed into law was the Lilly Ledbetter Fair Pay Act, which restores basic protections against pay discrimination for women and other workers.

The Administration will follow through on this commitment to equal pay for men and women by creating an Equal Pay Enforcement Task Force. Responsibility for equal pay enforcement is fragmented across three different agencies with distinct responsibilities and inadequate means for coordinating efforts or limiting potential gaps in enforcement. The Task Force will improve coordination between the Departments of Justice and Labor and the Equal Employment Opportunity Commission with the goal of ensuring that all applicable equal pay laws are vigorously enforced throughout the country. The Task Force will conduct an inter-agency review of existing regulations, reporting requirements, and administrative practices that relate to equal pay, and will recommend modifications to improve compliance. It will also conduct a public education campaign to educate employers and employees about their rights.

Employee Free Choice Act

As noted in the introduction to this report, both the President and Vice President have consistently voiced support for collective bargaining and unions, viewing them as central to building America's middle class. Many of the Task Force's events and activities, from helping to pass executive orders that promote labor fairness, to joining with Labor Secretary Solis to elevate the role of union apprenticeship programs in green job training, have stressed the positive role unions can play in supporting middle-class jobs and incomes.

It is, however, the case that union membership has fallen in recent decades from about 25% in the early 1970s to about half of that today.[24] Part of the explanation for this trend is that the industrial mix of jobs in our economy has changed over the past few decades, as jobs have shifted from traditionally unionized sectors, like manufacturing, to less unionized service sectors. But this compositional shift explains only a small share of decline in unionism. The main reason is that fewer workers within any given industry have joined unions.

One might think that this represents a benign shift in American workers' sentiments about unions—perhaps in a more global economy with fewer jobs in heavy industry, people no longer view unions as relevant institutions. But the evidence belies that view. Noted Harvard labor economist Richard Freeman reports that "[t]he proportion of workers who want unions has risen substantially over the last 10 years, and a majority of nonunion workers in 2005 would vote for union representation if they could."[25]

One reason there is less collective bargaining in our workforce than workers desire is that the organizing playing field is far from level. Of course, not all employers oppose union organizing campaigns. Those who do, however, are able to block the wishes of their employees with relative impunity as the current system makes it much easier for them to prevent their employees from forming or joining a union than for workers to exercise their legal right to do so.

The Administration has supported the Employee Free Choice Act (EFCA) as a way to rebalance the union organizing playing field. In our policy work and events, as well as in various statements by the Vice President, the Task Force has consistently stressed the importance of EFCA as well. This support stems from our diagnosis that one underappreciated reason for the negative trends portrayed in our economic analysis of middle-class families is the loss of worker bargaining power. While raising the unionized share of the workforce would not close the gap between income and productivity, it would help to provide low- and middle-income workers with some of the clout they need to claim a fairer share of the fruits of their labors.

The Employee Free Choice Act would institute three basic changes designed to make the organizing process more equitable. It would allow workers to choose to organize either through a balloting process or through a "majority sign-up" process in which a majority of workers signs cards stating their desire to form a union, whereas the current system lets employers refuse to voluntarily recognize such a majority sign-up. EFCA would also prevent employers from stalling on the first contract, and it would increase penalties against employers who illegally block organizing drives.

Over the course of this year, the Task Force will continue to promote the benefits of union membership and to amplify the President's message of the importance of EFCA as a way to guarantee workers who want to organize a fair chance to do so.

[24] Bureau of Labor Statistics. In 2009, total union membership was about 12% of the wage and salary workforce; private-sector membership was about 7% and public-sector membership was about 37%.

[25] Richard B. Freeman, "Do Workers Still Want Unions? More Than Ever," Economic Policy Institute, February 2007, http://www.sharedprosperity.org/bp182/bp182.pdf

III. Retirement Security

In the wake of the stock market crash and the credit crisis, many middle-class workers are feeling more anxiety about their retirement security than ever before. Many workers saw their 401(k)s lose 30 or 40 percent of their value; workers who are nearing retirement are now facing the prospect of living on significantly less than they had planned. This decline in the value of financial assets has been coupled with an equally dramatic decline in home prices across America, which has further diminished workers' retirement security by eroding the value of the largest single investment for many middle-class families. Household net worth plummeted by over $16 trillion from 2007 through the first quarter of 2009, and while it has since stabilized and begun to recover, households remain far less wealthy and less secure than they appeared in the first half of this decade.[26]

But while the recent financial crisis has raised awareness of this issue and increased the urgency of the need to address it, the problem itself is not new. Many workers, especially low- and middle-income workers, have long lacked access to quality workplace retirement plans, and some of those who do have access to retirement plans save too little or do not participate at all. And the gradual shift from defined-benefit pensions to 401(k)s and other defined-contribution retirement plans, which has been taking place for decades, has left more workers than ever before to plan their retirements for themselves and to bear the risk of investing for retirement alone. Many of these workers, even those who save at recommended rates over long periods, have seen the returns on their retirement savings eaten away by high fees and expenses, leaving them with less than they had hoped for.

This Administration recognizes that the current system does not provide sufficient retirement security for millions of Americans, which is why we are proposing a set of initiatives to help more workers save for retirement, to help those who already have retirement accounts start saving more, and to help workers with 401(k)s save with confidence.

Establishing Automatic IRAs

Many workers had saved too little for retirement even before being hit by steep drops in asset prices, in large part because too many workers in America have no access to a retirement plan at work. Workers with access to a 401(k) or other pension plans fared relatively well prior to the crash, but just 60 percent of working heads of families were eligible to participate in any type of job-related pension or retirement plan in 2007. Even among those who were eligible, more than 15 percent did not participate in the plan, leaving roughly half of the workforce—78 million working Americans—with no employer-based retirement plan.[27]

Furthermore, there are significant disparities in participation in retirement plans among workers of different income levels. Those at the top end of the income scale almost universally choose to participate in workplace retirement programs; meanwhile, of those who have access to a retirement plan at work,

[26] "Flow of Funds Accounts of the United States," The Federal Reserve, December 2009, http://www.federalreserve.gov/releases/z1/current/z1.pdf.

[27] Brian K. Bucks, et al, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, February 2009, http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf

one in five families headed by a worker in the middle fifth of the income scale do not participate. The situation is much worse still for workers in the bottom fifth of the income scale, where among the subset of workers who have access to a retirement plan, half of families do not participate.[28]

The Administration recognizes that inadequate access to retirement savings plans is threatening the retirement security of workers, which is why we have proposed to lay the groundwork for a system of automatic Individual Retirement Accounts (IRAs) in the workplace. This system will require employers who do not currently offer a retirement plan to enroll their employees in a payroll-deduction IRA, providing a valuable new way to save for many workers. This proposal will allow workers to voluntarily opt out of these automatic contributions, but including nearly all workers in this system by default will make it dramatically easier to save for the nearly half of the workforce that currently has no access to an employer-based retirement plan. Small businesses will receive tax breaks to help them establish these arrangements and the smallest businesses (those with no more than ten employees) will be exempt from these requirements.

Simplifying and Expanding the Saver's Credit

Even among those who already have retirement accounts, it is not always easy for workers to save enough to provide themselves with the retirement they deserve. Even when combined with Social Security, many workers' account balances at retirement are not enough to provide a comfortable income.

To help address this issue, we have proposed to help families save for retirement by simplifying and expanding the Saver's Credit, a tax credit that provides a government match for workers' contributions to retirement savings plans. The expanded Saver's Credit will match 50 percent of the first $1,000 of contributions ($500 for an individual and $500 per spouse in the case of a married couple filing jointly) to retirement plans by families earning up to $65,000, and provide a partial credit to families earning up to $85,000.

While the credit was previously targeted more to lower-income savers, this expansion will make many more middle-class families eligible for the credit. At the same time, we are proposing to make the credit fully refundable, allowing lower-income savers to take full advantage of the credit for the first time. The Saver's Credit will also work together with our automatic IRA proposal, encouraging workers to participate in the retirement savings system for the first time by matching the retirement savings of the lower-income workers who currently lack workplace retirement plans.

Together, these two policies will help middle-class families build up the nest eggs they need to provide themselves with a secure retirement, while helping lower-income families start to build up crucial savings that will help them rise into, and remain part of, the American middle class.

[28] Ibid.

Updating 401(k) Regulations to Improve Transparency and Reliability

The proposals above are significant legislative steps, and this Administration will continue to work with Congress to make these proposals law because we believe they are crucial to strengthening the retirement security of American workers. These policies will help more workers to save, and will help those who already have retirement accounts to save more, but even workers who are saving enough may see their returns diminished by high fees and expenses. A majority of American workers with retirement plans rely on 401(k)-style defined-contribution plans, making it critical that the 401(k) system be safe, transparent, and well-regulated.[29]

We need to do more to give families better choices to reach a secure retirement. To ensure that workers have good options to save for retirement, and to provide workers with all the information they need to make the best choices about their retirement savings, the Administration is improving the regulation of 401(k)s to make the system more reliable and transparent. These regulatory actions include:

Improving the transparency of 401(k) fees to help workers and plan sponsors make sure they are getting investment, record-keeping, and other services at a fair price.

Encouraging plan sponsors to make unbiased investment advice available to workers, helping workers avoid common errors that undermine retirement security, while providing strong protections against conflicts of interest.

Promoting the availability of guaranteed lifetime income products, which transform at least a portion of retirees' savings into guaranteed future income, reducing the risks that retirees will outlive their savings or that their living standards will be eroded by investment losses or inflation.

Reviewing and requiring clear disclosure regarding target-date funds, which automatically shift assets among a mix of stocks, bonds, and other investments over the course of an individual's lifetime. Due to their rapidly growing popularity, these funds should be closely reviewed to help ensure that employers that offer them as part of 401(k) plans can better evaluate their suitability for their workforce and that workers have access to good choices in saving for retirement and receive clear disclosures about the risk of loss.

Administrative Actions to Improve Retirement Security

In addition to the proposals discussed above, this Administration has already taken smaller steps to strengthen retirement security through direct administrative actions. President Obama has already announced, and this Administration has begun to implement, a series of common-sense measures to help workers save for retirement. These include:

Making it easier for small businesses to help their employees save by automatically enrolling their workers in a 401(k) or a "SIMPLE" individual retirement account plan.

[29] "Defined Contribution Plans More Common Than Defined-Benefit Plans," U. S. Bureau of Labor Statistics, March 2009, http://www.bls.gov/opub/perspectives/issue3.pdf

Making it easier for people to save their Federal tax refunds by letting them choose to receive their refund as a savings bond that can be deposited into IRAs or bank accounts.

Making it possible for employers to allow workers to put payments for unused vacation and sick days in to their retirement plans, an option that is not currently available to most workers.

Making it easier for people to understand their options for retirement saving with the help of an easy-to-follow guide and website created by the IRS and the Treasury. So that complicated rules will not discourage workers from saving, so we need to simplify and clarify rules and instructions, especially for workers changing jobs who are often unsure of their options for managing their existing 401(k) or other retirement funds and continuing to save for retirement.

Another Option: Safe Investment Choices

The proposals above are designed to encourage workers, especially low- and middle-income workers, to save more for retirement. This is a critical goal, and will have an especially pronounced impact on the half of the workforce that currently has no access to a retirement plan at work. But the problems workers are now facing go beyond the fact that many workers save too little for retirement. Even for workers who save at recommended rates for their entire lives, the possibility of a market crash always poses a serious risk, as the recent financial crisis has tragically illustrated.

All workers, no matter their level of financial sophistication, should have access to well-diversified low-cost investment options. They should also have an easy way to put a portion of their savings in a safe, inflation-protected investment choice. While Treasury Inflation-Protected Securities (TIPS) and I Savings Bonds offer this kind of protection today, many investors are unfamiliar with them or lack an easy way to access these options in their retirement accounts. To address this, some have suggested the creation of Guaranteed Retirement Accounts (GRAs), which would give workers a simple way to invest a portion of their retirement savings in an account that was free of inflation and market risk, and in some versions under discussion, would guarantee a specified real return above the rate of inflation. These accounts would allow workers to be sure that the funds invested in them will grow steadily without the risk of a market collapse.

GRAs would not replace Social Security, which provides and will continue to provide a dependable retirement income on which tens of millions of Americans rely, and most workers will want to continue to have a mix of assets with different risk and return profiles in their overall retirement portfolios. But in combination with the proposals above, increased access to safe investment options may provide a more secure retirement for American workers. The Task Force recommends further study of these issues.

IV. Balancing Work and Family Responsibilities

The American workforce looks very different than it did two decades ago—two-income families are the norm, older workers are staying in the workforce longer, and men and women are more evenly sharing caregiving responsibilities—but the workplace has, for the most part, not changed to reflect these realities. For the majority of middle-class families, it is no longer the case that one parent is the breadwinner while the other is the caregiver. The economic stability of middle-class families depends at least in part on policies that help families balance work and caregiving obligations so that adults do not need to step away from the workforce to care for children or elderly parents or to update their own training, certifications, or skills.

The shift to two-income families has been accelerated by this recession, in which male-dominated industries have been hit particularly hard. Women make up nearly half of all workers on US payrolls, and two-thirds of families with children are headed either by two working parents or by a single parent who works.[30] In addition, older workers are forgoing retirement and working longer, a trend that began in the last expansion and has continued through the downturn.[31] These changes are unlikely to go away as the economy recovers. As economist Heather Boushey said at our November Task Force meeting, "Taking seriously the challenges facing middle-class families means taking a long, hard look at the reality of their day-to-day lives—the dual-earner families, the single-parent families and the one-in-five traditional families—and adapting to this reality by ensuring that every worker can be a good family caregiver, as well as a good employee."

Child Care

In 1970, 30 percent of married women with children under the age of six were in the labor force.[32] By 2007, more than 60 percent of these moms were in the labor force.[33] The employment rate for single moms has similarly skyrocketed. Child care is more important than ever—and it is very expensive. Since 2000, child-care costs have grown significantly faster than inflation and twice as fast as the median

[30] "Families with own children: Employment status of parents by age of youngest child and family type," Bureau of Labor Statistics, http://www.bls.gov/news.release/famee.t04.htm.

[31] Peter R. Orszag, "Why Are Older Workers Working Longer," September 2009, http://www.whitehouse.gov/omb/blog/09/09/25/WhyAreOlderWorkersWorkingLonger/.

[32] The 2007 Statistical Abstract: Table 584," Census Bureau, http://www.census.gov/compendia/statab/2007/labor_force_employment_earnings/labor_force_status.html.

[33] "Women in the Labor Force: A Databook (2009 Edition)," Bureau of Labor Statistics, http://www.bls.gov/cps/wlftable6.htm

household income.[34] The average annual cost of full-time center-based care for an infant ranges from $4,560 in Mississippi to $15,895 in Massachusetts. More than 126 million Americans live in states where the price exceeds $10,000. The average cost of care for a four year old ranges from $4,055 to $11,680 a year.[35]

Home-based care is slightly less expensive but still costs more than $5,000 per year for a four year old, and even more for an infant, in nearly 40 states. And the expenses do not end when children reach school age; before- and after-school care costs more than $4,000 a year in the majority of states where that data is available.[36]

To put those costs into perspective, in every region of the country, the average price of child care for one infant exceeds average annual expenditures on food. In 39 states and the District of Columbia, child-care center fees for an infant are higher than a year's tuition at a four-year public college. And in every state, monthly child-care fees for two children at any age are higher than the median cost of rent.[37]

Expanding the Child and Dependent Care Tax Credit

While the cost of child care has skyrocketed, the Child and Dependent Care Tax Credit has only increased once in 28 years and is not indexed for inflation. For families with incomes above $43,000, the credit covers 20 percent of qualifying child-care expenses, up to $3,000 in expenses for one child and $6,000 in expenses for families with two or more children. This results in a maximum credit of $600 per child and $1,200 per family. The credit also applies to expenses incurred for the care of a spouse or dependent with a disability.

We should be providing more financial assistance to families who must put their kids in child care so they can work. The Task Force led a policy process aimed at restructuring the Child and Dependent Care Tax Credit to deliver significantly more help to middle-class families. As a result, the Budget includes a $900 increase in the maximum credit available to many middle-class families. Currently, families with incomes below $15,000 are eligible for a 35 percent credit, which phases down to 20 percent for all families above $43,000. Under our proposal, all families with incomes up to $85,000 would get a 35 percent credit on their expenses. The credit rate would phase down slowly so that nearly all families with incomes below $115,000 would receive a larger credit than they do under the current structure.

Increasing Child Care Assistance to Low-Income Working Families

Many working parents simply cannot lift their families into the middle class without child-care assistance. The Administration recognizes the connection between child care and economic mobility. The Recovery Act provided $2 billion for the Child Care and Development Fund to provide child-care assistance to

[34] Bureau of Labor Statistics, Consumer Price Index, www.bls.gov. Census Bureau, Historical Income Tables, http://www.census.gov/hhes/www/income/histinc/inchhtoc.html.

[35] "2008 Price of Child Care," National Association of Child Care Resource and Referral Agencies, http://www.naccrra.org/randd/docs/2008_Price_of_Child_Care.pdf.

[36] Ibid.

[37] "Parents and the High Price of Child Care: 2009 Update," National Association of Child Care Resource and Referral Agencies, http://issuu.com/naccrra/docs/parents-and-the-high-price-of-child-care-2009?mode=embed&layout=white.

low-income families and improve the quality of this care. The Budget builds on this important investment by providing a $1.6 billion increase in funding that will fund services for approximately 235,000 children and support an improvement in quality, safety and outcomes through a reauthorization of the Child Care and Development Fund.

The Recovery Act also included $1 billion in additional funding for Head Start and $1.1 billion for Early Head Start. These programs promote healthy child development and school readiness for children from low-income families. The Recovery Act funds will allow both programs to serve more children, will improve staff training, and will allow for Head Start centers and classrooms to be upgraded. The Budget continues the Recovery Act expansions while adding new funds focused on lifting program outcomes.

Early Learning Challenge Fund

The Administration's interest in helping families with children in early learning and care arrangements outside the home goes beyond increasing affordability. The quality of early-learning programs varies widely. The President has proposed a $9.3 billion Early Learning Challenge Fund to raise the bar and ensure that more children are ready to succeed when they start school. This competitive grant program will drive states to develop models of coordinated early-learning systems that promote high standards of quality and a focus on outcomes. The House of Representatives passed the President's proposal in September and the Administration is working closely with the Senate to ensure that this initiative becomes law.

Supporting Family Caregivers

AARP and the National Alliance for Caregiving estimate that 65 million Americans provide unpaid care to seniors or people with disabilities.[38] Caring for an elderly person is difficult enough, but many caregivers are part of the "sandwich generation"—they must care for their children and their aging parents at the same time. Nearly one-third of those caring for someone over the age of 50 have their own children at home.[39] Many caregivers struggle to balance work with their family obligations—nearly 60 percent of caregivers work full or part-time and two-thirds of these working caregivers say they have had to go in late, leave early, or take time off as a result of their caregiving responsibilities.[40]

To ease the burden on families with elder care responsibilities and improve the quality of life for seniors, the Task Force worked with the Department of Health and Human Services to develop a new Caregiver Initiative in the FY 2011 Budget. The Caregiver Initiative provides a total of $50 million in additional funding for the National Family Caregiver Support Program and the Native American Caregiver Support Program. These programs provide temporary respite care, counseling, and training, and help with retro

[38] "Caregiving in the U.S.: Executive Summary," AARP and National Alliance for Caregiving, November 2009, http://www.caregiving.org/data/CaregivingUSAllAgesExecSum.pdf.

[39] "Caregiving in the U.S.: A Focused Look at Those Caring for the 50+," AARP and National Alliance for Caregiving, November 2009, http://www.caregiving.org/data/FINALRegularExSum50plus.pdf.

[40] "Caregiving in the U.S.: Executive Summary," AARP and National Alliance for Caregiving, November 2009, http://www.caregiving.org/data/CaregivingUSAllAgesExecSum.pdf

fitting homes to accommodate the needs of aging relatives. They also link caregivers with information and referrals to other supports. The extra funding will allow nearly 200,000 additional caregivers to be served and three million more hours of respite care to be provided.

The Caregiver Initiative also adds $50 million in funding to programs that provide transportation assistance for medical and other appointments, adult day care, and in-home services, such as aides to help seniors bathe, cook and clean. The new resources will support one million additional hours of adult day care and three million rides to critical daily activities. All of the programs boosted by the Caregiver Initiative are administered through the successful network of local aging agencies across the country, which are already providing critical help to seniors and caregivers, but whose strained resources limit their reach. Just ask Mary Lynn, a social worker from North Carolina, who wrote in to the Task Force website to tell us that there are not enough resources to provide needed respite care to the family caregivers she works with, and to ask whether we could help.

This initiative is not exclusively focused on caregivers of the elderly. The Lifespan Respite Care Program, which will double in size, is designed to help families caring for people of all ages with disabilities. The National Family Caregiver Support Program is primarily focused on caregivers of seniors, but it also provides assistance to people over the age of 55 who are taking care of younger relatives with disabilities. Many of the workplace flexibility initiatives that we discuss below will also provide support for people with disabilities, and the Task Force will continue to explore ways to support people with disabilities and their families.

Idea for Further Consideration: More Financial Assistance for Caregivers

Going forward, the Task Force believes that we should study additional options for easing the financial burden of caregiving. Many caregivers spend thousands of dollars a year out of their own pocket.[41] According to survey data, only 20 percent of care recipients over the age of 50 live with their caregiver.[42] Yet the Child and Dependent Care Tax Credit provides no break for out-of-pocket caregiving expenses paid on behalf of an elderly relative who does not live in the taxpayer's home. We should consider modifying this credit to cover taxpayers who do not live with their elderly parents or grandparents. But even an expanded Dependent Care Credit would not defray many of the costs that caregivers face. We should also study proposals for a new tax credit—not tied to any particular expenses—for the primary caregivers of people with long-term care needs.

It is also important to note that, as more families depend at least in part on paid caregivers, the Task Force believes these should be good jobs, so that these workers can support their own families and provide high quality care to our children and parents.

[41] "Family Caregivers—What they Spend, What they Sacrifice," National Alliance for Caregiving and Evercare, November 2007, http://www.caregiving.org/data/Evercare_NAC_CaregiverCostStudyFINAL20111907.pdf

[42] "Caregiving in the U.S.: Executive Summary," AARP and National Alliance for Caregiving, November 2009, http://www.caregiving.org/data/CaregivingUSAllAgesExecSum.pdf

More Flexible Workplaces

Expand paid leave

The United States is one of the only industrialized countries without any requirement that employers provide paid family leave.[43] Workers covered by the Family and Medical Leave Act can take up to 12 weeks of unpaid time off annually without losing their jobs, but millions of families cannot afford to use unpaid leave. A handful of states have enacted policies to offer paid family leave, but more states should have that chance. The Budget establishes a $50 million State Paid Leave Fund within the Department of Labor that will provide competitive grants to states to plan and establish paid-leave programs.

Roughly 40 percent of private-sector employees work at a company that does not offer sick pay for their own illness or injury. And low- and middle-income workers are much less likely to be offered paid sick leave than highly paid workers.[44] In November, the Administration announced its support for the Healthy Families Act. This legislation would allow millions of working Americans to earn up to 56 hours per year of paid sick time, which they could use to care for themselves or for a sick family member. Providing job security and a short-term continuation of income when a worker must take time off to get well or provide care to a family member is an important step in meeting the needs of modern working families.

Conduct Research and Disseminate Data on Work/Life Policies and Flexible Work Arrangements

It is imperative that we expand our understanding of work/life policies and their impact on the labor market—both to learn more about key issues for working families and learn more about the impact of these policies on the performance of the labor market. In the coming year, the Department of Labor will enhance its data collection and analysis around issues like parental leave, child-care responsibilities, usage of family leave insurance programs, and other topics related to the intersection of work and family responsibilities. The Budget provides additional funding to the Women's Bureau at the Department of Labor to support this effort.

Idea for Further Consideration: Modernize the Family and Medical Leave Act

The Family and Medical Leave Act (FMLA) provides for up to 12 weeks of unpaid leave. It applies to employers with 50 or more employees and protects workers who have worked at least 1,250 hours over the past 12 months. It was an important first step in providing economic security to dual-income, dual-caregiving parents or single parents, but more is needed.

In October, the President signed legislation expanding FMLA coverage for military families. In December, the President signed legislation that will make flight attendants and crewmembers eligible for FMLA for the first time. These changes will make a huge difference for the families that are impacted, but there is much more that needs to be done. More than 40 percent of American workers are in firms that are not covered by the Act. And millions of workers at businesses covered by the Act are not eligible for its protections because they do not work enough hours or have worked for their employer for less than a

[43] Ann O'Leary and Karen Kornbluh, "Family Friendly for All Families," in "The Shriver Report: A Woman's Nation Changes Everything," 2009, http://www.awomansnation.com/government.php.

[44] Bureau of Labor Statistics, National Compensation Survey, http://www.bls.gov/news.release/ebs2.t06.htm

year.[45] The Task Force believes that we should consider extending FMLA to employers with 25 or more employees. In addition, the Task Force recommends that the Administration explore the possibility of expanding the activities and circumstances that are covered by FMLA protections.

Idea for Further Consideration: Make the Federal Government a Model Employer

The Task Force also recommends gathering data on flexible work arrangements in the Federal workforce and considering piloting a variety of best practices from the private sector in the Federal workforce, including enhanced telework options, results-based management systems that improve productivity and encourage flexibility, and a "right to request" process for flexible work arrangements for Federal workers. Policies like these have the potential not only to help middle-class families balance their work and family responsibilities, but also to enhance the efficiency and competitiveness of the Federal workforce.

An Administration-Wide Commitment

The Task Force is not the only entity focused on helping families balance work and caregiving obligations. In March, President Obama signed an executive order creating the White House Council on Women and Girls. Like the Task Force, the Council is based in the White House, but brings together the best minds from across the Administration to address pressing problems. One of the Council's specific areas of focus is working closely with each agency to ensure that the Administration evaluates and develops policies that support a balance between work and family responsibilities. When he announced the Council, the President noted that "issues like equal pay, family leave, child care and others are not just women's issues; they are family issues and economic issues. Our progress in these areas is an important measure of whether we are truly fulfilling the promise of our democracy for all our people."[46]

[45] "Use of the FMLA," U.S. Department of Labor, http://www.dol.gov/asp/archive/reports/fmla/chapter3.htm.

[46] "President Obama Announces White House Council on Women and Girls," http://www.whitehouse.gov/the_press_office/President-Obama-Announces-White-House-Council-on-Women-and-Girls/

V. Pathways to the Middle Class

Making Higher Education A ordable and Accessible

It has long been one of the core aspirations of middle-class families to provide their children with the opportunity to get a college education. Postsecondary education is strongly linked to higher earnings and greater economic mobility, offering one of the most reliable routes to a good career while providing a critical pathway into the middle class for children from lower-income families.[47] For many middle-class parents, higher education means the chance for their children to realize their full potential and represents the hope that their children will do even better than they did themselves.

Unfortunately, the cost of college has risen rapidly while the income of typical American families has stagnated in recent years, making it increasingly difficult for working- and middle-class families to afford college and leading more and more students to take on significant debt to pay for higher education.

The Task Force heard about these challenges first-hand at the two events on college affordability that we held over the course of the past year. The first event was held on April 17 at the University of Missouri-St. Louis, and in September, the Task Force traveled to Syracuse University for our second meeting on this topic. At these two events, the Vice President and members of the Task Force, including Secretary of Education Arne Duncan and Secretary of the Treasury Timothy Geithner, heard from students, parents, faculty, and administrators in open, town hall-style question-and-answer sessions. We got a variety of feedback at these sessions, but one message we heard over and over again was that while postsecondary education remains as important as ever, middle-class families are finding it harder and harder to afford a college education.

The magnitude of this problem is striking: growth in the cost of college has dramatically outpaced the growth of middle-class incomes. Since the 1979-80 academic year, the inflation-adjusted value of the average published college tuition has shot up from $2,174 to $7,020 for public four-year colleges and from $9,501 to $26,273 for private four-year colleges.[48] Family incomes, by contrast, have stagnated, as documented above. From 1979 to 2008, the real median income of American families with children grew just 7.6 percent, from $55,830 to $60,055.[49]

These figures translate into a 0.25 percent annual growth rate in median family income over the past three decades, compared to an annual growth rate of 3.98 percent for public four-year colleges and 3.45 percent for private four-year institutions over that same time span. In other words, college tuition costs

[47] See "Barriers to Higher Education," Middle Class Task Force, http://www.whitehouse.gov/assets/documents/MCTF_staff_report_barriers_to_college_FINAL.pdf

[48] "Trends in College Pricing: 2009," The College Board, 2009, http://www.trends-collegeboard.com/college_pricing/1_4_over_time_constant_dollars.html?expandable=0.

[49] United States Census Bureau, http://www.census.gov/hhes/www/income/histinc/incfamdet.html

have grown over ten times as fast as real median incomes for families with children. This trend is partially offset by increasing levels of financial aid; most students are aided by various grants and adjustments, bringing the average actual cost paid by students for college in 2009-10 to $1,620 for public four-year institutions and $11,870 for private four-year institutions.[50] This expansion of financial aid is a significant and positive development, but despite the growing generosity of aid, families are finding it harder to afford college as prices continue to rise and their incomes fail to keep pace.

Vice President Joe Biden and members of the Middle Class Task Force at a Task Force meeting on higher education in St. Louis, Missouri. Official White House Photograph by David Lienemann.

One reflection of the persistent difficulties that families are having in paying for college is the rising debt load with which students leave college. About two-thirds of students now take out loans to pay for college, and the average debt of a college graduate is now more than $23,000.[51] Like tuition, the size of these student loans is growing significantly faster than middle-class incomes, placing increasingly heavy burdens on students and their families.

[50] "Trends in College Pricing: 2009," The College Board, 2009, http://www.trends-collegeboard.com/college_pricing/3_1_net_prices.html?expandable=0.

[51] "Student Debt and the Class of 2008," Project on Student Debt, December 2009, http://www.projectonstudentdebt.org/files/pub/classof2008.pdf.

Partly because of these difficulties paying for college, middle-income children are not only less likely to enroll in college than their high-income peers, they are less likely to complete college once enrolled. High school graduates from middle-income families are significantly less likely to enroll in two- or four-year colleges than children from high-income families.[52] In addition, middle-income children are about half as likely to complete college as wealthier children, with a 25 percent college completion rate, compared to 53 percent for children from families in the top income fifth.[53] These income effects can be seen even among students with comparable merit or academic ability; about 30 percent of high-ability eight-graders from low-socioeconomic status families eventually completed college, which is similar to the share of their high-socioeconomic status peers with unusually low scores on ability tests.[54]

These problems are compounded in the case of lower-income children and families by additional nonfinancial barriers. Low-income students often do not have access to information and networks that would encourage them to attend college, help them find good, affordable colleges and universities, or alert them to the availability of financial aid.

For low- and middle-income families, these financial and nonfinancial barriers to college are deeply troubling because college is such a critical pathway to a good career. The returns to higher education are not only high, they are growing; in 1973, a college graduate earned 46 percent more per hour than a high school graduate, and by 2007, this difference had grown to 77 percent.[55]

The benefits of college are perhaps even more striking for low-income individuals, as college is strongly linked to upward mobility. Among children who grew up in low-income families, those who did not graduate from college were almost three times more likely to remain in the bottom fifth of the income scale than were low-income children who went on to complete college.[56] Even among middle-income children, higher education is linked to upward mobility; those with college educations are significantly more likely to move toward the top of the income scale than their peers without college educations.

These statistics all underscore a critical point, which families across America already understand: higher education is not just a core component of the American dream and a widespread aspiration of middle-class families, it is the single best route to a good career for children from all backgrounds and a crucial pathway for low-income children to reach the middle class for the first time. Access to college is critically important for American families, and it is our responsibility to ensure that if a qualified student wants to attend college, he or she can, regardless of income or background.

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[52] U.S. Department of Education, Institute of Education Sciences, http://nces.ed.gov/programs/coe/2009/section3/table-trc-1.asp

[53] Ron Haskins, Harry Holzer, and Robert Lerman, "Promoting Economic Mobility by Increasing Postsecondary Education," Pew Economic Mobility Project, 2009, http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/PEW_EM_Haskins%207.pdf

[54] Mary Ann Fox, Brooke A. Connolly, and Thomas Snyder, "Youth Indicators 2005: Trends in the Well-Being of American Youth," National Center for Education Statistics, Institute of Education Sciences, U.S. Department of Education, July 2005, http://nces.ed.gov/pubs2005/2005050.pdf. The socioeconomic status was measured with a composite score, based on family income as well as on the parents' education levels and on the occupations in which the parents worked.

[55] See "Financing the Dream: Securing College Affordability for the Middle Class," Middle Class Task Force Staff Report, http://www.whitehouse.gov/assets/documents/staff_report_college_affordability1.pdf.

[56] Lawrence Mishel, Jared Bernstein, and Heidi Shierholz. The State of Working America 2008/2009. And Economic Policy Institute Book. Ithaca, N.Y.: ILR Press, an imprint of Cornell University Press (2009).

Reforming Student Aid and Restoring American Leadership in Higher Education

To compete in the global economy and build a strong foundation for future economic growth, America must have a highly skilled and educated workforce. That is why the President has set a goal that by 2020, America will once again have the highest proportion of college graduates in the world. This Administration's commitment to expanding educational opportunity is reflected in the Recovery Act and in the comprehensive plan that the President has laid out to reform student aid and restore America's leadership in higher education. The Administration is currently working with Congress to make each element of the President's plan a reality.

Capping Student Loan Payments. Last July, the Department of Education launched the Income-Based Repayment (IBR) plan for Federal student loans. This repayment option protects borrowers by linking payments to their income and family size, so that those with a high debt-to-income ratio will have lower payments than they would under the standard repayment plan.[57]

Right now, the annual repayment amount for IBR participants is capped at 15 percent of the difference between the borrower's income and 150 percent of the poverty line for the borrower's family size. A borrower is eligible for IBR if this calculation produces a lower repayment amount than the borrower would owe under the standard ten-year repayment plan. If the borrower still has a remaining balance after making payments under IBR for 25 years, the debt is forgiven. For borrowers working continuously in a public-service job, the remaining debt is forgiven after only 10 years.

The Task Force has advocated for an expansion of the Income-Based Repayment plan to provide more relief from crushing debt burdens. The President's FY 2011 Budget includes a proposal to make IBR more generous, so that borrowers would have to pay only 10 percent of their income above 150 percent of the poverty line, and their remaining debt would be forgiven after only 20 years of IBR payments. Borrowers in public-service jobs would have their debt forgiven after 10 years. This proposal would significantly reduce monthly payments for eligible borrowers; the monthly payment for a single borrower earning $30,000 who owes $20,000 in loans would be $115 a month, compared to $228 a month under the standard ten-year repayment plan.

At our Task Force meeting in St. Louis, Missouri, we heard from a mother whose daughter was struggling after graduating from college with $60,000 in student loans and taking a job as a teacher. This proposal will help with the staggering burden of student loan debt and allow a generation of young adults to enter public service and other careers with historically low pay.

Student Loan Reform. The Administration is proposing to make student loans more reliable and cost-effective by shifting all loans to the Direct Loan program. Right now, Federal loans are processed and delivered through either the Federal Family Education Loan (FFEL) program or through the Direct Loan program. In the FFEL program, private student lenders get excessive entitlement subsidies at

[57] For more information about the Income-Based Repayment Plan, see http://studentaid.ed.gov/students/attachments/siteresources/IBRQ&A_template_123109_FINAL.pdf. The Department of Education has developed an online Income-Based Repayment eligibility calculator that can be found at http://studentaid.ed.gov/PORTALSWebApp/students/english/IBRCalc.jsp

levels set by Congress. In the Direct Loan program, the Federal Government provides the capital for all new student loans, and contracts with private companies to manage and collect on those loans in a competitive process that rewards good performance. Shifting all loans to the Direct Loan program will eliminate FFEL subsidies on new student loans and generate billions of dollars in savings that can be used to expand Pell Grants and make historic investments in community colleges.

The shift to Direct Loans will not only save money, it will make Federal student loans more reliable. Lenders are more interested in their short-term bottom line than in the long-term ability of the FFEL program to guarantee that every eligible student seeking a loan will receive one. The FFEL program was rocked by the turmoil in our financial markets and might have collapsed were it not for Congressional intervention. The Direct Loan program suffered no disruptions.

Larger Pell Grants. The Recovery Act provided more than $17 billion in additional Pell Grant funds for needy students, and the combination of the Recovery Act and the 2009 appropriations bill increased the maximum Pell Grant by more than $600, for a total award of $5,350.[58] For the 2010-2011 academic year, the maximum Pell Grant award will increase to $5,550. The Administration is proposing to build on these increases by making Pell Grant funding mandatory, rather than partially dependent on annual appropriations from Congress, and by guaranteeing that Pell Grants, which are worth less than half as much as they were 30 years ago, grow faster than inflation in the future.

The American Opportunity Tax Credit. The Recovery Act created a new American Opportunity Tax Credit, which is worth up to $2,500 per year and can be claimed against tuition, fees and textbook expenses for 4 years of college. The full credit is available to families making up to $160,000, and is partially refundable so that working-class and low-income families can benefit.[59] The Administration is now working to make this temporary credit permanent.

Expanding the Work-Study Program. The Recovery Act provided an additional $200 million in funding to the Federal Work-Study program, which allows colleges and universities to provide jobs that help students with their expenses.[60]

Expansion of Low-Interest Perkins Loans. The Administration has proposed a dramatic increase in the availability of Perkins Loans. Perkins Loans, which carry an interest rate of only 5 percent, help fill the gap for students who still have unmet financial need after other Federal student loans are taken into account. The Administration's plan would make Perkins Loans available to 2.4 million students each year.

Simplifying the Federal Student Aid Application. The historic increases in Federal student aid outlined above will only achieve their desired result if students know they are available and are not deterred by the application process. Unfortunately, the application for Federal student aid—known as the Free

[58] "The American Recovery and Reinvestment Act of 2009: Saving and Creating Jobs and Reforming Education," March 2009, http://www.ed.gov/policy/gen/leg/recovery/implementation.html.

[59] More information on the American Opportunity Tax Credit is available at http://www.irs.gov/newsroom/article/0,,id=205674,00.html

[60] "The American Recovery and Reinvestment Act of 2009: Saving and Creating Jobs and Reforming Education," March 2009, http://www2.ed.gov/policy/gen/leg/recovery/implementation.html

Application for Federal Student Aid, or FAFSA—is needlessly long and complex. According to a National Economic Council and Council of Economic Advisers report that was released and discussed at our Task Force meeting at Syracuse University, the FAFSA acts as a barrier to college access for many students and their families, and can be simplified with little or no impact on aid eligibility or the amount of aid granted for the vast majority of students.[61]

The Department of Education has already streamlined the online FAFSA, and more improvements have recently been implemented. Some applicants can now access data they have provided to the IRS and transfer it to the FAFSA, and the Administration is working with Congress on legislation that would eliminate the financial questions that cannot be answered with IRS data.

Strengthening Community Colleges. Last year, the President called for a $12 billion investment in community colleges over the next 10 years that would support the President's goal of graduating five million additional community college degree or credential recipients by 2020. The Administration strongly supports the American Graduation Initiative, contained in pending legislation, which would create a new competitive grant program to encourage community colleges and states to innovate and expand on proven reforms, a new online skills laboratory with freely available courses offering new opportunities for students to gain knowledge on their own time, and a new fund to help community colleges modernize their facilities to meet growing demand.

The Administration's plan to improve quality and raise graduation rates will give students a cost-effective choice. The average price of tuition and fees at public two-year colleges is $2,544, compared to $7,020 for in-state students at four-year public schools and $26,273 at private four-year schools.[62] Community college degrees and certificates are valuable as standalone credentials or as a low-cost intermediate step towards a bachelor's degree from a four-year institution. The American Graduation Initiative would provide an incentive to states to establish better articulation agreements, which would allow students to more easily transfer from a community college to a four-year institution.

College Access and Completion Fund. Only about half of all college students graduate within 6 years, and the graduation rate is much worse for low-income students. These statistics have consequences—workers with bachelor's degrees make an average of 54 percent more than those who attended college but did not graduate.[63] The Administration has proposed the creation of a College Access and Completion Fund to finance innovative efforts at the state level to boost college graduation rates and close achievement gaps. The Fund will devote resources to evaluating these efforts and expanding programs that are proven to be successful.

[61] "Simplifying Student Aid: The Case for an Easier, Faster, More Accurate FAFSA," Council of Economic Advisers/National Economic Council, September 2009, "http://www.whitehouse.gov/assets/documents/FAFSA_Report.pdf.

[62] Trends in College Pricing: 2009. The College Board, 2009. http://www.trends-collegeboard.com/college_pricing/1_4_over_time_constant_dollars.html?expandable=0

[63] Bureau of Labor Statistics.

Improving 529 College Savings Plans

At our first Task Force meeting on college affordability in St. Louis, the Vice President directed the Department of the Treasury to prepare a report with recommendations for making Section 529 college savings plan more effective and reliable for middle-class families. The Treasury Department released the report at our second Task Force meeting on college affordability in Syracuse.[64] The report identifies several approaches that states and plan administrators should take to improve Section 529 plans, including:

- Providing age-based index funds, which have lower fees than actively-managed funds and automatically shift to more conservative investments as the beneficiary approaches college age.
- Eliminating home-state bias in state tax policies to stimulate competition between plans and give consumers more investment options.
- Improving transparency so it is easier for investors to access data on the historical returns of different plans.

Idea for Further Consideration: Slowing Tuition Increases

When middle-class families sit down to figure out how they will pay for college, they consider at least two key factors: the total cost of attendance and the aid package their child has received. This Administration is seeking to address both of these issues. In addition to laying out a comprehensive plan to increase student aid and make it easier for students and families to pay for college, we took critical steps to mitigate the impact of the economic crisis on tuition.

The recession has made it especially difficult for states to hold down tuition at public universities. However, the Recovery Act responded to this challenge by setting aside nearly $50 billion for a State Fiscal Stabilization Fund, which has already had a tangible effect as public universities in at least 22 states used Recovery Act funds to scale back tuition increases. For example, the Minnesota State College and University System reduced a planned tuition increase from 5 percent to 2 percent. At the University of Virginia, a tuition increase was cut in half by Recovery Act funds.[65]

As our economy begins to recover, it is time to take the next step and ask colleges and universities to think about ways to increase productivity and lower operating costs as they simultaneously seek to improve quality. In his State of the Union speech, the President challenged colleges to do their part. The Task Force focused on rising tuition in our first staff report on higher education, which highlighted several strategies that could help schools control costs, and we plan to continue working on this important issue in the future.[66]

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[64] "An Analysis of Section 529 College Savings and Prepaid Tuition Plans," Department of the Treasury, September 9, 2009, http://www.treas.gov/press/releases/docs/529.pdf.

[65] For more examples of the Recovery Act's impact on tuition see "U.S. Department of Education, American Recovery and Reinvestment Act Report: Summary of Programs and State-by-State Data," November 2, 2009, http://www.recovery.gov/News/featured/Documents/Education%20Dept.%20ARRA%20Programs%20and%20Jobs.pdf

[66] "Financing the Dream: Securing College Affordability for the Middle Class," Middle Class Task Force Staff Report, http://www.whitehouse.gov/assets/documents/staff_report_college_affordability1.pdf

Connecting Workers to Career Ladders

The Administration is committed to expanding economic opportunity on several fronts. Effective job training is critical to helping workers get and keep middle class jobs. It can help workers expand their skills to continue and improve their careers, provide new skills that put workers on promising career pathways, or supply basic skills for those seeking to enter and remain in the workforce. Over the past year, we invested heavily in workforce development to ensure that American workers are equipped to compete for the good jobs of the future. Our FY 2011 Budget continues this commitment and supports evidence-based innovation in the job training system that will provide improved training and employment services and produce better outcomes for workers.

The Recovery Act provided nearly $5 billion for Workforce Investment Act training and employment programs, including $750 million for competitive grants to support worker training and placement in high-growth industries, of which $500 million is focused on the clean energy sector. Close to $75 million of the funds in this competitive grant program are being used to help communities impacted by restructuring in the auto industry.[67] The Recovery Act also provided over $500 million for employment assistance for people with disabilities.

Innovation is a key to strengthening training programs and providing good jobs for middle-class families in the clean energy jobs of the future. For this reason, the Department of Labor's green job training initiatives funded by the Recovery Act include new and innovative partnerships among labor unions, businesses, community colleges, registered apprenticeship programs, and workforce investment boards. These partnerships help prepare dislocated workers, young people, veterans, women, persons with disabilities, persons from underserved and diverse communities, and older workers for the economy of tomorrow. They are training workers to be weatherization experts, solar panel installers, energy auditors, and sustainable manufacturing and hybrid automobile experts. In short, they are preparing workers for good jobs — safe, secure jobs that pay family-supporting wages. The FY 2011 Budget builds on the Recovery Act's investments in training programs that target high-growth sectors and dislocated workers by providing an additional $85 million for green job training and $40 million for transitional jobs demonstration projects.

In addition to presenting principles for Workforce Investment Act reauthorization, the President's FY 2011 Budget increases total funding for displaced workers, adults, and youth, including those with disabilities—the three major funding streams under Title I of the Act. The Budget invests in innovation by setting aside $321 million for the Partnership for Workforce Innovation, a coordinated effort between the Departments of Labor and Education to provide incentives to create and replicate new and improved ways of producing better employment outcomes for workers more efficiently. The two departments will support state and local efforts to accelerate and improve outcomes for jobseekers through collaboration across state and Federal programs, streamlined service delivery, and innovative service delivery models. They will award competitive grants that support and test promising strategies, such as summer and year-round work experiences and comprehensive services for disconnected youth, "learn and earn" models such as apprenticeships and on-the-job-training, and regional and sectoral collaborations.

[67] "DOL Information Related to the American Recovery and Reinvestment Act," http://www.dol.gov/recovery/implement.htm.

VI. Conclusion

Just over a year ago, the President created the Middle Class Task Force, chaired by the Vice President, to focus on raising the living standards of middle-class families. We believe that the proposals outlined in this report represent an important first step toward addressing some of the biggest economic challenges facing the American middle class. In the coming year, the Task Force will work with Congress to enact our legislative proposals, and the Administration will press forward on those proposals that do not require legislation. We will also continue studying new policies that have the potential to further help working families, with an eye toward making additional recommendations in the future. And we will once again travel the country to engage with policy experts, advocates, and most importantly, middle-class Americans.

The challenges facing the middle class took many years to develop, and they will take time to address. The American economy is beginning to pull out of this deep recession, but as the economy returns to growth, the middle class must not be left behind again. As the Vice President said on the day the Task Force was created, "it is our charge to get the middle class—the backbone of this country—up and running again." The Task Force will continue working tirelessly in pursuit of this goal in the months ahead.

Employment Development Department
State of California

ANNUAL REPORT

FRAUD DETERRENCE AND DETECTION ACTIVITIES

A REPORT TO THE CALIFORNIA LEGISLATURE

THIRTEENTH REPORT

JUNE 2007

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EXECUTIVE SUMMARY

This report documents the Employment Development Department's (EDD) fraud deterrence and detection activities for Calendar Year (CY) 2006, as required by California Unemployment Insurance Code (CUIC) Section 2614.

The EDD's major program responsibilities include Unemployment Insurance (UI), Disability Insurance (DI), Employment Tax Collection, Job Service (JS), and Workforce Investment Act (WIA) programs. During 2006, through the administration of its programs, EDD collected more than $41.7 billion in employment taxes from over 1.2 million employers and issued benefit payments in excess of $8.1 billion on over 2.1 million UI and DI claims.

To protect the integrity of its programs, EDD enforces the CUIC provisions and various other California codes affecting its programs. Doing so assures the integrity of all EDD programs and protects the interests of employers, claimants, and taxpayers. Research suggests that organizations can reduce the risk of fraud through a combination of prevention, detection, and deterrence measures. A strong emphasis on fraud prevention may reduce opportunities for fraud to take place while fraud deterrence could persuade individuals that they should not commit fraud because of the likelihood of detection and punishment.[1]

The EDD takes a comprehensive approach to fraud prevention, detection, and deterrence. This approach involves EDD programs, EDD oversight entities, and business partners including federal, state, and local law enforcement agencies, and prosecutors. During CY 2006, EDD's comprehensive anti-fraud activities in the DI, UI and Tax programs identified fraud (in dollars), as follows:

Description	DI Program	UI Program	Tax Program
Cases Under Investigation	$ 9,048,113 215 cases	$ 8,990,404 87 cases	$ 38,838,202 110 cases
Criminal Complaints Filed	$ 234,451 12 cases	$ 565,619 8 cases	$ 3,281,870 25 cases
Completed Criminal Prosecutions	$ 2,724,513 7 cases	$ 2,252,508 11 cases	$ 8,300,951 17 cases
Fraud Overpayments (OP)	$ 5,428,292 1,254 OPs	$ 127,460,958 169,645 OPs	N/A
Fraudulent Benefits Prevented	$ 1,081,953	$ 1,325,094	N/A

The detection and deterrence of fraud in the WIA program is accomplished through a variety of processes that EDD requires of the local administrative entities that provide employment training services. The program integrity components[2] include: Monitoring Reviews; an Incident Reporting System; Single Audits; Program Oversight; and Regulatory Controls.

The remainder of this report highlights fraud deterrence and detection activities by each EDD program and summarizes oversight activities across the Department. The final section of this report highlights enterprise-wide efforts in progress and under consideration to prevent, detect, and deter fraud.

[1] Management Antifraud Programs and Controls – Guidance to Help Prevent and Deter Fraud, American Institute of Certified Public Accountants, 2002, p. 5.
[2] See WIA program details on pages 21-22.

BACKGROUND

The CUIC Section 2614 requires the Director of EDD to report to the Legislature by June 30 of each year on the Department's fraud deterrence and detection activities.

In CY 2006, EDD collected more than $41.7 billion in employment taxes and issued benefit payments in excess of $8.1 billion to UI and DI claimants. The EDD administers the UI, DI, JS, and WIA programs. Through its Employment Tax Collection Program, EDD collects UI and Employment Training Tax, and DI and Personal Income Tax withholding for the State of California.

As with any program where large sums of money are involved, the temptation to defraud the system for personal gain is present. Employers may not fully pay their employment taxes as required by law; claimants may use multiple social security numbers or the identities of others or claim benefits while working; physicians may certify disability inappropriately; and claimants or physicians may submit forged documents. Further, threats may be made to the security of EDD's systems or employees.

APPROACH

The EDD uses a multi-tiered, comprehensive approach to fraud deterrence and detection. This approach involves EDD programs, EDD independent oversight entities, and business partners including federal, state, and local law enforcement agencies, and prosecutors.

Each program area has established ongoing anti-fraud activities. In addition, independent oversight entities perform other activities including internal control reviews and audits, quality reviews to measure the accuracy and propriety of benefit payments, and information technology system reviews to detect system control deficiencies. Lastly, the Investigation Division (ID) identifies, investigates, and prosecutes fraud within EDD's various programs and internal operations.

Anti-fraud activities within EDD range from up-front fraud prevention such as customer education, reviews of internal control systems, employer audits, internal systems edits and controls, fiscal monitoring activities, and ongoing or special fraud detection activities. Fraud detection activities include but are not limited to: analyzing client, employer, and medical provider demographic data; establishing internal program checks and balances; performing electronic cross-matches; participating in joint efforts with other agencies and business partners; operating a fraud reporting hot line; and conducting criminal investigations that include surveillance, undercover operations, computer forensic analysis and data mining, search warrants, witness and suspect interviews, evidence seizure, and, in concert with other law enforcement agencies, arrest and prosecution of suspects.

FRAUD DETERRENCE AND DETECTION ACTIVITIES

DISABILITY INSURANCE (DI) PROGRAM

The DI program is comprised of two benefit programs, the State Disability Insurance (SDI) program, and the Paid Family Leave (PFL) program. The SDI program provides partial wage replacement for California workers who are unable to work due to illness, injury, or pregnancy. Workers covered under the DI program are potentially eligible for PFL benefits when they are unable to work because of the need to care for a seriously ill child, parent, spouse, or registered domestic partner, or to bond with a new minor child within the first year of birth or placement by adoption or foster care into the family.

The EDD is continuing its comprehensive, multi-faceted approach to combating fraud and improving benefit payment accuracy in the DI program. During CY 2006, the SDI program processed 725,467 claims and paid out over $3.5 billion in benefits. The Paid Family Leave (PFL) program processed 167,373 claims and paid nearly $368 million in benefits.

The EDD collects and analyzes data to support cases for prosecution and administrative action against those suspected of committing fraudulent acts. The DI Integrity Program within the DI Branch includes a Program Integrity Manager and 10 Field Office Integrity Specialists (FOIS) located throughout the State. The manager and the FOIS oversee, coordinate, and conduct various staff education efforts and investigative activities involving suspicious claims in the DI offices. The DI Branch staff work closely with ID's criminal investigators to combat fraud in the DI program.

Primary DI program fraud deterrence and detection tools include:

- **Claimant Notification** of the legal consequences for willfully making a false statement or knowingly concealing a material fact in order to obtain benefits is provided on the claim form declaration statement signed by the claimant when applying for benefits.

- **Independent Medical Examinations** (IME) provide EDD with a second medical opinion regarding the claimant's ability to perform his/her regular or customary work when the period of disability allowed by the treating physician exceeds the normal expected duration for that diagnosis. Photo identification is requested to ensure that the claimant, and not a substitute, appears for the examination.

  Although the primary use of IMEs is the validation of the treating physician's prognosis and a means of controlling the duration of claims, IMEs are also a useful tool in curtailing the loss of benefits in those cases where fraud or abuse is suspected. In CY 2006, of the 28,438 IME results received, 2,475 (8.7 percent) of the claimants scheduled for an IME failed to appear, and 7,946 (27.9 percent) were found able to work on the date of the examination.

- **Monthly Doctor Activity Reports** provide a list of the top 200 doctors certifying to the highest total amount of benefits, newly certifying physicians who certify more than a specific monetary amount or number of claims, and doctors whose claim-certifying activity has dramatically increased during the report period. These reports enable the FOIS to identify significant changes in claims activity and/or filing patterns, which may be indicators of fraud.

- **Automated Tolerance Indicators** (flags) that are associated with the certifying healthcare provider's license number help staff identify and track claims on which fraud or abuse is suspected or has previously been detected. They also alert staff to refer to special instructions that have been created to assist in the adjudication/payment of claims on which a Tolerance Indicator has been attached.

- **UI/DI Overlap Flags** generate an automated stop pay on both UI and DI claims when a prior UI claim period overlaps the dates that DI benefits are claimed. DI blocks payment pending an eligibility determination, thereby helping in the prevention of potentially improper payments.

- **Decedent Cross-Match Reports** identify benefit payments issued after the date of death to DI claimants by checking the Social Security Numbers (SSN) of all DI claimants against SSNs of individuals reported as deceased by the Department of Health Services. The report enables DI Branch to identify benefits paid subsequent to the date of death that may not otherwise have been discovered.

- **Address/Name Change Reports** record all changes of the claimant names or addresses by date and operator identification, as a means to identify claim manipulation, or "hijacking" by employees committing internal fraud.

- The **Doctor Activity Tracking System** tracks the status of investigations involving potential doctor[3] or doctor impostor[4] fraud cases. The system also provides a useful management tool to ensure appropriate follow up occurs, and to document and evaluate accomplishments.

- **Doctor License Reports** identify all DI claims that any particular doctor has certified. Analysis of the claims listed on the report can lead to discovery of fraudulent claims or program abuse.

- **DI Quality Control Reviews** test a random sample of up to 1,121 DI warrants annually for accuracy, completeness, and propriety. These reviews detect the nature and extent of improper payments, reveal operating weaknesses, and serve as a check on employee fraud or collusion. Claims that appear fraudulent are referred to investigators for follow up.

- **PFL Quality Control Reviews** test a random sample of 601 PFL warrants annually for accuracy, completeness, and propriety. These reviews detect the nature and extent of improper payments, reveal operating weaknesses, and serve as a check

[3] Doctors who knowingly certify claims for individuals who are not disabled.
[4] Someone other than the doctor signs the doctor's name on DI claim forms.

on agency employee fraud or collusion. Claims that appear fraudulent are referred to investigators for follow up.

- **Medical Hotsheet Reports** identify healthcare providers whose licenses have been revoked or suspended. This information, supplied by the Medical Board of California, helps ensure that claims are certified by properly licensed healthcare providers and alerts EDD to potential fraudulent situations.

- The **DI Personal Identification Number (PIN) System** provides identification, authentication, and authorization services via EDD's Interactive Voice Response (IVR) system. The system enhances security of the IVR system and improves claimant privacy by preventing unauthorized access to confidential data.

  Claimants are required to enter their SSN and PIN each time they request confidential payment information through DI Branch's IVR system. Claimants select their PIN the first time they use the IVR system to obtain payment information by matching personal identifying information. As an additional security and fraud detection measure, when a PIN is established or changed the claimant is sent a notice.

- The **In-Office Eligibility Review Process** provided for in Title 22, California Code of Regulations, permits the Department to require claimants suspected of fraud, who are currently receiving benefits, to submit to an in-person interview before a decision is made regarding their continued eligibility to receive benefits. The process provides the claimant with a fair and equitable opportunity to be heard in person and enables the Department to gather additional information before making its decision. The regulations provide precise time frames and procedures for conducting interviews to ensure that claimants' rights to due process are protected.

- An EDD **Toll-free Fraud Tip Hot Line**, (800) 229-6297, provides employers or individuals a designated telephone number to report alleged fraud directly to the ID's Criminal Intelligence Unit (CIU). The number of DI program fraud allegations reported through the Hot Line is as follows: 931 allegations in CY 2004, 695 allegations in CY 2005, and 488 allegations in 2006. Effective February 2005, fraud allegations were also reported via the EDD Web site (*www.edd.ca.gov*): 328 allegations were received in CY 2005; and 439 allegations in CY 2006 were received by the Hot Line operators in this manner.

- The **Truncation of Claimant SSNs** to only the last four digits on DI and PFL benefit checks helps to deter identity theft and protect the confidentiality of information assets.

- **Program Integrity Training** is provided to all new hires to heighten staff awareness and capacity to detect and deter fraud and abuse in the DI and PFL programs. New hires are initially exposed to the concepts and tools during new employee orientation shortly after being hired and once again in greater detail during formalized training. In addition, field office staff designated as Program Integrity Single Points of Contact (PI SPOC), who perform PI functions and work closely with the FOIS, receive specialized training.

- **Automated Detection Reports** developed collaboratively with ID's CIU permit CIU staff to detect unusual patterns of activity in the DI benefit payment system involving addresses, issuance of multiple checks, and multiple claims filed by the same claimant within a specified period of time.

- An **Educational Outreach Campaign** to the California medical community led by the EDD Medical Director's Office is designed to enhance understanding of the purpose of the DI and PFL programs and their role in the claim filing process. This effort enhances the integrity of both programs by improving the quality of medical information received thereby ensuring that the benefits paid are consistent with the claimant's inability to perform their regular or customary work. It also helps to minimize the occurrence of medical certifications that extend the disability duration beyond normal expectancy.

- **Formal Identity Alert (ID) Procedures** were provided to staff for handling DI and PFL claims with an ID Alert flag. The Department places a "flag" on potentially compromised SSNs identified by employers/employer agents, and Investigation Division, or UI Branch. When a claim with an ID Alert flag is processed, DI program integrity staff conducts an in-depth review to ensure that the claimant is the true wage earner.

- An **Interactive On-Line Fraud Reporting** form was placed on the EDD Web site. It provides the ability to report fraud and other sensitive information (SSNs, etc.) in a secure environment.

- **Medical Refresher Training** provided to field office staff by EDD's Medical Director is a comprehensive presentation of medical information intended to educate and update staff's knowledge of disabling medical conditions and medical terminology. This information allows the staff to communicate more effectively with medical providers when discussing and obtaining additional medical information regarding a DI or PFL claim. The information provides staff with a better understanding of the diagnoses, assists them in determining the severity and expected length of a disability, enables them to read and understand the medical side of the claim form with more confidence, and take appropriate action to control claim duration or potential abuse of the programs.

In addition to the aforementioned fraud deterrence and detection tools, special claim processing safeguards and automation techniques unique to the PFL program are being developed. Some that are currently being utilized include:

- Requirement for submission of the birth certificate, adoption or foster care certification on all bonding claims.

- The PFL automated system includes a scanning process that provides an online viewable copy of all claim documents. To assist in detecting possible forgeries, claims examiners are able to compare signatures of claimants and physicians with past documents submitted by the same claimants and/or physicians.

- The PFL automated system also includes a powerful tool for identifying patterns on suspicious claims by allowing claims examiners to retrieve all information about a claimant including all flags, images, and care recipients for current and past claims.

- The **PFL Address/Name Change Report** records all changes of the claimant's name or address by date and operator identification, as a means to identify claim manipulation, or "hijacking" by employees committing internal fraud, thus adding protection to claimant information.

RESULTS/ACCOMPLISHMENTS DURING CY 2004 through 2006

The following table shows the DI's program results for the last three years.

	2004	2005	2006
Cases Under Investigation	$ 6,039,275 200 cases	$ 10,048,046 204 cases	$ 9,048,113 215 cases
Criminal Complaints Filed	$ 2,688,535 7 cases	$ 345,726 22 cases	$ 234,451 12 cases
Completed Criminal Prosecutions	$ 95,595 15 cases	$ 487,653 12 cases	$ 2,724,513 7 cases
Fraud Overpayments[5] (OPs)	$ 3,738,595 1,283 OPs	$ 3,678,479 1,135 OPs	$ 5,428,292 1,254 OPs
Fraudulent Benefits Prevented	$ 7,869,849	$ 3,133,852	$ 1,081,953

- During CY 2006, 215 cases potentially representing $9,048,113 were investigated. These investigations focused on the following case types: impostor fraud/identity theft (30 cases representing $2,690,866); altered or forged documents (109 cases representing $1,309,590); and medical practitioner fraud (10 cases representing $4,238,430). The remaining 66 miscellaneous cases, representing $809,177 included impostor fraud/forgery enabled by taking over the claim of another, counterfeit checks, and fictitious employers.

- In CY 2006, ID filed 12 Criminal Complaints representing potential fraudulent benefits in the amount of $234,451. The ID has continued their emphasis on the more complex fraud cases such as impostor/identity theft that take longer to investigate.

- During CY 2006, ID completed 7 criminal prosecutions representing fraudulent benefits in the amount of $2,724,513. These completed prosecutions primarily involved altered and forged medical and working while certifying for benefits.

- In CY 2006, the DI and PFL programs established a cumulative total of 1,254 fraud overpayments in the amount of $5,428,292.

[5] "Fraud overpayments established" includes overpayments established as a result of criminal and administrative actions.

- The DI program established 650 fraud overpayments totaling $1,968,552 on claims associated with claimants who were prosecuted.

- The DI program established 604 fraud overpayments that were not attributed to prosecutions. These overpayments, totaling $3,459,740 were the result of administrative actions applied by the DI program, such as false statement overpayments.

- In CY 2006, departmental anti-fraud efforts stopped $1,081,953 in fraudulent DI benefits from being paid. Of this total, $975,311 is attributable to DI program anti-fraud efforts such as IMEs, verification of SSN ownership with deletion of improper base period wages, and all referrals to ID resulting in convictions or administrative actions which prevented payment of further benefits. Payment of approximately $106,642 in fraudulent benefits was prevented through ID's ongoing investigations of identity theft, forgeries, and medical practitioner fraud.

- In 2006, 79 doctors certified to over $1 million in benefits. In 52 cases, after review by the DI Branch and/or ID, it was concluded that the doctors' high volume of activity was justified and no fraud or abuse was detected. In the remaining 27 cases, three are under investigation by ID; a Tolerance Indicator has been established for four doctors, and 24 cases are pending further evaluation by the FOIS.

RECENT DI PROGRAM ENHANCEMENTS

In the DI program's ongoing effort to develop systems and processes to detect and prevent fraud and abuse, the following enhancements have been installed or are under development:

- **On-Line DI Program Integrity Awareness Training** module development was completed by the FOISs in 2006. In addition to classroom training, field office staff are able to take the on-line portions of the Refresher Program Integrity training at their work station.

- **Overpayment Conviction Workgroup** was established to ensure prompt and accurate establishment of conviction overpayments and collection activities. Various departmental entities are involved to ensure understanding of their individual roles in this effort and explore technology solutions and other procedural recommendations to enhance the department's ability to collect on conviction overpayments and restitution orders.

- **Address/Name Change Reports** record all changes of the claimant names or addresses by date and operator identification, as a means to identify claim manipulation, or "hijacking" by employees committing internal fraud. Analysis of these reports has been expanded to expose evidence of fraud or abuse which had previously gone undetected. Specifically, a variety of research tools, such as address lists for state and federal correctional institutions, address lists for all EDD offices, and reverse address directory, etc., have been developed as cross-match devices. Additionally, suspect addresses are tracked for a minimum of six months.

As a result of these enhancements, 21 referrals were made to FOISs for further action.

- **Anti-Fraud Partnership Presentation** with the external stakeholder Voluntary Plan Advisory Group by DI's Program Quality and Integrity Section and Program Review Branch Investigation Division on Fraud Prevention, Detection, and Deterrence was made in October 2006. The presentation included the Department's "Anti-fraud Focus on the DI Program," as well as its strategies and tactics for combating fraud perpetrated against the DI Fund. EDD speakers also shared information regarding the established specialized anti-fraud units in EDD and outlined key goals to diminish vulnerability to fraud, reduce losses, increase savings, and enhance fraud safeguards and detection capacity through technology.

UNEMPLOYMENT INSURANCE (UI) PROGRAM

The EDD administers the UI program, which provides benefits to individuals who have lost their jobs through no fault of their own, are actively seeking work, are able to work, and willing to accept employment. During CY 2006, the UI Program processed 1,405,552 new claims and paid a total of $4.62 billion in benefits. The EDD is committed to maintaining the integrity of the UI Program.

The UI Program utilizes a variety of processes, tools, and techniques to deter and detect fraud, which include:

- **Claimant Notification** provides notice to the claimant, by way of a Claimant Handbook, of claim eligibility requirements and legal consequences of willful misrepresentation[6] or willful nondisclosure of facts.

- **30 Percent Fraud Penalty Assessment** on any overpayments resulting from claimant fraud.

- **Weekly Claim Certification** by claimants of their continued eligibility for benefits. This process requires the claimant's signature certifying to the accuracy and truthfulness of the statements made and that he/she understands that the law provides penalties for making false statements to obtain benefits.

- **UI Quality Control** is an independent review of a random sample of 1,100 claims annually to test the effectiveness of procedures for the prevention of improper UI payments. These reviews detect the nature and extent of improper payments, reveal operating weaknesses, and serve as a check on agency employee fraud or collusion. Claims that appear fraudulent are referred to investigators for follow up.

- The **Benefit Audit Process** matches wages reported quarterly by employers to UI benefits paid within the same period. Through this process, the UI benefits program is able to detect when claimants have been fraudulently collecting benefits while working. Overpayments and penalties are established and collected as a result of this process, protecting the solvency of the UI Trust Fund. These matches are performed on a quarterly and annual basis. The EDD utilizes an employer compliance database to track benefit audit forms that have been mailed and returned by employers.

  Future programming enhancements will combine the existing benefit audit process with the New Employer Registry (NER) Benefit Cross-Match to enable EDD to detect fraud sooner. (Refer to **Recent UI Program Enhancements** in this report for additional information regarding the NER Benefit Cross-Match.)

- **Verification of a Claimant's Right to Work** enables EDD to identify claimants who do not have legal authorization to work in the United States (U.S.), thus preventing payments to individuals who are not eligible for benefits. The Systematic Alien

[6] To willfully provide false information or withhold information that affects the payment of UI benefits.

Verification for Entitlement process enables EDD to link with the database of the U.S. Citizenship and Immigration Services (formerly Immigration and Naturalization Service) to submit both initial and additional verification queries to obtain information necessary to reduce improper payments to individuals who do not have legal authorization to work in the U.S.

- A **SSN Verification** provides real time (on-line) access to Social Security Administration's (SSA) records. Implemented in June 2006, the claimant' SSN is verified during initial claims filing, to detect potential fraud prior to filing a UI claim. In addition, SSA provides information when the verified owner of the SSN is deceased.

- In October 2006, real time (on-line) access to the **Department of Motor Vehicle's** databases was obtained to verify a claimant's California driver's license or identification card number, prior to filing a UI claim.

- Employers or individuals are offered several options to report alleged fraud activities. The ID operates a **Toll-free Fraud Tip Hot Line**, telephone number (800) 229-6297. The number of UI program fraud allegations received through the Hot Line is as follows: 1,406 allegations in CY 2004, 2,270 allegations in CY 2005, and 1,499 allegations in 2006. Effective February 2005, fraud allegations were also reported via the EDD Web site (*www.edd.ca.gov*). An additional 830 allegations were received in CY 2005; and 825 allegations in CY 2006 were received by the Hot Line operators in this manner.

- The **UI Personal Identification Number (PIN)** is an automated system that allows claimants to select a PIN in order to obtain personal claim information through the Interactive Voice Response (IVR) system, which is available seven days a week, 24-hours a day. The UI PIN was established to protect claimants' confidential information. Without a PIN, claimants will be unable to access their personal and confidential claim information through the IVR.

- Changes to the **UI benefit check** were implemented as part of the Department's ongoing commitment to deter identity theft and to protect the confidentiality of its information assets. The heading "SSA NO." was removed from the face of the UI benefit check and the 9-digit SSN is no longer printed on the face of the check. In its place, **only** the last 4 digits of the claimant's SSN will display.

- The EDD has always used various measures to ensure the true identity of a claimant for UI benefits. Since April 2003, however, **UI Impostor Fraud Prevention** was enhanced with the implementation of EDD's Identity Alert Process. The process, developed to reduce the risk of identity theft fraud, was implemented when employers and/or employers' payroll agents contacted the Department to report that their records containing confidential employee information had been compromised. The Identity Alert Process was designed to protect the worker and employer from ongoing fraud and to ensure proper payments of UI benefits.

  When a claim is initiated into the Identity Alert Process, no payments are issued until the Department obtains the information needed to validate the identity of the individual filing the UI claim. The UI Identity Regulations, signed by the governor in

December 2003, revised prior regulatory language to allow the Department to require a claimant to provide identity verification documentation upon request.

The tools utilized by EDD to prevent UI Impostor Fraud include:

- Flagging potentially compromised SSNs identified by employers/employer agents and EDD's ID. If a new claim is filed using one of the flagged SSNs, the claim is initiated into the Identity Alert Process and a request for identity information is mailed to the claim filer, the last employer, and the base period employer(s).

- Stopping benefit payments on active UI claims that are associated with compromised SSNs until the identity of the claimant is confirmed.

- Implementing enhanced screening procedures during the claim filing process to better authenticate the identity of claimants and to ensure only the true owner of the identity will receive UI benefits.

- Utilizing a variety of communication methods to provide information to all California employers on how to protect and properly destroy confidential personnel information and assist the Department in preventing UI fraud. This includes published articles in the California Employer's Guide (DE 44-Tax publication) as well as the California Employer Newsletter (Quarterly-Tax publication).

- Updating the EDD Web site *(www.edd.ca.gov)* with information on UI impostor fraud and identity theft assists both employers and employees. The brochures **"How You Can Prevent Unemployment Insurance Impostor Fraud"** (designed for employers) and **"Protect Your Identity and Stop Unemployment Insurance Impostor Fraud"** (designed for employees) can be viewed as well as downloaded and printed from the EDD Web site.

- Partnering with other states that have also experienced increases in UI impostor fraud. The Department has worked closely with other states to identify common patterns and trends, share anti-fraud processes, and resolve fraud cases where the parties have a connection to multiple states.

- As part of an ongoing **public education campaign**, EDD developed a "toolkit" for employers that includes information on how they can prevent and detect UI impostor fraud. Success in preventing, detecting, and deterring UI impostor fraud is greatly dependent upon a strong partnership with the employer community.

- Utilizing internal workgroups to evaluate the effectiveness of existing anti-fraud systems, identify enhancements, and develop new methods for detecting, deterring and preventing fraud. Currently, UI staff, in partnership with ID and the Audit and Evaluation Division (A&ED), are exploring data mining tools to actively identify patterns, data elements, and trends to detect and prevent potentially fraudulent UI claims earlier in the process.

RESULTS/ACCOMPLISHMENTS DURING CY 2004 through 2006

The following table shows the UI program's results for the last three years.

	2004	2005	2006[7]
Cases Under Investigation	$ 77,526,097 106 cases	$ 17,048,818 83 cases	$ 8,990,404 87 cases
Criminal Complaints Filed	$ 3,410,552 21 cases	$ 1,994,251 15 cases	$ 565,519 8 cases
Completed Criminal Prosecutions	$ 63,275,339 22 cases	$ 7,287,065 17 cases	$ 2,252,508 11 cases
Fraud Overpayments (OPs) est.	$ 89,477,742 103,171 OPs	$104,081,174 145,534 OPs	$127,460,958 169,645 OPs
Fraudulent Benefits Prevented By Investigation Division	$ 19,437,721	$ 11,938,565	$ 1,325,094

- During CY 2006, ID investigated a total of 87 ongoing and new UI fraud cases representing potential fraudulent benefit payments in the amount of $8,990,404. These investigations focused on the following case types: impostor fraud/identity theft (47 cases representing $8,020,859); working while certifying for benefits (22 cases representing $176,340); forgery – taking over another's claim (3 cases representing $109,481); and conspiracy between employer and claimant to certify for benefits (3 cases representing $36,634). The remaining 12 miscellaneous cases, representing $647,090, included counterfeit checks and the use of multiple SSNs by one person.

- In CY 2006, ID filed 8 Criminal Complaints representing potential fraudulent benefits in the amount of $565,619. During 2006, the ID gave priority to investigating complex fraud cases involving the most egregious violations and the highest overpayments.

- In CY 2006, ID completed 11 criminal prosecutions representing fraudulent benefits in the amount of $2,252,508.

- During CY 2006, UI program staff established a total of 169,645 fraud overpayments totaling $127,460,958.

  - 141,899 fraud overpayments totaling $99,639,714 were established as a result of the benefit audit cross-match system. The EDD submitted a Budget Change Proposal, for State Fiscal Year 2005-2006, requesting additional funding to liquidate the Benefit Audit workload. This caused an increase over last year's

[7] Results, in economic terms, for the UI program during 2006 are lower than the previous two years. This is attributable primarily to two factors: 1) UI Fraud dollars investigated, filed, and prosecuted were uncharacteristically high during 2004 and 2005 due to several large UI fraud cases that were uncovered during 2003-2004, at the start of EDD intensive anti-fraud program; 2) The ID suffered the loss of seasoned investigators through attrition during 2006, and the hiring process for criminal investigators is lengthy due to extensive background checks and screening, thereby delaying backfill of vacant positions and a reduction on the number of staff working the UI fraud cases.

figures. The benefit audit process protects the integrity of the UI Trust Fund, and detects UI fraud.

- UI program staff established fraud overpayments on 1,896 cases of identity theft totaling $5,537,459.

- A total of 25,850 fraud overpayments were established that were not attributed to the benefit audit cross-match system or identity theft. These overpayments, totaling $22,283,785, were established for a variety of reasons including retroactive disqualifications of miscellaneous eligibility issues and unreported earnings that were not discovered through the benefit audit cross-match system.

- In addition, in compliance with California regulations, UI program staff imposed disqualifications and overpayments on 2,460 cases totaling an additional $7,362,135 in non-fraud overpayments when claimants failed to comply with the Department's request for identity verification information and there was insufficient information to determine the real owner's identity.

- In CY 2006, ID prevented approximately $1,325,094 in benefits paid from UI claims that were filed by impostors based upon the identity and wage credits of full-time active employees.

  - The ID prevented $1,174,169 in benefits from being paid on UI claims associated with ongoing criminal investigations.

  - The ID prevented $93,852 in benefits from being paid on UI claims based on information received by the CIU. These claims are not associated with ongoing criminal investigations.

  - The ID prevented $57,073 in benefits from being paid on UI claims filed through the Internet e-apply process. These claims are not associated with ongoing criminal investigations.

FUTURE UI PROGRAM ENHANCEMENTS

The EDD continues to monitor, research, and investigate systems and activities in order to detect and prevent fraud within the UI program. As EDD moves towards an electronic system, such as Web-based applications for delivering UI services to our clients, the need to maintain the security and integrity of the program is a high priority. California has taken a lead role in developing system enhancements for the detection and prevention of fraud within the UI program. The following describes fraud detection and prevention system enhancements to the UI program that are currently being developed:

- The **NER Benefit Cross-Match** will enable EDD to use new hire information from California employers to identify claimants who improperly continue to receive benefits after they have returned to work. This is accomplished by matching the new hire information with the Department's records of claimants currently collecting UI benefits. Through this process, EDD will be able to detect fraud and other eligibility issues up to six months earlier than through the Department's current benefit audit

process, allowing EDD to protect the UI Trust Fund by reducing the amount of dollars overpaid to claimants. NER Benefit Cross-Match programming efforts are currently underway, and training and implementation is scheduled for July 2007.

- **Web-Based Claim Filing (WBCF)** project is reengineering the UI claim filing process to improve claimant authentication and the collection of claimants' eligibility information. This new claim filing system for staff, will improve issue detection and decrease fraud, while improving the quality of information collected during the claim filing process. This project is augmented with federal grants and once completed, will integrate the on-line (real-time) verification of a claimant's SSN and DMV license and identification card numbers, and create a cohesive process to detect potential fraud earlier in the claim filing process. This will allow EDD to conduct data cross-matches directly with the SSA and California's DMV as well as obtain last employer address information from EDD's internal Tax Accounting System (TAS). Cross-matching information with these entities, and the ability to cross-match employer addresses with EDD's TAS database rather than relying upon the client to provide the Department with this information, will better ensure that proper payments are made to the appropriate individual.

- The **Address Integrity Project** will ensure that only the rightful owner of the claim makes a change of address to a claim. As a security and fraud detection measure, a letter will be sent to the old address to notify the claimant that EDD has received a request for change of address.

- **Fraudulent Claim Profiles** are being established to institute ongoing system checks for identification of claims that fit fraud patterns.

- The **Continued Claims Redesign Project** provides claimants with the option to certify for UI benefits by telephone or the Internet, and will allow for the collection of additional client data and creation of a new client database for fraud detection.

- The **Call Center Network Platform and Application Upgrade Project** provides EDD with more detailed call information for trend analysis to improve fraud detection, as well as other automation enhancements. This upgrade will provide historical tracking data on prior calls from the caller's phone number, caller ID, calls associated with the supplied SSN, and a single management information system that reports all call activity in order to detect and deter fraud.

- The **Combat Identity Theft Project** will develop and implement data mining software that will be used to improve EDD's ability to prevent and detect identity theft in the UI program. This project is funded in part by a Department of Labor grant. The software will be used to improve UI fraud detection by conducting in-depth data analyses and automatically identifying patterns and trends that will serve as probable indicators of fraudulent activity. The data mining software will be used by other organizations within EDD to develop predictive models to improve decision-making and reduce fraud. This program is scheduled for implementation during CY 2007.

EMPLOYMENT TAX PROGRAMS

The EDD is one of the largest tax collection agencies in the United States, collecting UI and Employment Training Tax, and DI and Personal Income Tax withholding. Only the Internal Revenue Service (IRS) collects more payroll tax dollars than EDD. During 2006, EDD collected $41.7 billion in California payroll taxes from over 1.2 million employers.

As with the benefit programs, EDD's approach to employment tax fraud deterrence and detection involves independent oversight and investigative activities, plus extensive efforts within the Tax Branch to ensure integrity and accuracy of this program. Tax Branch efforts focus on increasing voluntary compliance with the tax laws through education, cooperation, and enforcement. To achieve this goal, the Tax Branch conducts a Taxpayer Education and Assistance program, actively participates with employer organizations on issues of concern, and conducts various enforcement activities. The major components of the Tax Branch enforcement program include:

- The **Tax Audit Program** educates employers and provides them with an incentive to voluntarily comply with State employment tax laws. Individual employers are selected for audit based on certain criteria. Most commonly, an employer is audited when a former employee files a claim for UI or DI benefits, and the former employer has not reported the wages to EDD, or paid the required employment taxes. During 2006, EDD audited 4,611 employers. The audits revealed that 67 percent of the employers audited made an error in reporting wages on tax returns. In addition, the audits revealed that 124 (2.7 percent) of the 4,611 employers audited were found to have misreported wages with the intent to evade payment of taxes. These audits resulted in employment tax assessments of $18,243,904.

- The **Joint Enforcement Strike Force (JESF)** combats the underground economy by pooling resources and sharing data among the State agencies that enforce licensing, labor, and tax laws. The JESF on the Underground Economy was formed by Executive Order in 1993 and codified in 1994. The members of JESF include EDD (lead agency), the Department of Consumer Affairs, the Department of Industrial Relations (DIR), the Franchise Tax Board (FTB), the Board of Equalization, the Department of Insurance (DOI), and the Department of Justice.

  The JESF obtains information indicating that a business may be operating illegally. Sources of information include informants who use established hot lines, complaints from legitimate businesses, and comparison of data in various databases maintained by member agencies.

  Four special projects, entitled the Employment Enforcement Task Force (EETF), the Construction Enforcement Project (CEP), the Janitorial Enforcement Project (JEP), and the newest effort, the Economic and Employment Enforcement Coalition (EEEC) were implemented since the formation of JESF.

  The EEEC, while not officially under the JESF umbrella, was established in 2005 as a joint effort by state and federal agencies to combat the underground economy. The coalition's education and enforcement efforts are intended to enhance fair

business competition, by targeting employers who gain an unfair advantage through violation of state and federal labor, licensing, and employment laws. The EEEC was created as a multi-agency enforcement program consisting of investigators from DLSE, Cal/OSHA, EDD, CSLB, and the USDOL, each expert in its own field, collaborating to educate business owners and employees on state and federal labor, licensing, and employment laws; conduct vigorous and targeted enforcement against labor law violators; help level the playing field and restore competitive advantage to law abiding businesses and their employees. The coalition is currently focusing its efforts on seven low-wage industries including agriculture, car wash, construction, garment manufacturing, janitorial, race track, and restaurant. These industries were selected for targeting by the EEEC because employers in these industries have a history of employing vulnerable workers, paying low wages, and are frequently found to be out of compliance with labor and tax laws.

RESULTS/ACCOMPLISHMENTS DURING CY 2004 through 2006

Statistics for the EETF, CEP, JEP, the Targeted Industries Partnership Program (TIPP) and EEEC programs are included in this section. Overall, the cumulative activities and results of these program areas over the past three years are as follows:

	2004	2005	2006
Joint Inspections	441[8]	1,010	1,330
Audit Referrals	265	162	139
Payroll Tax Audits	721	482	528
Payroll Tax Assessments	$ 32,927,369	$ 29,586,031	$ 22,004,213
Labor Code Citation Amounts	$ 2,126,950	$ 3,348,511	$ 5,319,150
Previously Unreported Employees	13,597	8,362	8,284

- In 2006, EETF inspected 423 businesses for payroll tax and Labor Code violations. Any business suspected of operating in the underground economy is subject to inspection although EETF focuses on industries known to have a high degree of noncompliance such as auto repair, bars, car washes, construction, and restaurants. The inspections resulted in the issuance of 293 citations totaling $2,390,950 for various violations of the Labor Code. In 2006, 308 EETF audits were completed, resulting in assessments of $10,597,994 in unpaid employment taxes, penalties, and interest. In addition, 4,278 previously unreported employees were identified.

The following table shows the EETF's program results for the last three years.

	2004	2005	2006
Joint Inspections	441	342	423
Payroll Tax Audits	339	280	308
Payroll Tax Assessments	$ 9,706,037	$ 11,238,855	$ 10,597,994
Labor Code Citation Amounts	$ 2,126,950	$ 2,333,261	$ 2,390,950
Previously Unreported Employees	3,512	3,403	4,278

[8] 2004 Numbers do not include EEEC program, which was not implemented until July 2005.

- In 2006, EEEC inspected 907 businesses for licensing, tax, and labor code violations and referred 184 employers for a payroll tax audit. The EEEC has been mandated to focus its resources within seven industries including agriculture, car wash, construction, garment manufacturing, janitorial, race track, and restaurant. In 2006, 95 EEEC audits were completed, resulting in assessments of $3,661,678 in unpaid employment taxes, penalties, and interest. In addition, 1,726 previously unreported employees were identified.

The following table shows the EEEC's program results for the last two years.

	2005	2006
Joint Inspections	668	907
Payroll Tax Audits	8	95
Payroll Tax Assessments	$ 1,258,834	$ 3,661,678
Labor Code Citation Amounts	$ 1,015,250	$ 2,928,200
Previously Unreported Employees	333	1,726

- In 2006, CEP referred 129 construction industry employers for audit. Completed audits resulted in assessments for $7,036,592 in unpaid employment taxes, penalty, and interest. In addition, 1,844 unreported employees were identified.

The following table shows the CEP's program results for the last three years.

	2004	2005	2006
Audit Referrals	188	124	129
Payroll Tax Audits	270	126	107
Payroll Tax Assessments	$ 16,155,481	$ 14,274,962	$ 7,036,592
Previously Unreported Employees	5,317	2,681	1,844

- In 2006, JEP referred 10 janitorial industry employers for audit. Completed audits resulted in assessments for $669,162 in unpaid employment taxes, penalty, and interest. In addition, 350 unreported employees were identified.

The following table shows JEP's program results for the last three years.

	2004	2005	2006
Audit Referrals	16	4	10
Payroll Tax Audits	34	14	15
Payroll Tax Assessments	$ 3,929,320	$ 813,643	$ 669,162
Previously Unreported Employees	2,706	384	350

- The TIPP program workload was incorporated into the EEEC on July 1, 2005. The following statistics are related to TIPP cases that were referred to the Audit Program prior to the implementation of EEEC.

The following table shows the TIPP's program results for the last three years.

	2004	2005	2006
Audit Referrals	61	34	0
Payroll Tax Audits	78	54	3
Payroll Tax Assessments	$ 3,136,531	$ 1,999,737	$ 38,787
Previously Unreported Employees	2,062	1,561	86

- The EDD's UEO conducts additional tax enforcement activities independent of the Strike Force. In 2006, these other UEO programs referred 54 employers for audit. Completed audits resulted in assessments for $5,239,938 in unpaid employment taxes, penalty, and interest. In addition, 2,257 unreported employees were identified.

- In 2006, EDD's ID conducted additional tax enforcement activities independent of JESF.

  - The ID investigated a total of 110 ongoing and new payroll tax evasion fraud cases representing a potential tax liability of $38,838,202.

  - The ID filed 25 criminal complaints representing a potential tax liability of $3,281,870.

  - The ID completed 17 criminal prosecutions representing a potential tax liability of $8,300,951.

  - The ID referred 17 criminal cases with tax liabilities in the amount of $8,723,461 to EDD Collection Division for recovery. The ID delivered restitution checks (received at sentencing hearings) in the amount of $1,635,092 to the Collection Division. To date, the Collection Division has recovered an additional $741,876 on these cases.

RECENT TAX PROGRAM ENHANCEMENTS

The UEO and Audit Programs continue to coordinate efforts to bring **the Courier Industry** into compliance. A common practice in this industry is misclassification of employees as independent contractors. EDD began these specialized audits in September 2003, and has expanded coordinated efforts to include other LWDA departments to ensure compliance for Worker's Compensation Insurance and other issues. There have been 381 courier cases completed and assessed with an increase in tax liability (liability change) of $30.8 million to date. In addition, there were 17,037 additional drivers found to be employees. The Courier Industry focus has been instrumental in effecting change in the industry and promoting compliance.

In late 2005, the EDD expanded its audit coverage of UI rate manipulation by training additional audit staff across the state in these specialized audit techniques. UI rate manipulation (SUTA Dumping) occurs when an existing business submits a new employer registration, then transfers payroll to the new account which has a lower UI tax rate. SUTA Dumping continues to be a concern in California. Of the 49 cases

completed during CY 2006, 38 filed petitions for reassessment. Of those 38 cases, only three have had hearings with decisions issued and 35 are still pending before the California Unemployment Insurance Appeals Board. During CY 2006, there were 6 assessments issued for a total liability change of $6,615,973. We continue to monitor the employers for prospective reporting purposes after they have been investigated and assessed for SUTA dumping. To date, the 49 employers investigated have paid an additional $163 million into the UI fund above what they would have reported had they been allowed to continue their scheme. The UI Rate Manipulation Team has continued to monitor the reporting of the businesses who were engaged in rate manipulation and although most chose to litigate the liability rather than pay it, many are reporting properly on a prospective basis.

Outreach and education efforts are also underway to get the word out that SUTA dumping and UI Rate Manipulation will not be tolerated in California. Information about UI rate manipulation and the SUTA dumping legislation (Chapter 827, Statutes of 2004) is available on EDD's Web site. Various articles have also appeared in the California Employer. Outreach events were held with various groups, including the Office of the California Attorney General, the California Society of Certified Public Accountants, the California BAR Taxation Litigation Subcommittee, the Department of Labor (DOL), the National Association of State Workforce Agencies, the National Association of Professional Employer Organizations, as well as EDD's internal stakeholders including the ID Criminal Tax Evasion Program Management Team.

EMPLOYMENT AND TRAINING PROGRAMS

WORKFORCE INVESTMENT ACT (WIA) PROGRAM

The EDD administers the federally funded WIA Program in California. The program provides funding to local entities that provide employment training opportunities. The Department guides the subgranting of WIA funds received from DOL, and provides general program direction to local administrative entities that deliver services to eligible clients via a statewide system of Local Workforce Investment Areas (LWIA) and other grantees.

The detection and deterrence of fraud in the expenditure of WIA funds is accomplished through a combination of processes that EDD requires of the local administrative entities. In addition, DOL may occasionally conduct specialized WIA reviews, which, even though their focus is on the adequacy of the State's management of the program, typically also include reviews of a sample of local administrative entity activities. The program integrity components related to the WIA program include:

- **Monitoring Reviews** determine whether programs operate in compliance with the WIA and applicable federal, state, and local rules and regulations, and require corrective actions for any deficiencies.

  Each LWIA administrative entity, as a condition of receiving WIA funds, is required to maintain and operate a monitoring system that ensures that each of its subrecipients is monitored on-site at least once during each program year in both fiscal and program areas. In addition, EDD conducts monitoring of LWIA administrative entities.

- **Incident Reporting System** provides reports of fraud, abuse, and criminal activity within the WIA program. This system is required by the DOL/Office of the Inspector General (OIG) under 20 Code of Federal Regulations 667.630. Each local administrative entity, as a condition of receiving WIA funds, participates in this system by being alert to indications and allegations of WIA-related fraud, abuse, and criminal activity, and by maintaining procedures that ensure that violations are reported promptly (within 24 hours of detection). The EDD then takes action to ensure that allegations are investigated and resolved.

- **Single Audits** are required of LWIA administrative entities and subcontractors that expend an aggregate of $500,000 or more in federal funds for fiscal years ending after December 31, 2003. These audits are required by the provisions of the U.S. Office of Management and Budget Circular A-133, as revised on June 24, 1997, entitled "Audits of States, Local Governments, and Non-Profit Organizations." Further, commercial subcontractors that expend $500,000 or more in federal funds to operate a WIA program must obtain either an organization-wide audit or an independent financial and compliance audit. These audits are usually performed annually, but must be performed not less frequently than once every two years. Audits of local subrecipients are resolved by the local administrative entity and audits

of the local administrative entities and other direct grantees are resolved by EDD. The EDD may conduct special WIA audits, as warranted.

- **Workforce Services Division** program staff oversees the delivery of services by WIA funded organizations. Staff provide ongoing programmatic and fiscal technical assistance to WIA funded projects. Staff review WIA grantee participant and financial records to ensure that they follow applicable State and federal requirements, and they ensure that each grantee adheres to the terms and conditions of their grant with the Department.

- **Regulatory Controls** provide for additional fraud protection. The DOL provides a Hot Line telephone number (800) 347-3756 to report fraud and abuse complaints. This functions as a national control point. Another control point is that the WIA program prohibits contracting or doing business with any agency that has been disbarred (e.g., license revoked, de-certified). Additionally, the WIA regulations have established controls against nepotism.

RESULTS/ACCOMPLISHMENTS DURING CY 2006

The results presented in this section represent resolution activities for both the WIA and Welfare-to-Work (WtW) programs. Although the WtW program ended on January 23, 2004, actions to resolve WtW fraud and abuse cases continue.

During CY 2006, the Compliance Resolution Unit (CRU) processed 135 cases, 76 of which were resolved, resulting in recovery of $168,847 in nonfederal funds recovered from LWIAs or subgrantees. At the end of the year, 59 cases with a total value of $10,608,576 remained open in various stages of the State resolution process as follows:

- The $10,608,576 applies to 27 of the 59 cases for which EDD has been able to determine the potential disallowance.

- Of the remaining 32 cases with undetermined potential disallowance, 26 cases are undergoing fact finding/investigation or resolution by local law enforcement, LWIA; or CRU; and six cases are under investigation by DOL or OIG.

INDEPENDENT OVERSIGHT ACTIVITIES

The EDD's Program Review Branch (PRB) performs independent departmental oversight activities of EDD programs, including fraud detection and deterrence. Fraud detection and deterrence are accomplished through sound internal control structures, internal and external audits, risk assessments, detailed Quality Control reviews, and criminal investigations. The PRB has increasingly taken an active role to identify and combat fraud within and across EDD's programs. Through partnerships with internal and external entities, PRB performs an essential role to prevent, detect, and deter fraud.

Fraud in EDD programs cover a variety of offenses, such as: fictitious employer registrations to establish future fraudulent UI and DI claims; forgery of checks and claim documents; identity theft/claims filed by impostors based on the wage credits of others; impostors taking over the claims of others; false certifications by medical practitioners and claimants; underground economy tax evasion such as underreporting or failure to report employee wages; and internal fraud by EDD employees.

This section addresses the various components of PRB's fraud deterrence and detection activities. Many of these activities are also included under the specific EDD program areas.

- **Independent Internal and External Audits** are conducted of departmental operations and recipients of federal funds such as LWIA and community-based organizations over which EDD has administrative and program responsibility. These audits are performed at the request of EDD management, or in response to issues that arise as a result of program monitoring activities or incident reports. The PRB performs internal audits in accordance with the either the "International Standards for the Professional Practice of Internal Auditing" or "Generally Accepted Government Auditing Standards." These standards require that the auditors have sufficient knowledge to identify indicators of fraud.

- **Independent Internal Control Audits** assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency. The EDD considers a strong system of internal controls to be a major deterrent to internal fraud. Internal controls are primarily developed during the system design phase, through technical assistance provided prior to and during system implementation. The EDD believes that it is more cost effective to build controls into the system, as opposed to raising internal control issues during an audit, which may require system redesign. Audit independence is achieved by reporting to a level in the organization that allows the internal audit activity to fulfill its responsibilities. The audit standards governing these audits also require auditors to include an evaluation of the systems of control used to detect illegal activities and deter fraud.

- **Information Technology (IT) Audits** are conducted of EDD's automated systems by auditors who are specially trained in this field. These IT audits ensure that automated system controls are built into new or upgraded systems and stay operational throughout the life of the system.

- A **Security Audit Logging and Monitoring System** (SALMS) is being established which will capture all business application and system auditable events. These include logging of view, query, inquiry, and transaction activities (e.g., add, delete, and update) to enable the detection of attempts to access unauthorized UI and Tax confidential data. The SALMS project will establish a baseline set of IT security logging and audit review requirements that can be used for all of the EDD UI and Tax Benefit systems, including event log file retentions, auditable event definition; log data file transfer protocols; and log file and server access security.

- **On-site Monitoring Reviews of WIA and Disaster Relief** is conducted to determine fiscal and program compliance. The EDD is required by DOL to perform scheduled on-site monitoring reviews of sub-recipients and sub-grantees of federally funded programs including WIA and Disaster Relief.

  The monitoring reviews include regularly scheduled examinations of both fiscal and programmatic systems and records. This oversight provides EDD with an opportunity to ensure that internal control structures are in place and that they function as prescribed. The PRB, therefore, provides fraud deterrence by continually ensuring that proper safeguards are in place to discourage fraudulent activity. Monitors are alert to symptoms and conditions that may be indicators of illegal activities.

- **WIA/Disaster Relief Incident Reporting** provides a reporting and follow-up process for allegations of program fraud and abuses. The PRB receives and tracks incident reports, and submits them to DOL for its determination whether to conduct the investigation itself, or refer the reports back to EDD for investigation. Based on DOL's determination, EDD may investigate the incident and take appropriate action against the grant recipients.

- **Quality Control Reviews** are mandated for the UI benefit program. The PRB also conducts a similar Quality Control review for the DI program. The UI and DI Quality Control processes detect fraud by verifying that EDD staff are following proper payment procedures.

  In conducting the UI and DI Quality Control processes, each week, a random sample of payments for each program is reviewed to verify that proper procedures were employed by EDD during claim processing, and to ensure that adequate documentation to support claimant eligibility is available at EDD claim filing offices, employer sites, and, in some cases, medical facilities. These detailed examinations provide information from various sources that may indicate fraudulent activity, which is then referred to EDD's ID.

- **Criminal Fraud Investigations** are conducted by PRB's ID to prevent, detect, and deter fraud committed against the UI Program, the DI Program, the Tax Programs, and other programs administered by EDD. The ID develops cases for criminal prosecution.

  Whenever appropriate, EDD seeks prosecution of perpetrators that commit fraud against EDD programs. Publication of the prosecutions and the heightened

awareness of EDD's actions against both external and internal fraud provide a deterrent effect. Fraud deterrence also includes court ordered restitution and imprisonment or probation for individuals who commit fraud against EDD programs. Restitution includes recovery of benefit overpayments, tax assessments, penalties, interest, investigation costs, and any other monies determined by the court to be owed to EDD by an entity or individual.

A deterrent used in internal affairs cases is the initiation of adverse action against EDD employees. The adverse action process includes suspensions, demotions, reductions in pay, and dismissal from State service.

The PRB utilizes several methods to detect fraud in departmental programs, provide leads to identify additional fraud, or obtain evidence in an investigation. Such methods include:

- The Fraud Tip Hot Line, telephone number (800) 229-6297, is available for the public to report employer tax evasion and allegations of fraud against the UI program, the DI program, and other programs administered by EDD. Effective February 2005, fraud allegations were also reported via the EDD Web site (*www.edd.ca.gov*).
- The Claimant Address Report, more commonly referred to as "Claimant ZIP Code Report," lists the mailing addresses within a particular postal ZIP Code area used by claimants to receive benefits. The report identifies mailing addresses where multiple claimants are receiving possible fraudulent payments.
- Participation in Task Forces with other state and federal law enforcement agencies such as the DOL, DOI, FTB, IRS, U.S. Postal Inspectors, and prosecutors.
- In collaboration with the ID and federal investigators, A&ED conducts forensic accounting and audit examinations to examine bank records, and personal and employer financial records.

The results of PRB's investigative activities for CY 2006 as well as the previous two CYs are covered in the DI, UI, and Employment Tax sections of this report.

- The **Criminal Intelligence Unit (CIU)** was created within ID to develop strategic and tactical intelligence for investigative planning and case identification, and to assist program managers and oversight functions to identify areas of focus to prevent and detect fraud. The CIU works with EDD program managers to develop characteristics of fraud and uses technology to screen claims for potential fraudulent activities. The CIU and A&ED are currently gathering and analyzing data from claims filed and investigative cases worked to gain insight into the fraudulent trends and patterns being employed against EDD. Strategies the Department can use to counter these trends and patterns can then be developed.

Additionally, A&ED utilizes CIU developed information in its risk assessment process to prepare EDD's Audit Plan. This enables PRB to schedule audits in areas most vulnerable to fraud, thereby making the most effective use of EDD's audit resources. Conversely, A&ED will provide information obtained during the course of its audits to CIU, such as internal control strengths and weaknesses, to further enhance CIU's efforts in developing strategic and tactical intelligence.

This effort is an ongoing challenge due to the advances of technology and the increased sophistication of criminal perpetrators seeking to defraud EDD.

- **Automated Data Analysis**: The PRB is developing staff expertise in using automated software to conduct complex, comprehensive data analysis.

ENTERPRISE-LEVEL ACTIVITIES

The EDD has increasingly taken an enterprise-wide approach to identify and combat fraud within and across programs. Additionally, EDD is continually seeking new approaches to prevent, detect, and deter fraud, through partnerships with both internal and external entities. This section summarizes enterprise-level anti-fraud efforts undertaken during 2006, and those activities that are under consideration for future implementation.

The areas for enhanced anti-fraud efforts include:

New and Expanded Internal and External Partnerships

- The EDD ID, jointly with both the UI and DI programs, has begun to identify claim or payment characteristics that are indicative of fraud. This has enabled automated trend analyses as a method to identify potential fraudulent claims/payments, which trigger additional steps to determine legitimacy of suspect claims.
- An expanded partnership between EDD ID and A&ED has enabled more thorough and timely analysis of large volumes of accounting data as a tool to identify and analyze perpetrators' fraudulent activities and develop investigative leads.
- The EDD ID has continued to foster joint investigative activities with DOL and the U.S. Attorney, as a means to develop and share fraud leads, and more effectively investigate and prosecute perpetrators of fraud.
- The ID coordinates with partner investigative/enforcement agencies to publicize joint investigative, arrest, indictment, and prosecution actions, with the intent of deterring fraud perpetrators.

Recent Internal and External Partnership Enhancements

- Expanded EDD investigator participation in local level task forces to enhance local level collaboration.
- Enhanced partnerships with other state and federal agencies to share fraud leads, anti-fraud methodologies, and activities.
- Increased marketing efforts to educate the public on the consequences associated with committing fraud.
- Developed a cross-program approach to fraud detection, deterrence, and prevention activities. The ID works closely with the UI and DI programs to develop joint strategies for early detection and prevention of fraud. Results of these efforts are anticipated to reduce the amount of dollars paid out on fraudulent claims.

Automated Fraud Detection and Prevention Tools Under Consideration

- Direct Deposit - A new automated Direct Deposit system for claimants to have their UI or DI benefit checks deposited directly into their bank accounts.

- Voice Print Technology - An automated Voice Print technology enhancement to identify claimants when they call to certify for benefits by telephone.
- Electronic linkage of the Tax and the UI systems to enhance EDD's ability to detect fraud.
- Enhancement of the Fictitious Employer Detection System that identifies potential employer/claimant fraud involving the establishment of fictitious employer accounts and fictitious claimants. The system contains certain characteristics that are fairly common among employers and claimants involved in fictitious employer schemes. The identification and addition of new characteristics to the system will increase EDD's ability to detect and deter fraud. An employer-tracking file serves as the basis to identify such employers and/or claimants.
- Establish automated links to other governmental agencies.
- Combat Identity Theft – A Supplemental Budget Request (SBR) was approved for the purchase and installation of data mining software and computer equipment to improve EDD's ability to prevent, deter, and detect identity theft in the UI program. The software will be used to improve UI fraud detection by conducting in-depth data analyses and automatically identifying patterns and trends that will serve as probable indicators of fraudulent activity. The data mining software will be used by the PRB to develop predictive models to improve decision-making and reduce fraud. See page 15 for additional information on this initiative.

ACRONYMS

A&ED	Audit and Evaluation Division
CEP	Construction Enforcement Project
CIU	Criminal Intelligence Unit
CRU	Compliance Resolution Unit
CUIC	California Unemployment Insurance Code
CY	Calendar Year
DI	Disability Insurance
DMV	Department of Motor Vehicles
DOI	Department of Insurance
DOL	U.S. Department of Labor
EDD	Employment Development Department
EEEC	Economic and Employment Enforcement Coalition
EETF	Employment Enforcement Task Force
FOIS	Field Office Integrity Specialist
FTB	Franchise Tax Board
ID	Investigation Division
IME	Independent Medical Examination
IRS	Internal Revenue Service
IT	Information Technology
IVR	Interactive Voice Response
JEP	Janitorial Enforcement Project
JESF	Joint Enforcement Strike Force
JS	Job Service
LWIA	Local Workforce Investment Area
NER	New Employer Registry
OIG	Office of the Inspector General
PFL	Paid Family Leave
PI SPOC	Program Integrity Single Points of Contact
PIN	Personal Identification Number
PRB	Program Review Branch
QC	Quality Control
SALMS	Security Audit Logging and Monitoring System
SBR	Supplemental Budget Request
SSA	Social Security Administration
SSN	Social Security Number
SUTA	State Unemployment Tax Act
TAS	Tax Accounting System
TIPP	Targeted Industries Partnership Program
UEO	Underground Economy Operations
UI	Unemployment Insurance
WBCF	Web Based Claim Filing
WIA	Workforce Investment Act
WtW	Welfare-to-Work

This report was prepared by the Program Review Branch of the California Employment Development Department

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STATE OF CALIFORNIA

LABOR AND WORKFORCE DEVELOPMENT AGENCY

EMPLOYMENT DEVELOPMENT DEPARTMENT

Employment Development Department
State of California

ANNUAL REPORT

FRAUD DETERRENCE AND DETECTION ACTIVITIES

A REPORT TO THE CALIFORNIA LEGISLATURE

SEVENTEENTH REPORT

JUNE 2011

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EXECUTIVE SUMMARY

This report documents the Employment Development Department's (EDD) fraud deterrence and detection activities for Calendar Year (CY) 2010, as required by California Unemployment Insurance Code Section 2614.

The EDD's major program responsibilities include Unemployment Insurance (UI), Disability Insurance (DI), Employment Tax Collection, and Workforce Investment Act (WIA) programs. During 2010, through the administration of its programs, EDD collected more than $50 billion in employment taxes from over 1.3 million employers and issued benefit payments in excess of $27 billion on over 7.4 million UI and DI claims.

To protect the integrity of its programs, EDD enforces the California Unemployment Insurance Code provisions and various other California codes affecting its programs. Doing so assures the integrity of all EDD programs and protects the interests of employers, claimants, and taxpayers. Research suggests that organizations can reduce the risk of fraud through a combination of prevention, detection, and deterrence measures. A strong emphasis on fraud prevention may reduce opportunities for fraud to take place while fraud deterrence could persuade individuals that they should not commit fraud because of the likelihood of detection and punishment.[1]

The EDD takes a comprehensive approach to fraud prevention, detection, and deterrence. This approach involves EDD programs, EDD oversight entities, and business partners including federal, state, and local law enforcement agencies, and prosecutors. During CY 2010, EDD's comprehensive anti-fraud activities in the DI, UI, and Tax programs identified fraud (in dollars), as follows:

Description	DI Program	UI Program	Tax Program
Cases Under Investigation	$ 4,417,761 126 cases	$ 11,573,397 118 cases	$ 50,670,527 186 cases
Criminal Complaints Filed	$ 525,446 21 cases	$ 1,080,329 20 cases	$ 2,057,458 16 cases
Completed Criminal Prosecutions	$ 759,984 25 cases	$ 1,297,710 22 cases	$ 2,885,307 11 cases
Fraud Overpayments (OP)	$ 3,601,131 806 OPs	$ 250,805,366 188,946 OPs	N/A
Fraudulent Benefits Prevented	$ 3,270,000	$ 3,435,897	N/A

The detection and deterrence of fraud in the WIA program is accomplished through a variety of processes that EDD requires of the local administrative entities that provide employment training services. The program integrity components[2] include: monitoring reviews; an incident reporting system; single audits; program oversight; and regulatory controls.

The remainder of this report highlights fraud deterrence and detection activities by each EDD program and summarizes oversight activities across EDD. The final section of this

[1] Management Antifraud Programs and Controls – Guidance to Help Prevent and Deter Fraud, American Institute of Certified Public Accountants, 2002, p. 5.

[2] See WIA program details on pages 25-26.

report highlights enterprise-wide efforts in progress and under consideration to prevent, detect, and deter fraud.

BACKGROUND

The California Unemployment Insurance Code Section 2614 requires the Director of EDD to report to the Legislature by June 30 of each year on EDD's fraud deterrence and detection activities.

In CY 2010, EDD collected more than $50 billion in employment taxes and issued benefit payments in excess of $27 billion to UI and DI claimants. The EDD administers the UI, DI, and WIA programs. Through its Employment Tax Collection Program, EDD collects UI and Employment Training Tax, and DI and Personal Income Tax withholding for the State of California.

As with any program where large sums of money are involved, the temptation to defraud the system for personal gain is present. Employers may not fully pay their employment taxes as required by law; claimants may use multiple social security numbers or the identities of others or claim benefits while working; physicians may certify disability inappropriately; and claimants or physicians may submit forged documents. Further, threats may be made to the security of EDD's systems or employees.

APPROACH

The EDD uses a multi-tiered, comprehensive approach to fraud deterrence and detection. This approach involves EDD programs, EDD independent oversight entities, and business partners including federal, state, and local law enforcement agencies, and prosecutors.

Each program area has established ongoing anti-fraud activities. In addition, independent oversight entities perform other activities including internal control reviews and audits, quality reviews to measure the accuracy and propriety of benefit payments, and information technology system reviews to detect system control deficiencies. Lastly, the Investigation Division (ID) identifies, investigates, and prosecutes fraud within EDD's various programs and internal operations.

Anti-fraud activities within EDD range from up-front fraud prevention such as customer education, reviews of internal control systems, employer audits, internal systems audits and controls, fiscal monitoring activities, and ongoing or special fraud detection activities. Fraud detection activities include but are not limited to: analyzing client, employer, and medical provider demographic data; establishing internal program checks and balances; performing electronic cross-matches; participating in joint efforts with other agencies and business partners; operating a fraud reporting Hotline; and conducting criminal investigations that include surveillance, undercover operations, computer forensic analysis and data mining, search warrants, witness and suspect interviews, evidence seizure, and, in concert with other law enforcement agencies, arrest and prosecution of suspects.

FRAUD DETERRENCE AND DETECTION ACTIVITIES

STATE DISABILITY INSURANCE (SDI) PROGRAM

The SDI program is comprised of two benefit programs, the DI program, and the Paid Family Leave (PFL) program. The DI program provides partial wage replacement for eligible California workers who are unable to work due to illness, injury, or pregnancy. Workers covered under the SDI program are potentially eligible for PFL benefits when they are unable to work because of the need to care for a seriously ill child, parent, spouse, or registered domestic partner, or to bond with a new minor child within the first year of birth or placement by adoption or foster care into the family.

The EDD is continuing its comprehensive, multi-faceted approach to combating fraud and improving benefit payment accuracy in the SDI program. During CY 2010, the DI program processed 737,497 claims and paid out over $4 billion in benefits. The PFL program processed 200,922 claims and paid out over $488 million in benefits.

The EDD collects and analyzes data to support cases for prosecution and administrative action against those suspected of committing fraudulent acts. The SDI Integrity program includes a Program Integrity Manager and 10 Field Office Integrity Specialists (FOIS) located throughout the State and 2 Program Integrity Analysts. The manager and the FOIS oversee, coordinate, and conduct various staff education efforts and investigative activities involving suspicious claims in the DI and PFL offices. The Program Integrity Analysts complete in-depth data analysis of various reports and develop procedures and forms to enhance program integrity efforts. The DI Branch staff work closely with ID's criminal investigators to combat fraud in the SDI program.

Primary SDI program fraud deterrence and detection tools include:

- **Claimant Notification** of the legal consequences for willfully making a false statement or knowingly concealing a material fact in order to obtain benefits is provided on the claim form declaration statement signed by the claimant when applying for benefits.

- **Independent Medical Examinations** (IME) provide EDD with a second medical opinion regarding the claimant's ability to perform his/her regular or customary work when the period of disability allowed by the treating physician or practitioner exceeds the normal expected duration for that diagnosis. Photo identification is requested to ensure that the claimant, and not a substitute, appears for the examination.

  The Medical Director's Office oversees the panel of healthcare professionals that perform IMEs. The Medical Director screens applicants for this panel to ensure they have appropriate credentials. In addition, the Medical Director recruits new members to the IME panel to ensure there are appropriate numbers of specialists in all areas of the State and outside the State.

  Although the primary use of IMEs is the validation of the treating physician's diagnosis and prognosis, and a means of controlling the duration of claims, IMEs are

also a useful tool in curtailing the loss of benefits in those cases where fraud or abuse is suspected. In CY 2010, of the 30,782 IME results received, 1,739 (5.65 percent) of the claimants scheduled for an IME failed to appear, and 8,625 (28 percent) were found able to work on the date of the IME examination.

- **Monthly Doctor Activity Reports** provide a list of the top 200 doctors certifying to the highest total amount of benefits, newly certifying physicians who certify more than a specific monetary amount or number of claims, and doctors whose claim-certifying activity has dramatically increased during the report period. These automated monthly reports, enable the FOIS to identify significant changes in claims activity and/or filing patterns, which may be indicators of fraud.

- **Automated Tolerance Indicators** (flags) that are associated with the certifying healthcare provider's license number assist staff to identify and track claims on which fraud or abuse is suspected or has previously been detected. They also alert staff to refer to special instructions that have been created to assist in the adjudication and payment of claims on which a Tolerance Indicator has been attached.

- **UI/DI Overlap Flags** generate an automated stop pay on DI and PFL claims when a prior UI claim period overlaps the dates that DI benefits are claimed. When alerted by a stop payment flag DI and PFL staff block the overlapping period pending an eligibility determination, thereby helping in the prevention of potentially improper payments.

- **Decedent Cross-Match Reports** identify benefit payments issued after the date of death to SDI claimants by checking the Social Security Numbers (SSN) of all claimants against SSNs of individuals reported as deceased by the Department of Public Health. The report enables DI Branch to identify and recover benefits paid subsequent to the date of death that may not otherwise have been discovered. When there is a material disparity between data provided on the owner of a particular SSN and that shown on EDD's Single Client Data Base for that SSN, DI Branch researches that SSN in Social Security Administration's Death Index.

- **Address/Name Change Reports** record all changes of the claimant names or addresses by date and operator identification, as a means to identify claim manipulation, or "hijacking" by employees committing internal fraud. Analysis of these reports has been expanded, identifying fraud or abuse which had previously gone undetected. Specifically, a variety of research tools, such as address lists for state and federal correctional institutions, address lists for all EDD offices, and reverse address directory, etc., have been developed as cross-match devices. As a result of these enhancements, 107 referrals were made to the FOIS for further action in CY 2008 and 24 in CY 2009, and 106 in CY 2010.

- The **Doctor Activity Tracking System** tracks the status of investigations involving potential doctor[3] or doctor impostor[4] fraud cases. The system also provides a useful management tool to ensure appropriate follow up occurs, and to document and evaluate accomplishments.

- **Doctor License Reports** identify all SDI claims that are certified by a particular doctor. Analysis of the claims listed on the report can lead to discovery of fraudulent claims or program abuse.

- **DI Quality Control Reviews** test a random, statistically valid, sample of DI benefit payments annually for accuracy, completeness, and compliance with the California Unemployment Insurance Code, Title 22 of the California Code of Regulation and DI Branch policy. These reviews detect the nature and extent of inaccurate payments, reveal opportunities for process improvement, and serve as a check on employee fraud or collusion. Claims that appear fraudulent are referred to the FOIS for follow up. As a result, seven referrals were made for further action in CY 2010.

- **PFL Quality Control Reviews** test a random, statistically valid, sample of PFL benefit payments annually to verify that a claimant has met essential eligibility requirements and that benefits have been paid accurately in compliance with the California Unemployment Insurance Code and Title 22 of the California Code of Regulations. These reviews detect the nature and extent of inaccurate payments, reveal opportunities for process improvement, and serve as a check on employee fraud or collusion. Claims that appear fraudulent are referred to the FOIS for follow up. As a result one referral was made for further action in CY 2010.

- **Medical Board Notifications** identify healthcare providers whose licenses have been revoked or suspended. This information, supplied by the Medical Board of California, helps ensure that claims are not certified by improperly licensed healthcare providers and alerts EDD to potential fraudulent situations.

- **Board of Chiropractic Notifications** identify chiropractors whose licenses have been revoked or suspended. This information, supplied by the Board of Chiropractic Examiners, helps ensure that claims are not certified by improperly licensed chiropractors and alerts EDD to potential fraudulent situations.

- The **DI Personal Identification Number (PIN) System** provides telephone identification, authentication, and authorization services via EDD's Interactive Voice Response (IVR) system. The system enhances security of the IVR system and improves claimant privacy by preventing unauthorized access to confidential data.

  Claimants are required to enter their SSN and PIN each time they request confidential payment information through DI Branch's IVR system. Claimants select their PIN the first time they use the IVR system to obtain payment information by

[3] Doctors who knowingly certify claims for individuals who are not disabled.
[4] Someone other than the doctor signs the doctor's name on DI claim forms.

matching personal identifying information. As an additional security and fraud detection measure, when a PIN is established or changed the claimant is sent a notice.

- The **In-Office Eligibility Review Process** provided for in Title 22 of the California Code of Regulations, permits EDD to require claimants suspected of fraud, who are currently receiving benefits, to submit to an in-person interview before a decision is made regarding their continued eligibility to receive benefits. The process provides the claimant with a fair and equitable opportunity to be heard in person and enables EDD to gather additional information before making its decision. The regulations provide precise time frames and procedures for conducting interviews to ensure that claimants' rights to due process are protected.

- An EDD **Toll-free Fraud Tip Hot Line**, (800) 229-6297, provides employers and individuals a designated telephone number to report alleged fraud directly to ID's Criminal Intelligence Unit (CIU). The number of SDI program fraud allegations reported through the Hot Line is as follows: 423 allegations in CY 2008, 670 allegations in CY 2009, and 790 allegations in CY 2010.

- Fraud allegations were also reported via the **EDD Web site** (*www.edd.ca.gov*). It provides the ability to report fraud and other sensitive information (SSNs, etc.) in a secure environment. An additional 802 allegations in CY 2008, 760 allegations in CY 2009, and 966 allegations in 2010 were received by the Hot Line operators in this manner.

- The **Truncation of Claimant SSNs** to only the last four digits on DI and PFL benefit checks helps to deter identity theft and protect the confidentiality of information assets.

- **Electronic Benefit Payment Project** provides an electronic payment system for disbursing of DI and PFL benefit payments. The Electronic Benefit Payment Project provides claimants immediate access to their benefits and eliminates fraud associated with theft or loss of paper warrants.

- **Program Integrity Training** is provided to all new hires to heighten staff awareness and capacity to detect and deter fraud and abuse in the DI and PFL programs. New hires are initially exposed to the concepts and tools during new employee orientation shortly after being hired and once again in greater detail during formalized training. In addition, field office staff designated as Program Integrity Single Points of Contact who perform program integrity functions and work closely with the FOIS, receive specialized training.

- **On-Line DI Program Integrity Awareness Training** module was developed by the FOIS. In addition to classroom training, field office staff are able to take the on-line portions of the Refresher Program Integrity training at their work station.

- **Automated Detection Reports** developed collaboratively with ID's CIU permit staff to detect unusual patterns of activity in the SDI benefit payment system involving

addresses, issuance of multiple checks, and multiple claims filed by the same claimant within a specified period of time.

- An **Educational Outreach Campaign** to the California medical community led by the EDD Medical Director's Office in partnership with SDI's Education Outreach Unit enhances medical providers' understanding of the purpose of the DI and PFL programs and their role in the claim filing process. The educational programs are geared to the California medical community including both resident physicians and physicians in practice. This effort enhances the integrity of both programs by improving the quality of medical information received thereby ensuring that the benefits paid are consistent with the claimant's inability to perform their regular or customary work or the need to care for a family member with a serious health condition. It also helps to minimize the occurrence of medical certifications that extend the disability duration beyond normal expectancy.

- **Formal Identity Alert Procedures** were provided to staff for handling DI and PFL claims with an Identity Alert flag. The EDD places a "flag" on potentially compromised SSNs identified by employers/employer agents, ID, or UI Branch. When a claim with an Identity Alert flag is processed, SDI program integrity staff conducts an in-depth review to ensure that the claimant is the true wage earner.

- **Medical Training** provided to field office staff by EDD's Medical Director is a comprehensive presentation of medical information and case study training intended to educate and enhance staff's knowledge of disabling medical conditions and medical terminology. This training allows the staff to communicate more effectively with medical providers when discussing and obtaining additional medical information regarding a DI or PFL claim. The information provides staff with a better understanding of the diagnoses assists them in determining the severity and expected length of a disability and enables them to read and understand the medical information on the claim form with more confidence, and take appropriate action to control claim duration or potential abuse of the programs.

  The Medical Director's Office is available to consult with staff concerning unusual medical conditions by providing guidance on how to establish an appropriate normal expectancy and how to appropriately employ duration control measures.

- **Fraud Penalty Assessment** of 30 percent on overpayments resulting from claimant fraud.

- **Education and Outreach** is provided to medical providers and public/private employers regarding program information and practices, as well as, their key role in verifying claimant information to ensure proper payment of benefits and continued integrity of the DI Fund.

- **Confidentiality Training Module** developed to reinforce management of EDD's confidential and sensitive information and appropriately document potential fraudulent activity.

- **Impostor Fraud Training** provided to staff in an effort to curtail fraud and abuse. Tools are provided to assist in identifying abusive or fraudulent activity and the appropriate referral process.

In addition to the fraud deterrence and detection tools, the following special claim processing safeguards and automation techniques unique to the PFL program are currently being utilized:

- The requirement to submit a birth certificate, adoption or foster care certification on all bonding claims for which no medical evidence of a birth exists.
- The PFL automated system includes a scanning process that provides an online viewable copy of all claim documents. To assist in detecting possible forgeries, claims examiners are able to compare current signatures of claimants and physicians with documents submitted previously by the same claimants and/or physicians.
- The PFL automated system also includes a powerful tool for identifying patterns on suspicious claims by allowing claims examiners to retrieve all information about a claimant including all flags, images, and care recipients for current and past claims.
- The **PFL Address/Name Change Report** records all changes of the claimant's name or address by date and operator identification, as a means to identify claim manipulation, or "hijacking" by employees committing internal fraud, thus adding protection to claimant information.

RESULTS/ACCOMPLISHMENTS DURING CY 2008 through 2010

The following table shows the SDI's program dollar value and case number results for the last three years:

	2008	2009	2010
Cases Under Investigation	$ 5,863,183 294 cases	$ 4,250,647 127 cases	$ 4,417,761 126 cases
Criminal Complaints Filed	$ 1,835,763 19 cases	$ 749,890 23 cases	$ 525,446 21 cases
Completed Criminal Prosecutions	$ 296,576 16 cases	$ 904,411 14 cases	$ 759,984 25 cases
Fraud Overpayments[5] (OP)	$ 3,425,725 671 OPs	$ 2,691,401 631 OPs	$ 3,601,131 806 OPs
Fraudulent Benefits Prevented	$ 3,458,393	$ 4,413,636	$ 3,270,000

- During CY 2010, ID investigated a total of 126 ongoing and new DI fraud cases representing a potential overpayment in the amount of $4,417,761[6]. These investigations focused on the following case types: impostor fraud/identity theft (21

[5] "Fraud overpayments established" includes overpayments established as a result of both criminal and administrative actions.

[6] Total does not equal case type detail due to rounding off to whole dollars.

cases representing $1,910,999); altered or forged documents (45 cases representing $1,176,615); medical practitioner fraud (7 cases representing $193,544); and counterfeit checks (2 case representing $23,440). The remaining 51 miscellaneous cases, representing $1,113,163 included working while certifying for benefits and other case types.

- In CY 2010, ID filed 21 Criminal Complaints representing potential fraudulent benefits in the amount of $525,446. The ID has continued their emphasis on the more complex fraud cases such as impostor/identity theft that take longer to investigate. Although 21 cases prosecuted out of the total number of cases investigated of 126 seems small, the number of investigators assigned to perform DI investigations has reduced greatly due to attrition thus delaying casework due to necessary reassignment of cases to the investigators remaining.

- During CY 2010, ID completed 25 criminal prosecutions representing fraudulent benefits in the amount of $759,984. These completed prosecutions primarily involved altered and forged medical, counterfeit checks, impostors and working while certifying for benefits.

- In CY 2010, the DI and PFL programs established a cumulative total of 806 fraud overpayments in the amount of $3,601,131.

  - The DI program established 30 fraud overpayments totaling $437,600 on claims associated with claimants who were prosecuted.

  - The DI program established 751 fraud overpayments that were not attributed to prosecutions. These overpayments, totaling $3,133,033 were the result of administrative actions applied by the DI program, such as false statement overpayments.

  - The PFL program established 25 fraud overpayments that were not attributed to prosecuted claimants. These overpayments, totaling $30,498 were the result of enforced administrative remedies available to the DI program, such as false statement overpayments.

- In CY 2010, departmental anti-fraud efforts stopped $3,270,000 in fraudulent SDI benefits from being paid. Of this total, $3,170,026 is attributable to SDI program anti-fraud efforts such as IMEs, verification of SSN ownership with deletion of improper base period wages, and all referrals to ID resulting in convictions or administrative actions which prevented payment of further benefits. Payment of approximately $99,974 in fraudulent benefits was prevented through ID's ongoing investigations of identity theft, forgeries, and medical practitioner fraud.

- In 2010, 57 doctors certified to a high volume of activity which included 10 that already had a Tolerance Indicator established based on a previous review. In 15 cases, after review by DI Branch and/or ID, it was concluded that the doctors' high volume of activity was justified and no fraud or abuse was detected. In the remaining 42 cases, 2 are under investigation by ID; 2 evaluations have been completed; leaving 38 cases pending further evaluation by the FOIS.

FUTURE DI PROGRAM ENHANCEMENTS

The **DI Automation Project** will provide claimants, medical providers, and employers the ability to file claim information via the Internet and provide claimants online access to claim status and payment history, thus improving access to services and delivery. The new system will provide DI Branch the ability to manage fraud and abuse through automated programs and business logic. In addition, the DI Automation Project will provide the following enhancements:

- **SSN Verification** through Social Security Administration's records. The claimant's SSN will be verified during the claimant's identification process, to detect potential fraud prior to filing a DI claim.

- Interface to the **Department of Motor Vehicles** records to allow DI program integrity staff to verify a claimant's California driver's license or identification card number.

- **Last employer address** information will be obtained from EDD's internal database. The ability to track and cross-match employer addresses rather than relying upon the claimant to provide EDD with this information will ensure that proper payments are made to the appropriate individuals.

- **New Employee Registry (NER) Benefit Cross-Match** interface will enable DI Branch to use new hire information from California employers to identify claimants who improperly continue to receive benefits after they have returned to work.

- The **Address Integrity** component of the DI Automation Project will ensure only the rightful owner of the claim makes a change of address to a claim. As a security and fraud detection measure, a letter will be sent to the old address to notify the claimant that DI Branch has received a request for a change of address.

- Secure **Health Insurance Portability and Accountability Act Compliant Online Claim Filing** reduces the risk of confidential information lost in the mail and reduces exposure for misuse.

- **Identity Management Software** authenticates, and authorizes external users (customers) who set up external user accounts. The system will create an online profile for each external user, and will encrypt and store the user identificaiton/password, profiles, and credentials in an enterprise Identity Management system. The solution will then validate and authenticate external users' logon credentials and allow authenticated users to access system functionality and improve DI Branch's ability to detect fraud.

- The **Benefit Audit Review** matches wages reported quarterly by employers to DI benefits paid within the same period. Through this review, the DI program will be able to detect when claimants have been fraudulently collecting benefits while working. Overpayments and penalties will be established and collected as a result

of this process, protecting the solvency of the DI Fund. The reviews will be performed quarterly.

Data Mining Project is underway to utilize software to improve DI Branch's ability to prevent and detect identify theft in the DI program. The software will be used to improve DI Branch's fraud detection by conducting in-depth data analyses and identify patterns and trends that will serve as probable indicators of fraudulent activity.

Electronic Benefit Payment Project provides an electronic payment system for disbursing of DI, PFL, and UI benefit payments. This will give claimants immediate access to their benefits and eliminate fraud associated with theft or loss of paper warrants.

UNEMPLOYMENT INSURANCE (UI) PROGRAM

The EDD administers the UI program, which provides benefits to individuals who have lost their jobs through no fault of their own, are actively seeking work, are able to work, and willing to accept employment. During CY 2010, the UI program processed 7.7 million initial claims, of which 6.5 million were new claims and paid a total of $22.9 billion in benefits. These figures include the regular UI program in addition to the four federal extended benefit programs: Emergency Unemployment Compensation Tiers I, II III and IV, which respectively began July 2008, November 2008, and November 2009 (both Tiers III and IV); the Federal-State Extended Benefits program, which began February 2009; and the Federal Additional Compensation (also known as $25 weekly Stimulus Payments), which began February 2009.

The EDD is committed to maintaining the integrity of the UI program. The UI program utilizes a variety of processes, tools, and techniques to deter and detect fraud, which include:

- **Claimant Notification** provides notice to the claimant, by way of a Claimant Handbook, of claim eligibility requirements and legal consequences of willful misrepresentation[7] or willful nondisclosure of facts.

- **30 Percent Fraud Penalty Assessment** on any overpayments resulting from claimant fraud.

- **Bi-weekly Claim Certification** by claimants of their continued eligibility for benefits. This process requires the claimants to certify the accuracy and truthfulness of the statements made and that they understand that the law provides penalties for making false statements to obtain benefits.

- **UI Quality Control** (also known as UI Benefit Accuracy Measurement) is an independent review of a random sample of claims throughout the year to test the effectiveness of procedures for the prevention of improper UI payments. These reviews detect the nature and extent of improper payments, reveal operating weaknesses, and serve as a check on agency employee fraud or collusion. Claims that appear fraudulent are referred to investigators for follow up.

- The **Benefit Audit Process** matches wages reported quarterly by employers to UI benefits paid within the same period. Through this process, the UI program is able to detect when claimants have been fraudulently collecting benefits while working. Overpayments and penalties are established and collected as a result of this process, protecting the solvency of the UI Trust Fund. These matches are performed on a quarterly and annual basis. The EDD utilizes an employer compliance database to track benefit audit forms that have been mailed and returned by employers.

[7] To willfully provide false information or withhold information that affects the payment of UI benefits.

- The **NER Benefit Cross-Match** enables EDD to use new hire information from California employers to identify claimants who improperly continue to receive benefits after they have returned to work. This is accomplished by matching on a daily basis, the new hire information with EDD's records of claimants currently collecting UI benefits. Through this process, EDD is able to detect fraud and other eligibility issues up to six months earlier than through EDD's benefit audit process, allowing EDD to protect the UI Trust Fund by reducing the amount of dollars overpaid to claimants.

- **Verification of a Claimant's Right to Work** enables EDD to identify claimants who do not have legal authorization to work in the United States (U.S.), thus preventing payments to individuals who are not eligible for benefits. The Systematic Alien Verification for Entitlement process enables EDD to link with the database of the U.S. Citizenship and Immigration Services (formerly Immigration and Naturalization Service) to submit both initial and additional verification queries to obtain information necessary to reduce improper payments to individuals who do not have legal authorization to work in the U.S.

- An **SSN Verification** provides real time (on-line) access to the Social Security Administration's records. The claimant's SSN is verified during the claimant's identification process, to detect potential fraud prior to filing a UI claim.

- The **Department of Motor Vehicles** provides real time (on-line) access to it's database to verify a claimant's California driver's license or identification card number, prior to filing a UI claim. This is part of the identity verification process is used to prevent identity theft fraud in the UI program.

- The **last employer address information** is obtained from EDD's internal database. The ability to cross-match employer addresses with this database rather than relying upon the client to provide EDD with this information will better ensure that proper payments are made to the appropriate individual.

- Employers or individuals are offered several options to report alleged fraud activities. The ID operates a **Toll-free Fraud Tip Hot Line**, telephone number (800) 229-6297. The number of UI program fraud allegations received through the Hot Line is as follows: 1,276 allegations in CY 2008, 2,999 allegations in CY 2009, and 4,197 allegations in CY 2010.

- Fraud allegations were also reported via the **EDD Web site** (*www.edd.ca.gov*). An additional 1,691 allegations in CY 2008, 3,326 allegations in CY 2009, and 4,679 allegations in CY 2010 were received by the Hot Line operators in this manner.

- The **UI Personal Identification Number (PIN)** is an automated system that allows claimants to select a PIN in order to obtain personal claim information through the IVR system, which is available seven days a week, 24-hours a day. The UI PIN was established to protect claimants' confidential information. Without a PIN, claimants are unable to access their personal and confidential claim information through the IVR system.

- Changes to the **UI benefit check** were implemented as part of EDD's ongoing commitment to deter identity theft and to protect the confidentiality of its information assets. The heading "SSA NO." was removed from the face of the UI benefit check and the 9-digit SSN is no longer printed on the face of the check. In its place, **only** the last 4 digits of the claimant's SSN are displayed.

- The EDD has always used various measures to ensure the true identity of a claimant for UI benefits. The **UI Impostor Fraud Prevention** was enhanced with the implementation of EDD's Identity Alert Process. The process, developed to reduce the risk of identity theft fraud, was implemented when employers and/or employers' payroll agents contacted EDD to report that their records containing confidential employee information had been compromised. The Identity Alert Process was designed to protect the worker and employer from ongoing fraud and to ensure proper payments of UI benefits.

  When a claim is initiated into the Identity Alert Process, no payments are issued until EDD obtains the information needed to validate the identity of the individual filing the UI claim. The UI Identity Regulations, pursuant to the California Code of Regulations, Title 22, Sections 1251-1 and 1326-2, allow EDD to require a claimant to provide identity verification documentation upon request.

  The Identity Alert Process is funded by both federal and State monies. Approximately 55 percent of this process is accomplished using State funds. For every Personnel Year dedicated to this function, there is an estimated corresponding savings to the UI Trust Fund of more than $4.3 million.

  The tools utilized by EDD to prevent UI impostor fraud include:

  - Stopping benefit payments on active UI claims that are associated with compromised SSNs until the identity of the claimant is confirmed.

  - Implementing enhanced screening procedures during the claim filing process to better authenticate the identity of claimants (e.g., SSN and Department of Motor Vehicles verifications) and to ensure only the true owner of the identity will receive UI benefits.

  - Utilizing a variety of communication methods to provide information to all California employers on how to protect and properly destroy confidential personnel information and assist EDD in preventing UI fraud. This includes published articles in the California Employer's Guide (DE 44-Tax publication) as well as the California Employer Newsletter (Quarterly-Tax publication.

  - Updating the EDD Web site *(www.edd.ca.gov)* with information on UI impostor fraud and identity theft assists both employers and employees. The brochures **"How You Can Prevent Unemployment Insurance Impostor Fraud"** (designed for employers) and **"Protect Your Identity and Stop Unemployment Insurance Impostor Fraud"** (designed for employees) can be viewed as well as downloaded and printed from the EDD Web site.

- Partnering with other states that have also experienced increases in UI impostor fraud. The EDD has worked closely with other states to identify common patterns and trends, share anti-fraud processes, and resolve fraud cases where the parties have a connection to multiple states.

- Developing a toolkit for employers, as part of an ongoing **public education campaign** that includes information on how they can prevent and detect UI impostor fraud. Success in preventing, detecting, and deterring UI impostor fraud is greatly dependent upon a strong partnership with the employer community.

- Utilizing internal workgroups to evaluate the effectiveness of existing antifraud systems, identify enhancements, and develop new methods for detecting, deterring and preventing fraud. Currently, UI Branch, in partnership with ID and the Audit and Evaluation Division, are exploring data mining tools to actively identify patterns, data elements, and trends to detect and prevent potentially fraudulent UI claims earlier in the process.

RESULTS/ACCOMPLISHMENTS DURING CY 2008 through 2010

The following table shows the UI program's results for the last three years:

	2008	2009	2010
Cases Under Investigation	$ 18,437,298 124 cases	$ 18,172,722 116 cases	$ 11,573,397 118 cases
Criminal Complaints Filed	$ 1,587,822 23 cases	$ 230,688 21 cases	$ 1,080,329 20 cases
Completed Criminal Prosecutions	$ 2,500,020 28 cases	$ 9,223,340 20 cases	$ 1,297,710 22 cases
Fraud Overpayments (OP) est.	$ 88,347,704 106,553 OPs	$ 138,301,528 129,148 OPs	$ 250,805,366 188,946 OPs
Fraudulent Benefits Prevented By Investigation Division	$ 10,972	$ 504,264	$ 3,435,897

- During CY 2010, ID investigated a total of 118 ongoing and new UI fraud cases representing potential fraudulent benefit payments in the amount of $11,573,397. These investigations focused on the following case types: impostor fraud/identity theft (24 cases representing $4,205,204); working while certifying for benefits (57 cases representing $830,305); forgery – taking over another's claim (13 cases representing $202,659); and conspiracy between employer and claimant to certify for benefits (1 case representing $5,746). The remaining 23 miscellaneous cases, representing $6,329,483, included counterfeit checks and the use of multiple SSNs by one person.

- In CY 2010, ID filed 20 Criminal Complaints representing potential fraudulent benefits in the amount of $1,080,329. During 2010, ID gave priority to investigating complex fraud cases involving the most egregious violations and the highest overpayments.

- In CY 2010, ID completed 22 criminal prosecutions representing fraudulent benefits in the amount of $1,297,710. Although 22 cases prosecuted out of the total number of cases investigated of 118 seem low, these prosecution cases are very large and complex both in terms of volume of claims and dollar value. Consequently, these cases take numerous staff resources and years to prosecute. The number of cases under prosecution in any given year is also dependent on local and federal prosecutors' workload and ability to take these cases.

- During CY 2010, UI program staff established a total of 188,946 fraud overpayments totaling $250,805,366. The increase in number of cases and overpayments from CY 2009 can be attributed to the significant increase in total claims filed that has occurred during the recent recession.

  - A total of 54,282 fraud overpayments totaling $34,058,944 were established as a result of the Benefit Audit cross-match system and the NER cross-match process. The benefit audit process protects the integrity of the UI Trust Fund, and detects UI fraud. Through this process, 28,179 overpayments were established, totaling $19,777,915. The NER cross-match established $14,281,029 in overpayments for 26,103 cases. Because the NER cross-match allows EDD to detect fraud and other eligibility issues up to six months earlier than through the Benefit Audit process, the amount of overpayment is $547 compared to $702 for a Benefit Audit overpayment, a variance of $155. This is an average savings, or benefit overpayment avoidance, of $4 million annually. Based on findings through the Benefit Accuracy Measurement system, the top two leading causes of fraud overpayments are unreported work and earnings during the bi-weekly benefit certification and misreported separation information at the claim filing point.

  - UI program staff established fraud overpayments on 286 cases of identity theft totaling $912,257.

  - A total of 134,378 fraud overpayments were established that were not attributed to the Benefit Audit or NER cross-match system or identity theft. These overpayments, totaling $215,834,165, were established for a variety of reasons including retroactive disqualifications of miscellaneous eligibility issues and unreported work and earnings that were not discovered through the Benefit Audit cross-match system.

- In addition, in compliance with California regulations, UI program staff imposed disqualifications and overpayments on 396 cases totaling an additional $1,186,492 in non-fraud overpayments when claimants failed to comply with EDD's request for identity verification information and there was insufficient information to determine the real owner's identity.

- In CY 2010, ID identified $3,435,897 in fraudulent benefits that were referred to the UI Branch for assessment of administrative penalties and collection of overpayments due to fraud. These violations were determined to be unsuitable for prosecution based on the amount of overpayment, number of weeks of violation, unavailability of witnesses and records, and other factors identified by prosecuting authorities. The

violations included claimant failure to report work and earnings while certifying for benefits, stolen identity, employer collusion with employees, and altered or forged documents.

FUTURE UI PROGRAM ENHANCEMENTS

The EDD continues to monitor, research, and investigate systems and activities in order to detect and prevent fraud within the UI program. As EDD moves towards an electronic system, such as Web-based applications for delivering UI services to our clients, the need to maintain the security and integrity of the program is a high priority. California has taken a lead role in developing system enhancements for the detection and prevention of fraud within the UI program. The following describes fraud detection and prevention system enhancements to the UI program that are currently being developed:

- **Fraudulent Claim Profiles** are being established to institute ongoing system checks for identification of claims that fit fraud patterns.

- The **Continued Claims Redesign Project** provides claimants with the option to certify for UI benefits by telephone or the Internet, and will allow for the collection of additional client data and creation of a new client database for fraud detection. Until the Continued Claims Redesign Project is completed, the following interim solutions allow claimants to certify for benefits.

  - **Internet Continued Claims Filing (EDD Web-Cert℠)** – In June 2010, EDD launched the first phase of a new Web option for many customers to complete and submit their bi-weekly continued claim forms, instead of the mail-only option. Going paperless helps customers by reducing common fill in errors that can cause benefit delays. The Web certification method also creates a more efficient delivery system. It allows claimants to certify for benefits on-line and reduces the time between the mail-in certification process and payments processing time.

  - **Telephone Continued Claims Filing (EDD Tele-Cert℠)** – In November 2010, EDD launched the first phase of a new telephone certification service which gives the majority of claimants a new self-service option to complete their bi-weekly continued claim forms via telephone. Again, a paperless option for the continued claim form helps customers avoid some of the common fill-in errors that occur with the hard-copy, mail-in version of the form and cause payment delays. The new telephone service is available 24 hours a day, seven days a week.

- The **Call Center Network Platform and Application Upgrade Project** provides EDD with more detailed call information for trend analysis to improve fraud detection, as well as other automation enhancements. This upgrade will provide historical tracking data on prior calls from the caller's phone number, caller identification, calls associated with the supplied SSN, and a single management information system that reports all call activity in order to detect and deter fraud. In December 2010, EDD implemented this system in the six Primary Call Centers. As of the end of February 2011, the Call Center Network Platform and Application Upgrade Project has been implemented in the eight Primary Adjudication Centers.

- The **Combat Identity Theft Project** will develop and implement data mining software that will be used to improve EDD's ability to prevent and detect identity theft in the UI program. This project is funded in part by a United States Department of Labor (DOL) grant. The software will be used to improve UI fraud detection by conducting in-depth data analyses and automatically identifying patterns and trends that will serve as probable indicators of fraudulent activity. The data mining software will be used by other entities within EDD to develop predictive models to improve decision-making and reduce fraud.

- The **Electronic Benefit Payments Project** will allow EDD to provide UI, DI, and PFL benefit payments through direct deposit and debit card accounts using an electronic payment system. Providing payments electronically is a safer and faster approach to deliver benefit payments to claimants while reducing costs associated with printing and mailing paper checks. The Electronic Benefit Payments Project is modeled after the best practices of other states that have implemented electronic payments for UI benefits, and will provide reduced program costs and improved claimant satisfaction. In December 2010, EDD began phasing in electronic benefit payments for DI and PFL benefits. The roll out of the new cards for these programs was recently completed. The EDD is now focusing on preparations for transitioning UI claimants to the electronic payments as well, which is expected to begin by Summer 2011.

EMPLOYMENT TAX PROGRAMS

The EDD is one of the largest tax collection agencies in the United States, collecting UI contributions, Employment Training Tax, DI withholdings and State Personal Income Tax withholdings. Only the Internal Revenue Service collects more payroll tax dollars than EDD. During 2010, EDD collected $50 billion in California payroll taxes from over 1.3 million employers.

The EDD's approach to employment tax fraud deterrence and detection involves extensive investigative activities, including sophisticated lead development processes, and an audit program that focuses on enforcement. Tax Branch also works to deter tax fraud by educating employers on the risks of participating in the underground economy through seminars and employer assistance programs offered through its Taxpayer Education and Assistance program.

The **Compliance Development Operations** (CDO) within EDD's Tax Branch's Field Audit and Compliance Division is the primary lead development arm for the Employment Tax Audit program, concentrating on identifying employers participating in the underground economy. The CDO leverages lead development activities in part by working with other governmental agencies to share information and by performing joint on-site inspections of employers determined most likely to be operating underground. The dedication of staff to perform lead development functions has proven very effective in producing positive audit results, sending a clear message to the employer community of their liability exposure when purposely failing to comply with reporting and payment requirements. These enforcement activities help create a level playing field for all employers and aid in protecting employee rights to UI and DI benefits.

The various CDO programs that concentrate on underground economy lead development are as follows:

- The **Joint Enforcement Strike Force (JESF)** combats the underground economy by pooling resources and sharing data among the State agencies that enforce licensing, labor, and tax laws. The JESF on the Underground Economy was formed by Executive Order in 1993 and codified in 1994. The members of JESF include EDD (lead agency), the Department of Consumer Affairs, the Department of Industrial Relations (DIR), the Department of Insurance, and the Department of Justice. The Internal Revenue Service, Franchise Tax Board and the Board of Equalization are not members of JESF but are active participants.

  The JESF obtains information through a number of sources which indicate that a business may be operating illegally. These sources include hot line referrals, complaints from legitimate businesses, and information sharing through partnering agencies' databases.

- The **Employment Enforcement Task Force (EETF)** is the primary joint enforcement effort undertaken by JESF partner agencies. The EETF conducts joint on-site business investigations to identify employers operating in the underground economy. The goal of EETF is to identify and bring into compliance those

individuals and businesses participating in the underground economy that are in violation of payroll tax, labor, and licensing laws.

- The **Tax Enforcement Group (TEG)** administers several of the mandated programs that focus on identifying underground economy activity. These programs include the Construction Enforcement Project and the Janitorial Enforcement Project. Additionally, TEG staff investigate businesses in a variety of industries in an effort to detect payroll tax fraud and noncompliance. The TEG conducts desk investigations through the use of various databases and income tax returns analysis to uncover noncompliant and fraudulent activity within the employer community.

- The **Economic and Employment Enforcement Coalition (EEEC)** was established in 2005 as a joint effort by state and federal agencies to combat the underground economy. The coalition's education and enforcement efforts are intended to enhance fair business competition by targeting employers who gain an unfair advantage through violation of state and federal labor, licensing, and payroll tax laws. The EEEC was created as a multi-agency enforcement program consisting of investigators from EDD, DIR (Division of Labor Standards Enforcement and California Occupational Safety and Health), Contractors State Licensing Board, and DOL. Each agency as an expert in its own field, collaborates to educate business owners and employees on state and federal labor, licensing, and payroll tax laws; conducts vigorous and targeted enforcement against labor payroll tax law violators; helps level the playing field and restore competitive equity for law abiding businesses and their employees. The EEEC partnering agencies conduct field compliance inspections on targeted industries within designated geographic locations in a sweep environment. The coalition is currently focusing its efforts on seven low-wage industries including agriculture, car wash, construction, garment manufacturing, auto body repair, pallet manufacturing and restaurant. These industries were selected for targeting by the EEEC because employers in these industries have a history of employing vulnerable workers, paying low wages, and are frequently found to be out of compliance with labor, licensing and payroll tax laws.

- The **Lead Development and Program Support Group** captures allegations of non compliance submitted via the Underground Economy Fraud Hotline, correspondence, and electronic mail. The allegations are screened and forwarded to EEEC, EETF, TEG, or the Tax Audit program.

- The **Out of State Audit Lead Development Process**, within the Lead Development and Program Support Group, provides coordinated geographical packages of leads on employers that maintain their business records outside of California. Packages of approximately seven employer leads, all within the same geographical area are distributed to the area audit offices. This coordinated process allows for audit program unit also develops audit referrals for out-of-state employers.

- The **Questionable Employment Tax Practices Program**, within the Lead Development and Program Support Group, continued to produce positive results in 2010. The Questionable Employment Tax Practices Memorandum of Understanding allows for exchange of case information between EDD and the Internal Revenue

Service. The EDD uses Internal Revenue Service case information to issue assessments for amounts owed to EDD. This saves time associated with conducting an audit and sends a strong message to the employer community on the risks of non-compliance.

- The **UI Rate Equity Group** identifies situations involving the California Unemployment Insurance Code, Sections 135.2 and 1061 and where applicable, makes assessments of UI rate differences when reserve accounts are transferred by employers who attempt to obtain a competitive business advantage by gaining a favorable UI rate.

The EDD **Tax Audit Program** reviews business entities' records to determine the level of compliance with payroll tax laws governing the reporting of wages and payment of taxes, and works with employers to gain long-term prospective voluntary compliance. Audit leads are obtained from various sources, including developed lead referrals from CDO, employee UI and DI obstructed benefit claims. The Tax Audit program also identifies industries that are out of compliance with payroll tax law and coordinates efforts to bring these specific industries into compliance through focused audits within an industry.

The Tax Audit program levies compliance assessments for the amount of deficient payroll taxes under-reported and makes determinations regarding the application of penalties due to negligence, intentional disregard, intent to evade, and fraud.

The Tax Audit program also works with the Taxpayer Education and Assistance program to deliver education and outreach to certain industries. These efforts include employer seminars, public presentations before professional groups, and articles for professional publications.

CDO AND RELATED AUDIT RESULTS DURING CY 2008 through 2010

Statistics for the EETF, TEG, and EEEC and Lead Development and Program Support Group programs are included in this section. Overall, the cumulative activities and results of these program areas over the past three years are as follows:

CDO Lead Development Results – Combined Statistics All CDO Programs

	2008	2009	2010
Joint Inspections	1,511	1,346	404
EDD Audit Referrals	960	833	566
EDD Payroll Tax Audits	948	768	1,258
EDD Payroll Tax Assessments	$ 61,559,778	$ 45,274,817	$ 168,598,851
DIR Labor Code Citation Amounts	$ 10,412,762	$ 8,061,148	$ 3,180,545
Previously Unreported Employees	13,202	10,670	10,355
Cases w/Fraud Penalty Assessed	153	124	85
Assessments on Fraud Cases	$ 23,881,162	$ 18,458,863	$ 24,354,382

- In 2010, EETF inspected 220 businesses for payroll tax and Labor Code violations. Any business suspected of operating in the underground economy is subject to inspection although EETF focuses on industries known to have a high degree of noncompliance. The inspections resulted in the issuance of 181 citations totaling

$1,369,321 for various violations of the Labor Code. In 2010, 224 EETF audits were completed by EDD, resulting in assessments of $13,677,364 in unpaid payroll taxes, penalties, and interest. In addition, 2,745 unreported employees were identified.

The following table shows the EETF's program results for the last three years:

	2008	2009	2010
Joint Inspections	504	388	210
EDD Audit Referrals	486	388	219
EDD Payroll Tax Audits	422	360	224
EDD Payroll Tax Assessments	$ 29,344,468	$ 17,922,866	$ 13,677,364
DIR Labor Code Citation Amounts	$ 5,523,562	$ 4,106,894	$ 1,369,321
Unreported Employees	4,638	4,119	2,745
Cases w/Fraud Penalty Assessed	62	31	36
Assessments on Fraud Cases	$ 11,469,688	$ 4,843,378	$ 12,353,238

- In 2010, the TEG conducted investigations and referred 166 cases to the Tax Audit program. This includes 68 Construction Enforcement Project cases and two Janitorial Enforcement Project cases. The 154 completed audits resulted in assessments for $11,962,537 in unpaid payroll taxes, penalty, and interest. In addition, 2,792 unreported employees were identified.

The following table shows the TEG program results for the last three years:

	2008	2009	2010
EDD Audit Referrals	196	211	166
EDD Payroll Tax Audits	204	158	154
EDD Payroll Tax Assessments	$ 17,437,202	$ 13,090,250	$ 1,962,537
Previously Unreported Employees	3,870	3,628	2,792
Cases w/Fraud Penalty Assessed	19	18	12
Assessments on Fraud Cases	$ 5,038,178	$ 4,202,112	$ 4,012,282

- In 2010, EEEC[8] inspected 184 businesses for licensing, payroll tax, and labor code violations and referred 181 employers for an EDD payroll tax audit. In 2010, 147 EEEC audits were completed, resulting in assessments of $10,853,878 in unpaid payroll taxes, penalties, and interest. In addition, 2,750 unreported employees were identified. In 2010, EEEC continued the "Self Audit Program." The program's focus was to allow employers with non compliance issues which were too small to be audited to report the wages of their misclassified workers. In the event the employer did not report the unreported workers, EEEC Agents issued assessments. Two hundred thirty four employers were enrolled in the program. The program proved to be an excellent tool to improve customer service and enforcement.

[8] The statistics referenced in the above table represent only those EEEC joint inspections where EDD participated.

The following table shows EEEC's program results for the last three years:*

	2008	2009	2010
Joint Inspections	1,007	958	184
EDD Audit Referrals	278	234	181
EDD Payroll Tax Audits	322	250	147
Self Audit Program	N/A	89	234
EDD Payroll Tax Assessments	$ 14,778,108	$ 14,255,701	$ 10,853,878
DIR Labor Code Citation Amounts	$ 4,889,200	$ 3,954,254	$ 1,811,224
Unreported Employees	4,694	2,923	2,750
Cases w/Fraud Penalty Assessed	72	75	37
Assessments on Fraud Cases	$ 7,373,296	$ 9,413,373	$ 7,988,862

* Please note that this report includes EEEC Calendar Year statistics while the EEEC Annual Report provides statistics on a State Fiscal Year. Consequently, the numbers in this report will not match with the EEEC Annual Report State Fiscal Year numbers.

The following table shows the number of audits and investigations completed as a result of out of state referrals over the last three years: *

	2008	2009	2010
EDD Payroll Tax Cases	181	184	61
EDD Payroll Tax Assessments	$ 4,731,519	$ 29,202,188	$ 2,077,638
Average Liability Change	$ 26,140	$ 158,707	$ 34,060
Unreported Employees	2,541	4,413	1,865

* Note that this table contains results of cases developed by EEEC, EETF, and TEG.

The following table shows the number of investigations completed as a result to the Questionable Employment Tax Practices project over the last three years:

	2008	2009	2010
EDD Payroll Tax Investigations	108	50	68
EDD Payroll Tax Assessments	$ 1,953,813	$ 1,388,821	$ 1,218,893
Average Liability Change	$ 18,090	$ 27,776	$ 17,925
Unreported Employees	498	245	1

The following table shows the number of allegations received and processed by the Lead Development and Program Support Group for the last three years:

	2008	2009	2010
Underground Economy Fraud Hotline	808	415	503
Underground Economy Mailbox (email)	1,723	2,380	2,527
Correspondence	413	488	496
Total	2,944	3,283	3,526

The following table illustrates the UI Rate Equity Group workload accomplishments for the last three years:

	2008	2009	2010
California Unemployment Insurance Code Section §1061			
Payroll Tax Investigations	243	438	363
Payroll Tax Assessments	$ 19,435,509	$ 31,329,784	$ 19,475,913
Average Liability Change	$ 79,982	$ 71,529	$ 53,653
California Unemployment Insurance Code Section §135.2			
Payroll Tax Investigations	0	10	7
Payroll Tax Assessments	$ 0	$ 24,102,586	$ 109,332,628
Average Liability Change	$ 0	$ 2,410,259	$ 15,618,947

- The Tax Audit program as a whole in 2010 conducted 3,951 audits and investigations, resulting in assessments totaling $135,431,737, and the identified 57,164 unreported employees. These enforcement efforts send a strong message to employers regarding the risks of failing to report employee wages and pay contributions due.

The results of audits conducted through non-CDO lead sources (including ID leads) where employer fraud was found over the last three years are as follows:

	2008	2009	2010
Cases w/Fraud Penalty Assessed	120	143	195
Unreported Employees	3,762	6,685	6,136
Assessments on Fraud Cases	$ 16,483,617	$ 48,389,394	$ 42,515,159

In 2010, EDD's ID conducted additional tax enforcement activities independent of JESF.

- The ID investigated a total of 186 ongoing and new payroll tax evasion fraud cases representing a potential tax liability of $50,670,527. The investigations focused on the following case types: payroll tax fraud (177 cases representing potential tax liability of $47,472,241) and EEEC (9 cases representing potential tax liability of $3,198,286). The EEEC cases represent investigations conducted on employers in the industries identified by EEEC.

- The ID filed 16 criminal complaints representing a potential tax liability of $2,057,458.

- The ID completed 11 criminal prosecutions representing a potential tax liability of $2,885,307.

- Prevention/Tax Money Collected by EDD: the ID referred 10 conviction cases with tax liabilities in the amount of $2,885,307 to EDD's Collection Division for recovery.

WORKFORCE SERVICES PROGRAMS

WORKFORCE INVESTMENT ACT (WIA) PROGRAM
AMERICAN RECOVERY AND REINVESTMENT ACT (ARRA) PROGRAM

The EDD administers the federally funded WIA and ARRA programs in California. The WIA and ARRA program provides funding to local entities that provide employment training opportunities. The EDD guides the sub-granting of WIA and ARRA funds received from the DOL and provides general program direction to local administrative entities that deliver services to eligible clients via a statewide system of Local Workforce Investment Areas (LWIA) and other grantees.

The detection and deterrence of fraud in the expenditure of WIA and ARRA funds is accomplished through a combination of processes that EDD requires of the local administrative entities. In addition, DOL may occasionally conduct specialized WIA and ARRA reviews, which, even though their focus is on the adequacy of the State's management of the program, typically also include the review of a sample of local administrative entity activities. The program integrity components related to the WIA and ARRA programs include:

- **Monitoring Reviews** determine whether programs operate in compliance with the WIA, ARRA, and applicable federal, State, and local rules and regulations, and require corrective actions for any deficiencies.

  Each LWIA administrative entity, as a condition of receiving WIA and ARRA funds, is required to maintain and operate a monitoring system that ensures that each of their sub-recipients are monitored on-site at least once during each program year in both fiscal and program areas. In addition, EDD conducts monitoring of LWIA administrative entities.

- **Incident Reporting System** provides reports of fraud, abuse, and criminal activity within the WIA and ARRA programs. This system is required by the DOL/Office of the Inspector General under 20 Code of Federal Regulations Section 667.630. Each local administrative entity, as a condition of receiving WIA and ARRA funds, participates in this system by being alert to indications and allegations of WIA- and ARRA-related fraud, abuse, and criminal activity, and by maintaining procedures that ensure that violations are reported promptly (within 24 hours of detection). The EDD then takes action to ensure the allegations are investigated and resolved.

- **Single Audits** are required of LWIA administrative entities and their subcontractors that expend an aggregate of $500,000 or more in federal funds for fiscal years ending after December 31, 2003. These audits are required by the provisions of the U.S. Office of Management and Budget Circular A-133, as revised on June 24, 1997, entitled "Audits of States, Local Governments, and Non-Profit Organizations." Further, commercial subcontractors that expend $500,000 or more in federal funds to operate a WIA and ARRA program must obtain either an organization-wide audit

or an independent financial and compliance audit. These audits are usually performed annually, but must be performed not less frequently than once every two years. Audits of local subrecipients are resolved by the local administrative entity and audits of the local administrative entities and other direct grantees are resolved by EDD. The EDD may also conduct special WIA and ARRA audits as warranted.

- **Workforce Services Division** program staff oversee the delivery of services by WIA and ARRA funded organizations. Staff provide ongoing programmatic and fiscal technical assistance to WIA funded projects. Staff also review WIA and ARRA grantee participant and financial records to ensure that they follow applicable State and federal requirements, and each grantee adheres to the terms and conditions of their grant with EDD.

- **Regulatory Controls** provide for additional fraud protection. The DOL provides a Hot Line telephone number (800) 347-3756 to report fraud and abuse complaints. This hot line functions as a national control point. Another control point is that the WIA program prohibits contracting or doing business with any agency that has been disbarred (e.g., license revoked, de-certified). Additionally, the WIA regulations have established controls against nepotism.

RESULTS/ACCOMPLISHMENTS DURING CY 2010

The Compliance Resolution Unit (CRU) makes determinations on incident report allegations, findings contained in audit reports, and findings contained in monitoring reports. The resolution of these cases is based on the proper expenditure of WIA funds, ARRA funds, and Welfare-to-Work (WtW) funds. Although the WtW program ended, activity continues to resolve those fraud and abuse cases.

During CY 2010 CRU processed 169 cases, 103 of which were resolved. At the end of the year, 66 on-going cases for a total of $1,271,728 in questioned costs remained open in various stages of the State resolution process.

- The $1,271,728 applies to 8 of the 66 cases for which EDD has been able to determine the potential disallowance.

- The remaining 58 cases are in various stages of resolution and fact-finding by CRU, Workforce Services Division, LWIA or other sub-grantees. These activities may also involve investigations by local law enforcement, DOL, or OIG.

INDEPENDENT OVERSIGHT ACTIVITIES

The EDD's Policy, Accountability and Compliance Branch (PACB) performs independent departmental oversight activities of EDD programs, including fraud detection and deterrence. Fraud detection and deterrence are accomplished through sound internal control structures, internal and external audits, risk assessments, detailed quality control reviews, and criminal investigations. The PACB has increasingly taken an active role to prevent, detect, and deter fraud within and across EDD's programs through partnerships with internal and external entities.

Fraud in EDD programs covers a variety of offenses, such as: fictitious employer registrations to establish future fraudulent UI and DI claims; forgery of checks and claim documents; identity theft/claims filed by impostors based on the wage credits of others; impostors taking over the claims of others who are deceased or returned to work; false certifications by medical practitioners and claimants; underground economy tax evasion such as underreporting or failure to report employee wages, taxes; and internal fraud by EDD employees.

The PACB performs audits in accordance with the Generally Accepted Government Auditing Standards, the International Standards for the Professional Practice of Internal Auditing, and the National Institute of Standards and Technology which are promulgated by the Comptroller of the United States, the Institute of Internal Auditors, and the U.S. Department of Commerce respectively. These standards require auditors to possess the knowledge, skills and other competencies needed to perform audits, including sufficient knowledge to identify the indicators of fraud and to evaluate the adequacy and effectiveness of controls encompassing the organization's operations and information systems that are used to detect illegal activities and deter fraud. Audit independence is achieved by reporting to a level within the enterprise that allows the audit organization to fulfill its responsibilities.

The following addresses the various components of PACB's fraud deterrence and detection activities; many of these activities are also included under the specific EDD program areas.

- **Independent Internal and External Audits** are conducted of departmental operations and recipients of federal funds such as LWIA and community-based organizations, over which EDD has administrative and program oversight responsibility. These audits are performed at the request of EDD management, or in response to issues resulting from EDD program monitoring activities or received incident reports.

- **Independent Internal Control Audits** assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency. The EDD considers a strong system of internal controls to be a major deterrent to internal fraud. The PACB provides technical assistance to EDD staff prior to and during the system design phase to ensure appropriate internal controls are developed and in place. The EDD believes that it is more cost effective to build controls into the system, as opposed to raising internal control issues during an audit, which may require system redesign.

- **Information Technology (IT) Audits** are conducted of EDD's automated systems by auditors who are specially trained in this field. These IT audits ensure that automated system controls are built into new, upgraded or existing systems and remain operational throughout the life of the system.

- **Audit Logging and Monitoring System** is being established to provide an automated means to capture business application and system auditable events. These include tracking the viewing of records and transaction activities (e.g., addition, deletion, and updates) to assist in the detection of unauthorized access to confidential data.

  The pilot application Security Audit Logging and Monitoring System (SALMS) was successfully created and tested. The pilot project is now complete. The SALMS provides the framework for security logging, audit review requirements and the protection of mission critical systems.

  Currently, the audit logging project team is reforming to include additional stakeholders to continue developing and designing an audit logging application that can be deployed in EDD's IT business environment.

- **On-site Monitoring Reviews of WIA, ARRA, and Disaster Relief** is conducted to determine fiscal and program compliance. The EDD is required by the DOL to perform scheduled on-site monitoring reviews of sub-recipients and sub-grantees of federally funded programs, including WIA, ARRA, and Disaster Relief.

  The monitoring reviews include regularly scheduled examinations of both fiscal and programmatic systems and records. This oversight provides EDD with an opportunity to ensure that internal control structures are in place and that they function as prescribed. The PACB provides fraud deterrence by continually ensuring that proper safeguards are in place to discourage fraudulent activity. Monitors are alert to symptoms and conditions that may be indicators of illegal activities.

- **WIA, ARRA, and Disaster Relief Incident Reporting** provides a reporting and follow-up process for allegations of program fraud and abuse. The PACB receives and tracks incident reports and submits them to DOL for its determination whether to conduct the investigation itself, or refer the reports back to EDD for investigation. Based on DOL's determination, EDD may investigate the incident and take appropriate action against the grant recipients.

- **Criminal Fraud Investigations** are conducted by ID to prevent, detect, and deter fraud committed against the UI, DI and Tax programs, and other programs administered by EDD. The ID develops cases for criminal prosecution at the county, State, and federal level.

  Whenever appropriate, EDD seeks prosecution of perpetrators that commit fraud against EDD programs. Publication of the prosecutions and the heightened awareness of EDD's actions against both external and internal fraud provide a deterrent effect. Fraud deterrence also includes court ordered restitution and

imprisonment or probation for individuals who commit fraud against EDD programs. Restitution includes recovery of benefit overpayments, tax liabilities, penalties, interest, investigation costs, and any other monies determined by the court to be owed to EDD by an entity or individual.

A deterrent used in internal affairs cases is the initiation of adverse action against EDD employees. The adverse action process includes suspensions, demotions, reductions in pay, dismissal from State service, and criminal prosecution.

The PACB utilizes several methods to detect fraud in EDD programs, provide leads to identify additional fraud, or obtain evidence in an investigation. Such methods include:

- The Fraud Tip Hot Line, telephone number (800) 229-6297, is available for the public to report employer tax evasion and allegations of fraud against the UI program, the DI program, and other programs administered by EDD.
- The EDD Web site (*www.edd.ca.gov*) has a link to a fraud reporting form so the public can report, via the Internet, allegations of fraud against programs administered by EDD.
- The PACB participates in task forces with other State and federal law enforcement agencies such as the California Department of Insurance, Franchise Tax Board, U.S. Internal Revenue Service, DOL, U.S. Postal Inspectors, and prosecutors.
- In collaboration with ID and federal investigators, the Audit and Evaluation Division conducts forensic accounting and audit examinations to examine subpoenaed bank records and personal and employer financial records.

The results of PACB's investigative activities for CY 2010, as well as the previous two CYs are covered in the DI, UI, and Employment Tax sections of this report.

The **Criminal Intelligence Unit (CIU)** was created within ID to develop strategic and tactical intelligence for investigative planning and case identification, and to assist program managers and oversight functions to identify areas of focus to prevent and detect fraud. The CIU works with EDD program managers to identify characteristics of fraud and uses technology to screen claims for potential fraudulent activities. The CIU and the Audit and Evaluation Division are currently gathering and analyzing data from claims filed and investigative cases worked to gain insight into the fraudulent trends and patterns being employed against EDD. Strategies that EDD can use to counter these trends and patterns can then be developed or enhanced.

The use of the EDD's Business Intelligence Competency Center is helping CIU to utilize complex software to improve data mining to prevent and detect fraud in EDD. The Business Intelligence Competency Center is used to improve CIU's fraud detection efforts by conducting in-depth data analyses and identify patterns and trends that will serve as probable indicators of fraudulent activity.

Additionally, the Audit and Evaluation Division utilizes CIU-developed information in its risk assessment process to prepare EDD's Audit Plan. This enables PACB to schedule

audits in areas most vulnerable to fraud, thereby making the most effective use of EDD's audit resources. Conversely, the Audit and Evaluation Division will provide information obtained during the course of its audits to CIU, such as internal control strengths and weaknesses, to further enhance CIU's efforts in developing strategic and tactical intelligence.

ENTERPRISE-LEVEL ACTIVITIES

The EDD has increasingly taken an enterprise-wide approach to identify and combat fraud within and across programs. Additionally, EDD is continually seeking new approaches to prevent, detect, and deter fraud, through partnerships with both internal and external entities. This section summarizes enterprise-level anti-fraud efforts undertaken during 2008, and those activities that are under consideration for future implementation.

The areas for enhanced anti-fraud efforts include:

New and Expanded Internal and External Partnerships

- The ID, jointly with both the UI and DI programs, has begun to identify claim or payment characteristics that are indicative of fraud. This has enabled automated trend analyses as a method to identify potential fraudulent claims/payments, which trigger additional steps to determine legitimacy of suspect claims.
- An expanded partnership between ID and the Audit and Evaluation Division has enabled more thorough and timely analysis of large volumes of accounting data as a tool to identify and analyze perpetrators' fraudulent activities and develop investigative leads.
- The ID has continued to foster joint investigative activities with DOL and the U.S. Attorney, as a means to develop and share fraud leads, and more effectively investigate and prosecute perpetrators of fraud.
- The ID coordinates with partner investigative/enforcement agencies to publicize joint investigative, arrest, indictment, and prosecution actions, with the intent of deterring fraud perpetrators.

Recent Internal and External Partnership Enhancements

- Expanded EDD investigator participation in local level task forces to enhance local level collaboration.
- Enhanced partnerships with other state and federal agencies to share fraud leads, anti-fraud methodologies and activities.
- Increased marketing efforts to educate the public on the consequences associated with committing fraud.
- Developed a cross-program approach to fraud detection, deterrence, and prevention activities. The ID works closely with the UI and DI programs to develop joint strategies for early detection and prevention of fraud. Results of these efforts are anticipated to reduce the amount of dollars paid out on fraudulent claims.
- The ID has partnered with the State Treasurer's Office to obtain direct online access for retrieving and printing State Treasurer's Office processed warrants. This partnership allows immediate review of paid and non-paid warrants and increases ID's ability to effectively investigate criminal activity.

Automated Fraud Detection and Prevention Tools Under Consideration

- Electronic linkage of the Tax and the UI systems to enhance EDD's ability to detect fraud.
- Enhancement of the Fictitious Employer Detection System – This system identifies potential employer/claimant fraud involving the establishment of fictitious employer accounts and fictitious claimants. The system contains certain characteristics that are fairly common among employers and claimants involved in fictitious employer schemes. The identification and addition of new characteristics to the system will increase EDD's ability to detect and deter fraud. An employer-tracking file serves as the basis to identify such employers and/or claimants.
- Automated interfaces with other governmental agency databases.
- Combat Identity Theft – A Supplemental Budget Request was approved for the purchase and installation of data mining software and computer equipment to improve EDD's ability to prevent, deter, and detect identity theft in the UI program. The software will be used to improve UI fraud detection by conducting in-depth data analyses and automatically identifying patterns and trends that will serve as probable indicators of fraudulent activity. The data mining software will be used by PACB to develop predictive models to improve decision-making and reduce fraud. See page 16 for additional information on this initiative.
- The Electronic Benefit Payment Project will provide UI, DI, and PFL benefit payments using an electronic payment system with the objective to eliminate fraud associated with theft or loss of warrants.

ACRONYMS

ARRA	American Recovery and Reinvestment Act
CDO	Compliance Development Operations
CIU	Criminal Intelligence Unit
CY	Calendar Year
DI	Disability Insurance
DIR	Department of Industrial Relations
DOL	Department of Labor
EDD	Employment Development Department
EEEC	Economic and Employment Enforcement Coalition
EETF	Employment Enforcement Task Force
FOIS	Field Office Integrity Specialist
ID	Investigation Division
IME	Independent Medical Examination
IVR	Interactive Voice Response
JESF	Joint Enforcement Strike Force
LWIA	Local Workforce Investment Area
NER	New Employee Registry
OP	Overpayment
PACB	Policy, Accountability and Compliance Branch
PFL	Paid Family Leave
PIN	Personal Identification Number
SDI	State Disability Insurance
SSN	Social Security Number
TEG	Tax Enforcement Group
UI	Unemployment Insurance
U.S.	United States
WIA	Workforce Investment Act

This report was prepared by the Policy, Accountability and Compliance Branch of the California Employment Development Department

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For more information, please call (916) 654-7249.

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STATE OF CALIFORNIA

LABOR AND WORKFORCE DEVELOPMENT AGENCY

EMPLOYMENT DEVELOPMENT DEPARTMENT

npr

Texas Contractors Say Playing By The Rules Doesn't Pay

by WADE GOODWYN

April 11, 2013 3:21 AM

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> "There's no way you can compete. When someone is paying less per hour, no workman's comp, no payroll taxes, [no] unemployment — we can't overcome that.
>
> *- Stan Marek, CEO, Marek Family of Companies*

This story is part of a two-part series about the construction industry in Texas. Find the first part here.

Homes in Texas are cheap — at least compared with much of the country. You can buy a brand new, five-bedroom, 3,000-square-foot house near Fort Worth for just $160,000.

But that affordability comes at a price — to workers, many of whom are in the country illegally and make $12 an hour or less, but also to business owners.

Let's say you own a big Texas construction firm, and you want to run your business the right way. You try your darndest to hire only legal workers and pay them a decent salary plus benefits.

Most importantly you pay all your taxes, Social Security, unemployment — everything you're supposed to — just like a normal company in other industries.

So, how's that working out?

"There's no way you can compete," says Stan Marek, CEO of the Marek Family of Companies, one of the largest commercial interior contractors in Texas. They've been in business 75 years, but Marek says the past four have been extremely difficult.

"When someone is paying less per hour, no workman's comp, no payroll taxes, [no] unemployment — we can't overcome that," he says.

Business

Construction Booming In Texas, But Many Workers Pay Dearly

Contractors, Subcontractors And Independent Contractors

At Baylor College of Medicine in Houston, Marek's workers are building the interior for the hospital's newest wing. Workers ride around on what are called "motorized man lifts," which allow them to work high in the air, power tools in hand.

Baylor Hospital is the kind of client that hires Marek's companies — an owner that must have its building done to exacting specifications. But these days, Marek says, that's unusual. The main thing most clients care about, he says, is how cheaply the job can be done.

That's where the subcontractors — and "independent contractors" — come in.

"It's very common in our industry for hourly guys to do the framing, which is putting up the middle studs, and then hiring a sub-crew to come in and do the Sheetrock, and then hiring a different sub-crew to come in and do the taping and floating," Marek explains. "And a *different* sub-

crew to come in and do the grid for the ceiling. And a different crew to put in the tile. That's very common."

And that's how an estimated half-million undocumented, mostly Hispanic construction workers go to work each day in Texas. Marek says in the 1940s, '50s, '60s and '70s, his uncle, John Marek, who started the company, paid union wages, and his workers lived stable, middle-class lives.

> "If I were to speculate, I would probably say they are not paying their Social Security [taxes]. I would also say that they're probably not filing their income tax returns on a regular basis.
>
> *- Trent, a landscape contractor, on his workers*

But according to a new study from the University of Texas and the Austin-based Workers Defense Project, today's construction workers in Texas make near-poverty wages — an average $12 an hour.

Marek says Texas high school kids no longer dream of a good life working in construction. "You're not gonna get kids to go to work in construction without a career path and a better wage," he says.

Marek is a Texas Aggie conservative Republican, but he says his industry and the country need immigration reform that will turn all the undocumented workers into documented workers. That would level the playing field for companies like his that want to abide by the law, he says, and will lead to better wages and a career path for American kids who aren't cut out for college.

Undocumented Laborers, Working For Cash

There are certainly no Texas high school graduates building a retaining wall in Dallas' upscale Highland Park neighborhood on a recent day. Well, unless you count Trent, the owner of a landscape construction company. Trent, who asked that NPR not use his last name because the IRS might take an interest in his business, designs and builds landscapes in the Dallas-Fort Worth area.

"I don't pay anyone by the hour. In fact, I treat the guys that work on my crew as subcontractors — they are self-employed," he says.

This is a key distinction. If Trent were to classify his workers as employees, he'd have to pay taxes, Social Security, unemployment and overtime. But by saying his workers are actually independent contractors — in essence, business owners — he's off the hook.

Trent says his workers have been working with him for years. He has between four and seven laborers per day on most projects. And he knows most of them don't have papers. "I would say 10 percent are documented," he says.

Trent pays his workers a fixed amount per project, in cash. If the job takes a little longer than expected, nobody asks for more money. On average, each worker makes $70 a day, more if they're skilled.

> "If there wasn't such a readily available supply of laborers that are looking for work in my exact line of business, then I would say I am doing wrong and that I should play by the rules. I don't feel as though I'm doing anything wrong.

- Trent, landscape contractor

Trent says he doesn't know if any of his guys are paying taxes. "That's their business," he says. "If I were to speculate, I would probably say they are not paying their Social Security [taxes]. I would also say that they're probably not filing their income tax returns on a regular basis."

An Underground Economy

The University of Texas and Workers Defense Project study estimates that $7 billion in wages go unreported from nearly 400,000 illegally classified Texas construction workers each year. It's evolved into a massive underground economy, the report says, that cheats the state and federal government of billions of dollars in taxes and revenue each year.

Trent says he'd be happy to classify his workers as employees and pay the government all it's owed as long as his competition does the same. But the reality is that Trent often finds he's underbid on landscape projects, even though he's paying his undocumented workers $70 a day.

"The fact of the matter is that the people that I'm competing against have the same large pool of undocumented workers to use on their crews," he says.

Trent says blaming him for the nation's immigration problem is like blaming an Army corporal because a war was lost. He says he didn't make this competitive playing field or the Texas or Mexican economies. He's one 40-year-old man in landscape construction, he says, doing the best he can.

"If there wasn't such a readily available supply of laborers that are looking for work in my exact line of business, then I would say I am doing wrong and that I should play by the rules," Trent says. "I don't feel as though I'm doing anything wrong."

Trent says this is now the way the construction business is done in Texas, and that nobody seriously worries about enforcement. There aren't enough IRS agents in the world to make a dent.

Underground Economy Operations

Report Payroll Tax Fraud

The Employment Development Department (EDD) has a charge to investigate businesses that avoid paying payroll taxes, many of which are part of the underground economy. If you would like to help us protect workers and create a level playing field for business competition, the EDD offers several methods for reporting such businesses:

- Call our toll-free hotline: 1-800-528-1783
- Fax: 916-227-2772
- Submit a Fraud Reporting Form online
- Mail us a *UEO Lead Referral/Complaint Form*, available in English (DE 660) and Spanish (DE 660/S/).
- *Help Us Fight Fraud*, DE 2370

Definition of "Underground Economy"

"Underground economy" is a term that refers to those individuals and businesses that deal in cash and/or use other schemes to conceal their activities and their true tax liability from government licensing, regulatory, and taxing agencies. Underground economy is also referred to as tax evasion, tax fraud, cash pay, tax gap, payments under-the-table, and off-the-books.

What Does It Cost You?

A February 2005 report, *California's Tax Gap*, prepared by California's Legislative Analyst's Office, estimates California's income tax gap to be $6.5 billion. Reports on the underground economy indicate it imposes significant burdens on: (1) the State of California, (2) businesses that comply with the law, and (3) workers who lose benefits and other protections provided by state law when the businesses they work for operate in the underground economy.

BUSINESS:

When businesses operate in the underground economy, they illegally reduce the amount of money expensed for insurance, payroll taxes, licenses, employee benefits, safety equipment, and safety conditions. These types of employers then gain an unfair competitive advantage over businesses that comply with the various business laws. This causes unfair competition in the marketplace and forces law-abiding businesses to pay higher taxes and expenses.

WORKERS:

Employees of the businesses that do not comply are also affected. Their working conditions may not meet the legal requirements, which can put them in danger. Their wage earnings may also be less than those required by law, and benefits they are entitled to can be denied or delayed because their wages are not properly reported.

CONSUMERS:

Consumers can also be affected when contracting with unlicensed businesses. Licensing provisions are designed to ensure minimum levels of skill and knowledge to protect the consumer.

The ultimate impact is erosion of the economic stability and working conditions in this State. Our pamphlet *Paying Cash Wages "Under the Table"...Is It Really Worth the Risk?* outlines some of the costs and effects of cash pay on your business, your employees, and taxpayers in general. It is available in both English (DE 573CA) and Spanish (DE 573CA/S/).

Important Links

- Register as an Employer
- Rates and Withholding
- e-Services for Business
- Reporting Requirements
- Forms and Publications

Top Links This Month

- Forms and Publications
- File and Pay Taxes
- e-Services for Business Information
- Rates and Withholding
- Am I Required to Register as an Employer

FAQs

- Payroll Taxes FAQs

Contact Us

- About Payroll Taxes

EDD's Underground Economy Operations

The EDD is concerned about workers who lose benefits and other protections provided by state law when the businesses that they work for operate in the underground economy. When businesses operate in the underground economy, they gain an unfair competitive advantage over businesses that comply with the law. This causes unfair competition in the marketplace and forces law-abiding businesses and every citizen in California to pay higher taxes. EDD's Underground Economy Operations (UEO) organization was established in 1993 to implement and administer the activities of the Joint Enforcement Strike Force. The mission of UEO is to reduce unfair business competition and protect the rights of workers by:

- Coordinating the joint enforcement of tax, labor, and licensing laws.
- Detecting and deterring payroll tax violations in the underground economy. This includes unreported cash pay, wages reported on Forms 1099, and unreported/unpaid payroll tax deductions.
- Conducting research to identify strategies to increase compliance with payroll tax laws.
- Educating customers on UEO programs to increase compliance with payroll tax laws.

Significant UEO Program Efforts

The UEO has three significant UEO program focus areas: the Employment Enforcement Task Force, the Labor Enforcement Task Force, and the Construction Enforcement Project.

Employment Enforcement Task Force (EETF)

Participating agencies in the EETF include:

- Employment Development Department (EDD)
- Department of Industrial Relations (DIR)
- Contractors State License Board (CSLB)

The goal of EETF is to identify and bring into compliance those individuals and businesses in the underground economy who are in violation of payroll tax, labor, and licensing laws.

The EETF agents from each agency jointly conduct on-site inspections of businesses by interviewing owners, managers, and workers to determine if businesses are in compliance with payroll tax, labor, and licensing laws. To minimize the disruption of compliant businesses, the EETF conducts investigations only if there is a reasonable belief of violations of the Unemployment Insurance Code, Labor Code, and/or the Business and Professions Code.

Employment Enforcement Task Force Program Results

Result	2008	2009
Joint Inspections	504	389
Previously Unreported Employees	4,638	4,092
Unreported Wages	$187,059,631	$118,249,769
Payroll Tax Audits	422	357
Payroll Tax Assessments	$29,344,488	$17,915,081
Labor Code Citation Amounts	$5,575,312	$4,106,894

To learn more about the EETF program, see our *Information Sheet: Employment Enforcement Task Force*, available in both English (DE 631) and Spanish (DE 631/S/).

Labor Enforcement Task Force (LETF)

The LETF was initially formed in 2005 as the Economic and Employment Enforcement Coalition and began operating as the Labor Enforcement Task Force in January of 2012. The LETF was formed to: ensure California workers receive proper payment of wages and are provided a safe work environment; ensure California receives all employment taxes, fees, and penalties due from employers; eliminate unfair business competition by leveling the playing field; make efficient use of state and federal resources in carrying out the mission of the LETF. They focus on industries that traditionally employ low wage workers. Agriculture, construction, automotive, carwash, courier, warehouse, garment, and restaurants are the program's current targeted industries. The LETF members include: the Department of Industrial Relation's (DIR) Division of Labor Standards Enforcement (Labor Commissioner) and Cal/OSHA; the EDD; the Board of Equalization (BOE); and the Department of Consumer Affairs' (DCA) Contractor's State Licensing Board (CSLB) and Bureau of Automotive Repair (BAR).

Construction Enforcement Project (CEP)

The EDD recognizes that the vast majority of construction contractors are honest business people who operate legitimately within the law and properly report payroll taxes. However, there are some contractors who do not properly report, and this impacts both workers and law-abiding contractors. The CEP was developed because usual techniques for identifying tax and employment fraud were not as effective in the construction industry. Unlike other industries that have permanent business locations, construction businesses have constantly changing job sites. By the time information is developed that a contractor is probably operating in the underground economy, work at the job site has often been completed and an on-site inspection would not discover any labor law violations.

The CEP uses a variety of investigative techniques to identify contractors who avoid payroll taxes. When a CEP investigator develops evidence of underground economy activities, a payroll tax audit referral is made to the EDD Audit Program. The CEP goal is to develop techniques that will maximize the detection of construction industry employers operating in the underground economy.

Construction Enforcement Project Program Results

Result	2008	2009

Previously Unreported Employees	1,777	4,965
Unreported Wages	$65,646,628	$56,554,550
Payroll Tax Audits	125	115
Payroll Tax Assessments	$8,834,006	$7,565,798

Joint Enforcement Strike Force

On October 26, 1993, the Governor signed Executive Order W-66-93, which created the Joint Enforcement Strike Force on the Underground Economy. The Governor subsequently signed Senate Bill 1490, which placed the provisions of the Executive Order into law as Section 329 of the California Unemployment Insurance Code, effective January 1, 1995.

The EDD is the lead agency for the Strike Force, and the Director of EDD is the chairperson. The Strike Force is responsible for enhancing the development and sharing of information necessary to combat the underground economy, to improve the coordination of enforcement activities, and to develop methods to pool, focus, and target enforcement resources. The Strike Force is empowered and authorized to form joint enforcement teams when appropriate to utilize the collective investigative and enforcement capabilities of the Strike Force members. For more information, visit the Joint Enforcement Strike Force (JESF) page.

In addition to EDD, the other Strike Force members are:

- Department of Consumer Affairs 1-800-952-5210
- Department of Industrial Relations
  Minimum Wage, Safety, and Work Violations 1-888-275-9243
- Department of Insurance 1-800-927-HELP (4357)
- Franchise Tax Board Tax Informant Hotline: 1-800-540-3453
- Board of Equalization 1-888-334-3300
- Department of Justice 1-800-952-5225

EDD Employment Development Department
State of California

INFORMATION SHEET

EMPLOYMENT ENFORCEMENT TASK FORCE (Employment Development Department, Department of Industrial Relations, and Department of Consumer Affairs)

Background

Reports on the underground economy indicate that it imposes significant burdens on the State of California, on businesses that comply with the law, and on workers who lose benefits and other protections provided by State law when the businesses that they work for operate in the underground economy. When businesses operate in the underground economy, they gain an unfair competitive advantage over businesses that comply with the law. This causes unfair competition in the marketplace and forces law-abiding businesses to pay higher taxes.

Employees of the businesses that do not comply are also affected. Their working conditions may not meet the legal requirements, which can put them in danger. Their wage earnings may also be less than those required by law and benefits they are entitled to can be denied or delayed because their wages are not properly reported.

Consumers can also be affected when contracting with unlicensed businesses. Licensing provisions are designed to ensure minimum levels of skill and knowledge to protect the consumer. The ultimate impact is an erosion of the economic stability and working conditions in this State.

Joint Enforcement Strike Force

On October 26, 1993, the Governor signed Executive Order W-66-93, which created the Joint Enforcement Strike Force on the underground economy. On January 1, 1995, Section 329 was added to the California Unemployment Insurance Code. This section placed the provisions of the Executive Order into law. The Joint Enforcement Strike Force includes the Employment Development Department (EDD), the Department of Consumer Affairs (DCA), the Department of Industrial Relations (DIR), the Office of Criminal Justice Planning, the Franchise Tax Board, the Board of Equalization, the Department of Insurance, and the Department of Justice.

The Strike Force is responsible for enhancing the development and sharing of information necessary to combat the underground economy, to improve the coordination of enforcement activities, and to develop methods to pool, focus, and target enforcement resources.

The Strike Force is empowered and authorized to form joint enforcement teams when appropriate to utilize the collective investigative and enforcement capabilities of the Strike Force members.

Employment Enforcement Task Force

In February 1994, the Strike Force created its first joint enforcement effort, called the Employment Enforcement Task Force, consisting of EDD, DIR, and DCA.

The objectives of the Employment Enforcement Task Force are:

- To create a *level playing field* for business competition.
- To ensure that workers receive benefit coverage provided by law for Unemployment Insurance, State Disability Insurance, and Workers' Compensation Insurance.
- To ensure that workers receive minimum wages and overtime in accordance with the law.
- To ensure that businesses obtain the proper licenses.
- To detect, deter, educate, and bring into compliance those employers that are avoiding their employment tax liabilities.

The Employment Enforcement Task Force operates through teams of Joint Enforcement agents from EDD and DIR. Leads are received from other agencies, from hotlines, and from individuals, labor, and businesses. These leads are verified with various databases to determine if there are current licenses, Workers' Compensation Insurance coverage, or registration with EDD. When there is a reasonable belief that there is some noncompliance with licensing, labor, or payroll tax law, agents will visit work sites of businesses to determine if there is cause for further action.

The agents will interview the owners and/or workers to determine if the workers are employees and if so, to determine if the business has Workers' Compensation Insurance and is issuing wage statements and reporting wages properly for benefit purposes. If the business appears to be out of compliance with payroll tax law, an audit appointment will be set up with the local EDD Area Audit Office. If violations of labor law are found, agents will cite owners with appropriate fines and penalties.

A visit to a business by an Employment Enforcement Task Force team means only that the team has information indicating that noncompliance with licensing, labor, or payroll tax law may exist. The team is charged with determining whether the information in its possession is correct. If the visit to the business verifies that noncompliance does exist, the team will inform the business owner as to his or her responsibilities and take any action required by law.

For More Information

If you would like additional information regarding this program or to report suspected underground economy activity, please contact EDD's Underground Economy Operations at (916) 227-2730 or toll free at (800) 528-1783, or visit our Web site at **http://www.edd.ca.gov/Payroll_Taxes/Underground_Economy_Operations.htm.** You may also e-mail information to UEO at **ueo@edd.ca.gov,** send a fax to (916) 227-2772, or mail to:

Employment Development Department
Underground Economy Operations
3321 Power Inn Road, Suite 140
Sacramento, CA 95826

EDD is an equal opportunity employer/program. Auxiliary aids and services are available upon request to individuals with disabilities. Requests for services, aids, and/or alternate formats need to be made by calling (888) 745-3886 (voice) or TTY (800) 547-9565.

United States Department of Labor
News Release

WHD News Release: [02/09/2012]
Contact Name: Sonia Melendez, Laura McGinnis, or Elizabeth Alexander
Phone Number: (202) 693-4672 or x4653
Release Number: 12-0257-SAN

US Labor Department, California sign agreement to reduce misclassification of employees as independent contractors

WASHINGTON — Nancy J. Leppink, deputy administrator of the U.S. Department of Labor's Wage and Hour Division, and California Secretary of Labor Marty Morgenstern have entered into a memorandum of understanding regarding the improper classification of employees as independent contractors. Leppink and California Labor Commissioner Julie A. Su hosted a press teleconference Feb. 9 during which they discussed how the U.S. Department of Labor and the state of California will embark on new efforts, guided by this memorandum, to protect the rights of employees and level the playing field for responsible employers by reducing the practice conducted by some businesses of misclassifying employees. This partnership is the 12th of its kind for the U.S. Department of Labor.

"This memorandum of understanding helps us send a message: We are standing together with the state of California to end the practice of misclassifying employees," said Leppink. "This is an important step toward making sure that the American dream is still available for workers and responsible employers alike."

"California is proud to enter into this partnership with the U.S. Department of Labor to work together to attack the problems of the underground economy," said Su. "Gov. Brown just signed an important law that went into effect on Jan. 1, increasing penalties for willful misclassification. With the Labor Department, we are poised to use all the tools in our arsenal to lift the floor for hardworking employers and employees throughout the state."

Employee misclassification is a growing problem. In 2011, the Wage and Hour Division collected more than $5 million in back wages for minimum wage and overtime violations under the Fair Labor Standards Act that resulted from employees being misclassified as independent contractors or otherwise not treated as employees.

Business models that attempt to change, obscure or eliminate the employment relationship are not inherently illegal, unless they are used to evade compliance with the law. The misclassification of employees as something else, such as independent contractors, presents a serious problem, as these employees often are denied access to critical benefits and protections — such as family and medical leave, overtime compensation, minimum wage pay and Unemployment Insurance — to which they are entitled. In addition, misclassification can create economic pressure for law-abiding business owners, who often struggle to compete with those who are skirting the law.Employee misclassification also generates substantial losses for state Unemployment Insurance and workers' compensation funds.

Memorandums of understanding with state government agencies arose as part of the U.S. Department of Labor's Misclassification Initiative, which was launched under the auspices of Vice President Biden's Middle Class Task Force with the goal of preventing, detecting and remedying employee misclassification. Colorado, Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, Missouri, Montana, Utah and Washington have signed similar agreements. More information is available on the U.S. Department of Labor's misclassification Web page at http://www.dol.gov/misclassification/.

The mission of the U.S. Department of Labor is to foster, promote and develop the welfare of the wage earners, job seekers and retirees of the United States; improve working conditions; advance opportunities for profitable employment; and ensure work-related benefits and rights. To learn more about the FLSA's requirements, call the Wage and Hour Division's toll-free hotline at 866-4US-WAGE (487-9243) or visit its website at http://www.dol.gov/whd.

PARTNERSHIP AGREEMENT

BETWEEN

THE U.S. DEPARTMENT OF LABOR, WAGE AND HOUR DIVISION

AND

CALIFORNIA LABOR AND WORKFORCE DEVELOPMENT AGENCY

This Agreement is made and entered into by and between The United States Department of Labor's Wage and Hour Division (hereinafter referred to as "WHD" or "Department") and the California Labor and Workforce Development Agency (hereinafter referred to as "LWDA"), together collectively referred to as "the agencies" or "the parties."

With the specific and mutual goals of providing clear, accurate, and easy-to-access outreach to employers, employees, and other stakeholders, and of sharing resources and enhancing enforcement by conducting joint investigations and sharing information consistent with applicable law, the parties agree to enter into this partnership.

THEREFORE, IT IS MUTUALLY AGREED THAT:

Purpose

The agencies recognize the value of establishing a collaborative relationship to promote compliance with laws of common concern in the State of California. The agencies are forming this partnership to more effectively and efficiently communicate and cooperate on areas of common interest, to share training materials, to provide employers and employees with compliance assistance information, to conduct joint investigations and share information as appropriate towards the goal of protecting the wages, safety, and health of America's workforce.

Agency Responsibilities

WHD is responsible for administering and enforcing a wide range of labor laws, including the Fair Labor Standards Act, the Family and Medical Leave Act, the Migrant and Seasonal Agricultural Worker Protection Act, worker protections provided in several temporary visa programs, and the prevailing wage requirements of the Davis-Bacon and Related Acts and the Service Contract Act. Nothing in this agreement limits the WHD's enforcement of these and other statutes.

LWDA is the California executive branch Agency charged with ensuring that California businesses and workers have a level playing field in which to compete and prosper and that Californians have access to employment and training programs. LWDA includes the Department of Industrial Relations (which oversees the California Labor Commissioner and Division of Occupational Safety and Health, among others) and Employment Development Department. Nothing in this agreement limits the LWDA's enforcement authority.

Contacts

- The agencies will designate a contact person responsible for coordinating the partnership activities.
- The agencies will designate a representative to meet annually to review areas of mutual concern and the terms and conditions of the partnership.

Enforcement

Where appropriate and to the extent allowable under law,

- The agencies may conduct joint investigations periodically in the State of California, if opportunity provides.
- The agencies may coordinate their respective enforcement activities and assist each other with enforcement.
- The agencies may make referrals of potential violations of each other's statutes.

Effect of Agreement

- This agreement does not authorize the expenditure or reimbursement of any funds. Nothing in this agreement obligates the parties to expend appropriations or enter into any contract or other obligation.

- By entering into this partnership, the agencies do not imply an endorsement or promotion by either party of the policies, programs, or services of the other.

- Nothing in this agreement is intended to diminish or otherwise affect the authority of either agency to implement its respective statutory functions.

- This agreement contains all the terms and conditions agreed upon by the parties. Upon execution of this agreement, no other understandings regarding the subject matter of this agreement, oral or otherwise, shall be deemed to exist. This agreement is not intended to confer any right upon any private person or other third party.

- Nothing in this agreement will be interpreted as limiting, superseding, or otherwise affecting the parties' normal operations. This agreement also does not limit or restrict the parties from participating in similar activities or arrangements with other entities.

- This agreement will be executed in full compliance with the Privacy Act of 1974, and any other applicable federal and California state laws.

Exchange of Information

- It is the policy of WHD to cooperate with other government agencies to the fullest extent possible under the law, subject to the general limitation that any such cooperation must be consistent with the WHD's own statutory obligations and enforcement efforts. It is WHD's view that an exchange of information in cases in which both entities are proceeding on basically the same matter is to our mutual benefit. There is a need for WHD to provide information to other law enforcement bodies without making a public disclosure.

- Exchange of such information pursuant to this agreement is not a public disclosure under the Freedom of Information Act, 5 U.S.C. 552.
- Confidential Information means information that may be exempt from disclosure to the public or other unauthorized persons under state and federal statutes. *See, e.g.*, 18 U.S.C. 1905 (Trade Secrets Act) and 5 U.S.C. 552a (Privacy Act of 1974). Examples of Confidential Information that may be shared under this agreement includes, but is not limited to: the identities or statements of persons who have given information to the parties in confidence or under circumstances in which confidentiality can be implied; any information identifying specific individuals in statements from employees that were obtained under these conditions; internal opinions and recommendations of federal or state personnel, including (but not limited to) investigators and supervisors; information or records covered by the attorney-client privilege and the attorney-work-product privilege; information that identifies or describes a specific individual; individually identifiable health information; and confidential business information and trade secrets.
- Confidential Unemployment Compensation (UC) information, as defined in 20 CFR 603.2(b), means any unemployment compensation information, as defined in 20 CFR 603.2(j), required to be kept confidential under 20 CFR 603.4 or its successor law or regulation.
- When Confidential Information is exchanged it shall be accessed and used by the recipient party solely for the limited purposes of carrying out specific activities pursuant to this agreement as described herein, and in no event shall such information be disclosed by the recipient party without the written authority of the other party or a court order.
- In addition to the requirements above, Confidential Unemployment Compensation Information may be exchanged only subject to the confidentiality requirements of 20 CFR 603.4, the California Unemployment Insurance Code (e.g., Sections 322, 1094, and 1095) and related regulations, and any other applicable laws.
- In addition to the requirements above, Confidential Information shared under this agreement may be exchanged only subject to (a) the applicable provisions of California law, including but not limited to, the Information Practices Act (Civil Code Section 1798 et seq.), the Evidence Code (e.g., Sections 950 and 1040), the Labor Code (e.g., Sections 6209, 6314 and 6322), and the Unemployment Insurance Code (e.g., Sections 322, 1094, and 1095) and (b) the terms and conditions of any confidentiality agreements that may exist under which Confidential Information has been obtained by LWDA or by an agency within LWDA.
- The exchange of Confidential Information and Confidential Unemployment Compensation Information under this agreement is purely voluntary, and no obligation to exchange such information is created by this agreement.
- In the event that there is a public proceeding such as a trial, in which Confidential Information provided to LWDA by WHD may be used or testimony of WHD's employees sought, the WHD requires that LWDA notify WHD. Similarly, in the event that there is a public proceeding such as a trial, in which Confidential Information or Confidential Unemployment Compensation Information provided to WHD by LWDA may be used or testimony of LWDA's employees sought, the LWDA requires that WHD notify LWDA.

Subject to the foregoing constraints:

- The agencies agree to exchange information on laws and regulations of common concern to the agencies, to the extent practicable.
- The agencies will establish a methodology for exchanging investigative leads, complaints, and referrals of possible violations, to the extent allowable by law and policy.
- The agencies will exchange information (statistical data) on the incidence of violations in specific industries and geographic areas, if possible.

Outreach and Education

- When appropriate and feasible, the agencies agree to coordinate, conduct joint outreach presentations, and prepare and distribute publications of common concern for the regulated community.

- The agencies agree to provide a hyperlink on each agency's website linking users directly to the outreach materials in areas of mutual jurisdiction and concern.

- The agencies agree to jointly disseminate outreach materials to the regulated community, when appropriate.

- All materials bearing the United States Department of Labor ("DOL") or WHD name, logo, or seal must be approved in advance by DOL.

Resolution of Disagreements

Disputes arising under this Agreement will be resolved informally by discussions between Agency Points of Contact, or other officials designated by each agency.

Period of Agreement

This agreement becomes effective upon the signing of both parties, and will expire 3 years from the effective date. This agreement may be modified or added to in writing by mutual consent of both agencies. The agreement may be cancelled by either party by giving thirty (30) days advance written notice prior to the date of cancellation. Renewal of the agreement may be accomplished by written agreement of the parties.

This agreement is effective as of the 21 day of December, 2011.

United States Department of Labor
Wage and Hour Division

By:
Nancy J. Leppink
Acting Administrator

Deputy

California Labor and Workforce Development Agency

By:
Marty Morgenstern
Labor Secretary

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Attorneys for All Named Defendants

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SACRAMENTO

LORIANNE SAWIN, an individual; MONICA GALLARDO, an individual; ROBERT LANGFORD, an individual; KIMBERLY HOLLIMAN, an individual; BILLY TRAHIN, an individual; and MERLE RENSLOW, an individual; on their own behalf and on behalf of all others similarly situated,

Plaintiffs,

v.

THE McCLATCHY COMPANY, a Delaware Corporation, d/b/a The Sacramento Bee; McCLATCHY NEWSPAPERS INC., a Delaware corporation, d/b/a The Sacramento Bee; and DOES 27 through 50, inclusive,

Defendants.

Case No. 34-2009-00033950-CU-OE-GDS

DEFENDANTS' MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF MOTION TO STRIKE CLASS ALLEGATIONS

[CRC 3.764, 3.767(a), (c)]

Judge. The Hon. Raymond M. Cadei
Date: May 13, 2011
Time: 1:30 p m.
Dept: 13

Complaint Filed: February 5, 2009

[Notice of Motion and Motion to Strike Class Allegations, Separate Statement of Material Facts, Appendix of Evidence, Declaration of Richard B. Lapp, Appendix of Non-California State Authority, Request for Judicial Notice, and [Proposed] Order Filed Concurrently]

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SUMMARY OF ARGUMENT

The current Named Plaintiffs are one current and five former home delivery newspaper carriers who agreed, as independent contractors, to provide delivery of *The Sacramento Bee* newspaper to home delivery subscribers during the class period, from February 2005 to the present.[1] Three Named Plaintiffs (Trahin, Gallardo, Langford) contracted only with Defendant McClatchy Newspapers, Inc., dba The Sacramento Bee ("The Sacramento Bee" or "The Bee"). The remaining three (Sawin, Holliman, Renslow) contracted with The Sacramento Bee and also occasionally contracted with one or two of the approximately 35 independent large newspaper delivery businesses ("Large Distributors") who have had contracts to deliver *The Sacramento Bee* during the class period.[2] Plaintiffs even seek to represent those carriers who contracted with dozens of Large Distributors for whom no Named Plaintiff has ever provided services. And Plaintiffs seek to represent both former and current carriers, even though these two sets of individuals have conflicting interests, and although the only current carrier—Renslow—has openly disavowed any interest in representing the class.

All Named Plaintiffs contend that, contrary to the written contracts they agreed to, The Sacramento Bee has been their employer. The Plaintiffs claim that The Bee has (1) failed to pay overtime pay and minimum wages due under Labor Code sections 1194 and 1197,[3] (2) denied them meal and rest breaks and therefore owes them pay under Section 226.7, (3) failed to reimburse them for business expenses owed under Section 2802, (4) imposed unlawful wage deductions forbidden by Sections 221 and 223, (5) failed to provide them with accurate wage statements required by Section 226, (6) failed to pay them for training time, and (7) failed to keep accurate payroll records under Section 1174. **Plaintiffs have chosen not to sue any Large Distributor on these claims.**

Plaintiffs' claims, and the associated defenses to them, raise numerous individualized issues that preclude class treatment as the proposed class would involve thousands of carriers with written contractual relationships with about 35 contracting companies, only one of whom—The Bee—is even a Defendant here.

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[1] Initially the case included six other Named Plaintiffs, all alleged by Plaintiffs' counsel to share common facts and typical claims with the purported class (February 4, 2009 Complaint ¶ 5). Four original Plaintiffs (Galindo, Compton, Fincham, Chapman) withdrew during their depositions; two more (Hundley, Hernandez) withdrew upon receiving discovery requests (SMF ¶ 328). Plaintiffs' counsel agreed that partially completed depositions can be used for all purposes here, and that the former Named Plaintiffs desire to be class members (SMF ¶ 329). No new Plaintiff has emerged since the filing of the initial complaint in February 2009.

[2] The Large Distributors who Plaintiffs claim are agents and joint employers of The Sacramento Bee include four independently owned daily newspapers.

[3] Undesignated section references are to the California Labor Code.

Class actions are proper only where common proof applies to an ascertainable class in a way that makes a class action manageable and superior to individual litigation. Here, by contrast, the current complaint, the Third Amended Complaint ("3AC"), proposes an unmanageable, unascertainable, and overbroad class of all "persons" "engaged" as newspaper home delivery carriers of *The Sacramento Bee*, "whether engaged directly by The Sacramento Bee or by an intermediary."

The diverse purported class includes individuals with vastly different work relationships with different entities[4] such as: (1) Plaintiff Billy Trahin, who contracted with The Sacramento Bee for several years for a small delivery area whose assembly and delivery he always completed within three hours a day; (2) Plaintiff Robert Langford, who contracted with The Sacramento Bee for less than four months, during which time he formed a joint-venture-type relationship with another Bee carrier, and together, they unilaterally changed delivery boundaries, engaged and set terms for numerous subcontractors, and used multiple vehicles in executing combined services; (3) former Plaintiff Richard Galindo, a sophisticated businessman whose academic career, significant management experience, and experience as a negotiator on behalf of numerous banks, left no question that he understood and voluntarily entered into an independent contractor relationship with a Large Distributor for less than eight months during the class period, and (4) Kevin Goosby, who contracted with The Sacramento Bee and later with Large Distributors for over 30 delivery areas at a time, managing the delivery results by contracting with at least ten different entities at a time, and receiving contract fees of $8,000 to $8,500 every two weeks.

Differences also abound among the entities with whom these carriers contracted. For some delivery areas, until June 2009, The Sacramento Bee itself contracted with carriers to secure home delivery results. The experience of these carriers vastly differed because of decentralized distribution operations: The Bee's Distribution Center Managers had extensive autonomy and did not observe uniform operating procedures.

Since June 2009, The Sacramento Bee has not contracted with any carrier to secure home delivery results. Instead, some 35 independent Large Distributors, including previously free-standing independent delivery and newspaper businesses, have contracted with hundreds of carriers to provide distribution results. There are significant differences in the Large Distributors' operations, including unique contract terms (including fees, supply costs and complaint charges), negotiation techniques, written communications, and

[4] The class definition also includes individuals who subcontracted with carriers.

carrier selection and communication processes. For example, Sealey News Agency, Inc. operated a newspaper distribution business for years before contracting with The Bee, and folded the home delivery distribution of *The Sacramento Bee* into an existing operational structure distributing many other California daily newspapers.

Plaintiffs, in contending that all carriers share common facts dispositive to their claims, ignore both law and facts that require an individualized analysis of disparate facts and contracting parties that defy class-wide adjudication. Individualized differences exist among even those carriers who contracted to deliver *The Sacramento Bee* with just one contracting entity, let alone among carriers who collectively have contracted with some 35 different business entities. There is no commonality on such critical factors as: (1) how each Large Distributor did business with The Bee and whether The Bee is liable for any alleged Labor Code violations a Large Distributor committed with respect to any carrier; (2) how each Large Distributor interacted with the carriers; (3) how each Bee Distribution Center Manager (before June 2009) interacted with carriers (including what practices each followed, what contractual terms each negotiated with each carrier, and each carrier's practices); and (4) how each carrier chose to distribute newspapers and operate his or her business.

These variations preclude any common proof on the threshold issue of whether the carriers were The Sacramento Bee's employees. Further precluding class certification are the individualized inquiries required by Labor Code elements and defenses, such as: (1) where each carrier performed services and the percentage of time spent inside versus outside distribution centers; (2) how often, if at all, each carrier provided distribution results for at least 3.5 hours a day; (3) how often, if at all, each carrier provided distribution results for more than five hours a day; (4) how often, if at all, each carrier took breaks; (5) how often, if at all, each carrier was prohibited from taking a break (and if so, by whom and with whose knowledge); (6) how many days a week each carrier provided distribution results; (7) how many hours per week each carrier provided services and how much weekly pay the carrier received; (8) the amount and reasonableness of each carrier's expenses; (9) whether each carrier understood that he or she was being paid an enhanced amount of compensation to cover his or her reasonably incurred expenses; (10) how much, if any, uncompensated "training" each carrier received; and (11) whether each carrier was injured by an inadequate wage statement.

Accordingly, dwarfing any common issues here are numerous individualized issues affecting liability that require examination of the independent contractor status of each Large Distributor, the practices of different Bee Distribution Center Managers, the independent contractor status of the carriers contracting with

each of the 35 or so different entities, the hours and days worked by each carrier, and the contract fees each carrier received and the expenses each carrier incurred. Thus, Plaintiffs' claims would not be suitable for class treatment even if they were typical and adequate class representatives. And, finally, as shown below, Plaintiffs are neither typical nor adequate.[5]

FACTUAL BACKGROUND

I. The Sacramento Bee's Business

The Sacramento Bee publishes *The Sacramento Bee*, a daily newspaper. (SMF ¶ 1). Historically, The Bee has outsourced non-core business functions such as sales, customer service, collections, distribution, finance, and advertising design (SMF ¶ 2). As to distribution, The Bee follows a longstanding national newspaper practice: contracting with independent contractors—carriers and Large Distributors— for newspaper delivery to home subscribers in geographical delivery areas. (*Id*).

II. The Sacramento Bee's Distribution Model Has Varied During the Class Period

Until mid-2009, The Bee's distribution system consisted of a mix of (1) individual carriers providing distribution results in one or several delivery areas, and (2) Large Distributors that contracted with carriers, leased warehouses, and developed their own distribution methods. By mid-2009, The Bee no longer contracted with carriers and instead dealt only with Large Distributors or separate newspaper companies (SMF ¶¶ 3-4).

A. Bee and Distributor Carrier Contracts Made Clear The Carriers Were Independent Contractors

The Sacramento Bee carrier contracts, titled "Independent Contractor Home Delivery Distribution Agreements" ("Agreements") (SMF ¶ 6), provided that carriers were independent contractors, not employees, who themselves solely controlled the manner and means of contractual performance (SMF ¶ 7). This freedom of operation entitled carriers to select their own employees and contractors, decide their own days of work and hours, if any, decide what vehicles, equipment, and supplies to use and where to buy them, and how to deliver newspapers (SMF ¶¶ 8-9). The Agreements disclaimed any right by The Bee to dictate carrier operations (SMF ¶¶ 10, 12).

It is undisputed that the Named Plaintiffs' contracts with Large Distributors, while differing among Large Distributors, were alike in one important way—they provided, like The Bee Agreements, that carriers

[5] An independent basis to strike class allegations is the inadequacy of counsel, who have undercut the credibility of named Plaintiffs to the detriment of the putative class. (See Section VI and VII, below).

were independent contractors who had the right to control the manner and means of newspaper distribution (SMF ¶ 11). Carriers contracting with Large Distributors were free to select their own employees and subcontractors, determine their own hours, decide what vehicles, equipment, and supplies to use and where to buy them, and the order in which to deliver newspapers (*Id.*).

This freedom to operate resulted in variations as to how carriers chose to provide contractual results. Those choices included whether to use helpers or substitutes, whether to subcontract the work in whole or in part, what types of tools, equipment, and supplies to use, where to buy supplies, how to prepare and deliver newspapers, how much to interact with subscribers, and what sequence of delivery to follow.

Moreover, carriers' intent to enter into an independent contractor relationship—whether with The Bee or Large Distributors—also varied. For example, while some Plaintiffs may claim that they never read their contracts and that The Sacramento Bee never explained the contractor relationship, many carriers clearly understood the Agreement's language and agreed they were independent contractors (SMF ¶ 13).

B. Large Distributors' Contracts With The Bee Reflect That They Are Varied Independent Businesses

Some 35 Large Distributors have contracted with The Bee since 2003 (SMF ¶ 14); about 30 are now under contract with The Bee (*Id*). The Bee has never owned any financial interest in or controlled Large Distributor operations (SMF ¶ 15). Large Distributors lease their warehouses, operate their own offices, use individualized methods to operate their distribution centers, and vary in how they interface with carriers, including developing and using home delivery contracts of their own making and choice (SMF ¶ 16).

The Large Distributors vary significantly. Some are small operations, while others are large, with numerous staff (SMF ¶ 17). Some are large LLCs or S Corporations (SMF ¶ 17), some are independently owned newspapers, including *Stockton Record, Chico Enterprise*, *Marysville Appeal-Democrat*, and *Grass Valley Union* (SMF ¶ 5). The *Stockton Record,* a daily newspaper with 38,000 readers, is owned by Dow Jones Local Media Group, the local newspaper subsidiary of Dow Jones & Company, not McClatchy Newspapers, Inc. or The McClatchy Company. (See http://www.mediaowners.com/company/ottawaynewspapers.html.). Similarly, Media News owns *Chico Enterprise*, Freedom Communications owns *Marysville Appeal-Democrat*, and Swift Communications owns *Grass Valley Union* (SMF ¶ 331). Some have principals who are former Bee employees, while others do not (SMF ¶ 18). Some existed well before they contracted with The Bee (SMF ¶ 19).

Carriers who have contracted only with Large Distributors have never had a contractual relationship with The Sacramento Bee (SMF ¶ 20). As to these carriers, The Bee has never engaged in carrier selection, contract negotiation, or contract administration (SMF ¶ 21). Large Distributors function in a decentralized, non-uniform way that results in individualized experiences as between the various Large Distributors and the carriers with whom they have contracted (SMF ¶22).

Large Distributors have always been free to contract with whomever they choose to perform their own contractual delivery obligations, and to provide distribution and other results to other entities, including The Sacramento Bee's competitors (SMF ¶ 23). Large Distributors are not required to attend Bee meetings (SMF ¶ 24) and have always been free to run their operations as they see fit (SMF ¶ 25). The Bee has never had power to discipline Large Distributors or their contractors or staff, and the manner and means of obtaining contractual results has always been entirely within Large Distributors' discretion (SMF ¶ 26). Large Distributors' independence has resulted in variability as to how they have operated and interacted with carriers.

C. Large Distributor Contracts With Individual Carriers Vary

Large Distributors have crafted their own home delivery agreements, sometimes with their attorneys (SMF ¶ 30). Large Distributor-carrier agreements have varied in many ways, including (1) rate structures, (2) complaint charges, (3) liquidated damages, (4) grounds for material breach, (5) bonding, (6) subscriber tips, (7) duration, (8) incentives, (9) the number and make up of delivery areas, (10) termination notices, (11) length (varying from two pages to more than ten), and (12) complexity (SMF ¶¶ 32-43). Consequently, carriers contracting with Large Distributors have experienced differing contractual obligations, influencing how they have chosen to provide distribution results.

D. Decentralized Large Distributor Operations Have Differed Greatly, With No Uniform Or Common Approach To Their Operations

The Sacramento Bee has provided subscriber information to Large Distributors, and Large Distributors determine how to use this information to provide the final contractual result of a newspaper delivered complaint-free to home delivery subscribers (SMF ¶ 44).[6] A closer look at a few Large Distributors illustrates the differences among them and their unique interactions with carriers.

[6] The subscriber information includes: subscriber addresses, subscription purchase dates, start and stop dates, subscriber delivery requests, and subscriber service complaints, which is necessary to complete the subscriber's newspaper delivery orders (SMF ¶ 44).

1. Western Slope News Agency ("WSNA")

WSNA is an unincorporated business owned and operated by Pete Cavaghan, who has contracted with The Sacramento Bee as a Large Distributor since 2000, operating out of three distinct distribution centers (SMF ¶ 45). WSNA distributes approximately 17,800 weekend newspapers and 15,000 weekday newspapers in 160 delivery areas through 40 independent contractor carriers (SMF ¶¶ 46-47). WSNA's carrier contracts have differed significantly from Bee Agreements, resulting in variations in how WSNA carriers operate: (1) WSNA agreements provide unique monetary incentives to provide outstanding customer service and minimize complaints; (2) WSNA varies contract lengths based on results: new carriers are offered contracts lasting just a few weeks while carriers who provide delivery results with few customer complaints are offered contracts with longer terms of up to one year; (3) WSNA agreements cover multiple delivery areas (as opposed to having one per delivery area), to incentivize carriers to fulfill contract obligations and avoid situations where a carrier terminates one delivery area's contract only; (4) WSNA's contracts have shortened notice provisions if a carrier elects to terminate a contract (10 days' written notice as compared with 30 days generally set forth in The Bee Agreements); and (5) WSNA's contracts have pricing varied by delivery area, with some offering flat rates and others offering per-piece rates (SMF ¶ 48).

WSNA has independently established business operations, infrastructure, and procedures (SMF ¶ 49). A WSNA-designed information system has a customized application for carrier payments that gives carriers access to WSNA accounts (SMF ¶ 50). WSNA gmail accounts provide information on starts, stops, and customer complaints, and other information, and carriers can log on to access information about delivery areas (SMF ¶ 51). None of these processes, programs or systems were available to carriers who contracted with The Sacramento Bee or with other Large Distributors. WSNA organizes its distribution center by geographic region to keep the center operating smoothly and has also dramatically reorganized the initial delivery area boundaries set up by The Sacramento Bee to improve its efficiency (SMF ¶¶ 52-53).

2. R&A Distribution Services, LLC ("R&A")

Anthony and Raquel Kinney formed R&A, which has contracted with The Sacramento Bee since 2006 (SMF ¶ 54). R&A, operating out of Rocklin, contracts with 40 carriers to deliver 13,000 daily newspapers and 17,000 weekend newspapers (SMF ¶ 55). R&A consulted its own Home Delivery Distribution Agreement in the process of preparing its carrier contracts (SMF ¶ 59). R&A gives prospective carriers a questionnaire—

created without any input or approval from The Bee—to confirm that carriers understand the independent contractor status and other key contractual elements (SMF ¶ 60). Plaintiff Holliman contracted with R&A (SMF ¶ 56). R&A determines the hours its distribution center is open (SMF ¶ 57). R&A funds its own expenses, without any advances from The Bee (*Id*). R&A maintains its own business plan to account for costs and expenses as to vehicles, staff, supplies, furniture, lease costs, payment to R&A carriers, and for R&A's profit (SMF ¶ 58). R&A has a unique carrier incentive program: carriers who provide results without wet paper complaints for a calendar period earn a case of poly bags, and carriers who provide results with low customer complaints for a calendar period earn a gas card (SMF ¶ 61). R&A also marks up its price on supplies it resells to carriers, to generate profits (SMF ¶ 62).

3. Moonlighting Distribution, LLC ("Moonlighting")

Moonlighting has contracted with The Sacramento Bee since 2006 (SMF ¶ 63). It distributes about 3,500 daily and 4,000 weekend newspapers (SMF ¶ 64). It has a small staff and often leaves its warehouse unattended, with open doors for carriers to pick up newspapers (SMF ¶ 65). Moonlighting leases warehouse space and owns its own computer systems, furniture, and equipment (SMF ¶ 66). The Bee does not review Moonlighting's operations or maintain any personnel at the warehouse where Moonlighting's carriers pick up newspapers (SMF ¶ 67). Nor, has The Bee influenced whom Moonlighting contracts with or what practices it uses (*Id*). This is not surprising as Moonlighting has contracted with Bee competitors to deliver the *Mountain Democrat* and *San Francisco Chronicle*, which dropped newspapers at one point at Moonlighting's distribution center for delivery by carriers who contract with Moonlighting to deliver *The Sacramento Bee* (SMF ¶ 68). Moonlighting carrier contracts—just two pages long—lack many terms contained in Bee Agreements or in other Large Distributors' carrier contracts on such subjects as material breach, liquidated damages, and tips (SMF ¶ 69). And, Moonlighting's practices are not always found in its contract. For example, Moonlighting does not charge carriers for complaints as it has the contractual right to do, but instead provides financial incentives to carriers for complaint-free deliveries (SMF ¶ 70).

4. D&L News Service, LLC ("D&L")

D&L, in Vacaville, not only contracts with The Sacramento Bee, but also contracts with others to deliver *Contra Costa Times* and *The Oakland Tribune* (SMF ¶¶ 71-72). Unlike some other Large Distributors, D&L does not lease a warehouse from The Bee (SMF ¶ 73). D&L has obtained its own vehicles, strapping

machines, tables, office equipment, and furniture, without any funding from any newspaper (SMF ¶ 74). It also has its own business banking accounts, and has not borrowed any money from The Bee (SMF ¶ 75).

D&L's carrier contracts–just two pages long, with no specified duration and terminable on two weeks' notice–differ significantly from Bee Agreements and from those used by other Large Distributors (SMF ¶ 76). D&L, unlike some other Large Distributors, does not charge carriers for complaints (*Id.*). And, unlike others, D&L charges carriers only a nominal fee for unlimited supplies (*Id.*). To offset supply costs, D&L, unlike other Large Distributors, retains tips received from subscribers (*Id.*).

5. Sealey News Agency, Inc. ("Sealey")

Sealey, run by Rick Sealey, contracted with The Sacramento Bee in 2009 (SMF ¶ 83). Before this time and continuing thereafter, Sealey has contracted with other companies to distribute, through various distribution centers, many other newspapers, including *USA Today, San Francisco Chronicle, Sacramento Union, Auburn Journal, Korea Times, Korea Daily, Sing Tao, Lincoln News Messenger, Press Tribune, Wall Street Journal, Barron's, New York Times*, and *IBD* (SMF ¶ 84). Sealey, like other Large Distributors, has complete operational independence, deciding how to achieve contractual results, how many carriers to contract, and what resources to use (SMF ¶ 85). Sealey manages its finances separately from The Bee (SMF ¶ 86).

Upon contracting with The Sacramento Bee, Sealey instituted operational changes, paying carriers semi-monthly instead of monthly, rearranging the distribution center, using a new informational form for prospective carriers, using its own existing written contract already in place with carriers delivering other newspapers (including unique financial incentives for carriers to increase home delivery subscriptions), and creating a new carrier statement. Sealey's business identifies itself explicitly as a company, using its own letterhead (SMF ¶ 87).

6. South County News ("SCN")

Ken Rushing owns and operates SCN, which began contracting with The Bee in 2000 (SMF ¶ 88). Bee management has never visited SCN to review its operation, does not tell SCN when to open its multiple distribution centers, and has not advanced SCN money (SMF ¶¶ 89-90). Rushing invested in SCN by buying computers, furniture, and vehicles (SMF ¶ 91). SCN maintains a business plan to account for costs and expenses for vehicles, staff, supplies, furniture, leases , payment to carriers, and for SCN's profit (SMF ¶ 92).

SCN's operations have changed over the class period. SCN contracted with The Bee from 2000 to

2008 to distribute newspapers in rural southern Sacramento County (SMF ¶ 93). For that purpose, SCN leased a warehouse (not from The Bee) and contracted with carriers (*Id*). In 2006, it contracted for another delivery area, in the City of Davis, and contracted with 30 more carriers for that purpose (SMF ¶ 94). In June 2008, SCN contracted for parts of Elk Grove and the "pocket" neighborhood in Sacramento, and consequently contracted with as many as 90 carriers (SMF ¶ 95). In March 2010, SCN contracted for an additional delivery area in south Sacramento, leasing another warehouse there to accommodate its growing business, and contracting with an additional 55 carriers (SMF ¶ 96). SCN contracted with as many as 145 carriers (SMF ¶ 97). It has also contracted with a Bee competitor, *San Francisco Chronicle* (SMF ¶ 98).

SCN also interacted with carriers differently, depending on delivery area. As to rural carriers, Rushing estimates a staff member communicated with a carrier no more than once a week (SMF ¶ 99). In comparison, for SCN's Elk Grove and South Sacramento distribution centers, SCN's staff of three to four people for each distribution center often saw and interacted with carriers on a daily basis (SMF ¶ 100).

SCN used its own unique carrier contracts, with no drafting assistance from The Bee. SCN terminates contracts for excessive complaints or increases in complaint charges, and provides incentives for minimizing complaints and improving delivery results (SMF ¶¶ 101-102). SCN also has had a unique form for carriers who receive excessive complaints, which includes suggestions on how to eliminate complaints (SMF ¶ 102).

E. The Sacramento Bee's Operations Varied Significantly During the Time Period it Contracted with Carriers

In addition to its long-standing business relationships with Large Distributors, until mid-2009, The Sacramento Bee also contracted directly with certain carriers. Those carriers picked up newspapers from decentralized distribution centers, public street corners, and other buildings (SMF ¶ 110). Carriers who picked up in public locations for example, rarely if ever saw any representative of The Sacramento Bee. Distribution Center managers responsible for the operations at each center operated autonomously (SMF ¶ 104). While The Bee made documents available for their use, managers could and did modify them, choosing to utilize their own unique practices in communicating and contracting with carriers (*Id*).

Carrier contract negotiations have varied from distribution center to distribution center: The Bee offered 170 different fees, and some managers restricted the number, type, and location of delivery areas they would offer, with some limiting by advertising zone or size (SMF ¶¶ 105-106). Actual practices also varied. Some centers waived complaint charges if a carrier explained a complaint was invalid; others had systems to

consider the frequency of complaints before issuing a charge (SMF ¶ 107). Similarly, efforts to increase subscriptions have varied; some managers offered incentives to obtain new subscribers, and others did not (*Id.*).

There were also significant differences across distribution centers in how carriers interacted with Bee managers or Large Distributor representatives (SMF ¶ 108). Practices varied with respect to how carriers got their papers, what physical areas were available to prepare papers, what postings and flyers were used, what methods were used to sell supplies and make equipment available, and when newspapers would be available to pick up (SMF ¶¶ 109-110). Additional differences include: (1) some centers offered carriers delivery lists and maps, some did not; (2) some centers routinely took prospective carriers on ride-alongs before contracting, some did not; (3) some centers required carriers to notify them regarding their use of a substitute (for safety purposes to confirm their identity if the individual was taking newspapers and supplies from the center), while some did not; (4) some centers required carriers, in the event of a paper shortage, to return to obtain additional newspapers, some delivered the newspapers to carriers, and some simply advised carriers to buy newspapers from single copy racks; (5) some centers had equipment such as tying machines, while others did not; (6) some centers used employees to deliver in delivery areas not under contract, while others only contracted out this work; (7) some centers permitted carriers to contact subscribers directly, some did not; (8) some centers exercised their right to terminate contracts for breach more often than others; (9) some centers charged carriers liquidated damages due under the contract while others waived the charges; and (10) some centers communicated product information on flyers, while some did not (SMF ¶¶ 109-119). These myriad differences require an individualized understanding of the terms applicable to any carrier at any time.

III. Carriers' Discretion in Providing Contractual Results Has Led To Varying Business Relationships and Distribution Practices

Carriers, whether contracting with The Bee or a Large Distributor, have had great latitude in providing delivery results (SMF ¶ 120). Carriers decide when to pick up newspapers, at times ranging from midnight (e.g., Belinda Houg) to as late as 4:30 a.m. (e.g., Named Plaintiff Holliman) (SMF ¶ 121). "Every day was different," said Plaintiff Holliman, depending on her own personal commitments (SMF ¶ 122). Some carriers, like Holliman, "fold on the fly" (assemble newspapers in vehicles) and spend as little as 30 minutes inside a Distribution Center each day; others fold at the distribution center or elsewhere (or have others fold for them). Carriers also decide how to assemble papers, using varying methods (SMF ¶ 124). Some once bought supplies (e.g , plastic bags) from The Bee, others now purchase from Large Distributors; others buy supplies and tools

elsewhere (SMF ¶ 125, 330).

Carriers also vary in how they choose to prepare and deliver newspapers. Some use helpers or substitutes frequently; others not at all (SMF ¶¶ 126-127). Carrier Pete Mitrou contracts with Large Distributor WSNA for two areas, and sub-contracts to another person, Michael Huffstutler, to complete *all* the delivery results in one area (without input from The Sacramento Bee or WSNA) (SMF ¶¶ 128-129). Carrier Kevin Goosby contracted for multiple delivery areas and used up to 10-11 subcontractors a day (SMF ¶ 130). Plaintiff Holliman provided delivery services to other carriers at their request (negotiating one of two different payment methods for her work) as well as retaining two other individuals to assist on Sundays (whom she paid $40-45 every two weeks.) (*Id.*).

Carriers individually determined the order of their deliveries. Many carriers, like Named Plaintiffs Langford, Gallardo, and Renslow, and carriers Kelly, Mitrou and James Triplett, varied the delivery order (making "significant changes" and creating "shortcuts" and adjusting their order of deliveries to improve speed and efficiency); in direct contrast, other carriers simply accepted the delivery sequence originally given to them by The Bee or a Large Distributor (SMF ¶ 132).

Some carriers deliver competing products while delivering *The Sacramento Bee*; some do not (SMF ¶ 133). Carrier Katherine Potts-Sanker delivers *Contra Costa Times*, *Vacaville Reporter*, *The Times Herald*, *N Y Times*, *USA Today*, and *The Oakland Tribune* under her contract with Large Distributor D&L; she also delivers *Daily Republic*, *San Francisco Chronicle*, *WSJ*, and *Sing Tao* for a Bee competitor, The Daily Republic (*Id*). Former Plaintiff Compton distributed newspapers for multiple entities while also delivering *The Sacramento Bee*, making it impossible for her to estimate accurately the time or expenses attributable to her distribution of *The Sacramento Bee* alone (SMF ¶ 134).

Carriers likewise differ on whether to take breaks: some do not, yet others do (carrier Candace Evans takes breakfast breaks.) (SMF ¶¶ 135-136). Others know they are free to take breaks, but choose not to do so (e.g., Regina Villaforte) (SMF ¶ 136).

Carriers also vary in how they interact with subscribers, some being very active in that regard, others avoiding interaction (SMF ¶ 137). Some carriers, like Plaintiffs Langford and Renslow, either gave their telephone numbers to subscribers or shared written communications with them to actively manage complaints; others do not (SMF ¶ 138). Some actively solicit tips (e.g., with holiday cards); others do not (SMF ¶ 139).

Some carriers purchase accident insurance for themselves and their substitutes; others do not (SMF ¶ 140). Some have had buy-sell agreements, purchasing newspapers for resale and collecting from subscribers; others have had fee-per-newspaper delivered agreements with no collection responsibilities (SMF ¶ 141).

Carriers have also greatly varied in the extent to which they have negotiated contracts. While Plaintiffs suggest that carrier contracts were non-negotiable, many carriers negotiated them. Carrier Mitrou negotiated with WSNA for an extra $400 per month (over the per-piece rate) (SMF ¶ 142). Carrier Kevin Goosby negotiated for higher per-piece rates in areas that included apartments (SMF ¶ 143). Carrier Tony Loveless negotiated for additional delivery areas (SMF ¶ 144). Carrier Ray Eddy negotiated for a higher rate on Thanksgiving (SMF ¶ 145).

These differences in negotiation activity may relate to variation among the carriers in sophistication and business acumen. While Plaintiffs may claim that they did not understand their contracts, many other carriers, including former Plaintiff Richard Galindo (an experienced businessman), understood the contract's terms and explained them to others (SMF ¶ 146). Carriers also vary on outside employment, with some maintaining jobs such as property managers or state employees, and others having no outside employment (*Id.*).[7]

Moreover, there exists little commonality among carriers regarding who they contracted with during the purported class period. Some (Plaintiffs Langford and Gallardo) contracted only with The Sacramento Bee; some (former Plaintiff Galindo) contracted only with a Large Distributor; and some (Plaintiffs Holliman and Renslow) contracted with both The Bee and a Large Distributor (SMF ¶ 148).

Carriers also have varied in their interaction with Sacramento Bee or Large Distributor employees (SMF ¶ 149). Plaintiffs claim they often interfaced with The Bee or Large Distributors, but many carriers rarely interacted with either, and received no training (SMF ¶ 149).

Other differences among carriers include which distribution centers they used, whether they used centers at all or simply picked up newspapers from other locations (SMF ¶ 150), their delivery rates (SMF ¶ 151), whether they were charged for missed deliveries (SMF ¶ 152), whether they were charged for subscriber complaints (*Id*), the duration of their agreements (SMF ¶ 153), the publications delivered (SMF

[7] Carrier Conrad Kling, in addition to being a carrier under contract with Large Distributor R&A, is a U.S. Postal Service employee. He draws a sharp contrast between being a postal service employee and a carrier, explaining, among other things, that the "Postal Service policies...require me to make my deliveries in a certain manner." (SMF ¶ 147).

¶ 154), their degree of industry experience (SMF ¶ 155), the number of areas contracted-for concurrently (varying from a single area to as many as 30, e.g., carrier Goosby) (SMF ¶ 156), the miles they covered in making deliveries and time they devoted to their contracts (ranging from no time on certain days for Plaintiffs Langford and Gallardo, as little as one hour for carrier Caraveo, and up to as many as seven for carrier Potts-Sanker) (SMF ¶ 157), the vehicles used and how they are modified for delivery, and the types and amounts of business expenses incurred (SMF ¶¶ 158-159).

Carriers even differ as to whether they want to join this lawsuit. Indeed, Plaintiff Merle Renslow does *not* wish to represent other carriers in this lawsuit and has no complaints against either The Sacramento Bee or any Large Distributor with which he has had a contract (SMF ¶ 160).

IV. There Are Vast Differences In The Experiences Just Among The Six Remaining Plaintiffs (as well as Former Plaintiffs)

The differences among Plaintiffs abound. Some contracted with Large Distributors, others never did (SMF ¶163). They vary in their education—some received college degrees, others did not complete high school (SMF ¶ 164). Some performed delivery services as their exclusive earnings, while others owned other businesses, delivered newspapers for other companies, and/or were employed at part-time or full-time jobs (SMF ¶ 165). Their interactions with The Sacramento Bee and Large Distributors also vary—some interacted frequently, others rarely (SMF ¶ 166). Some consistently delivered seven days a week, while others regularly used substitutes (SMF ¶¶ 175, 201). Some "folded on the fly," others did not (SMF ¶ 167). Some interacted with subscribers frequently, providing their telephone numbers and unique written communications; others did not (SMF ¶¶ 181, 208). They also vary significantly in how they treat the delivery of newspapers, some organizing and operating as a small business, others distributing alone (SMF ¶ 168). And, as Former Plaintiff Rick Chapman testified, Large Distributors Sealey and THL (both of whom he contracted with for the same delivery area at different times) varied greatly in their practices including critical terms such as rates and complaint charges (SMF ¶ 169). Moreover, Plaintiffs contracted for varying numbers of areas, which differ significantly in mileage, topography, density and the time needed to distribute (SMF ¶ 170).

A closer look at a few Plaintiffs illustrates the variations among them:

A. Named Plaintiff Robert Langford

Langford contracted with The Sacramento Bee to distribute newspapers in multiple delivery areas for approximately four months from September 2006 to January 2007 (SMF ¶ 171). During the first two months, Langford coordinated with another contractor, Andrew Kelly, to distribute newspapers in the delivery area

covered by Kelly's contract with The Sacramento Bee as well. Kelly drove Langford's car while Langford distributed newspapers in the combined distribution areas because Langford's drivers' license was suspended (SMF ¶ 172). In December of 2006, when Kelly's contract with The Sacramento Bee terminated, Langford contracted for that area as well, and continued to use Kelly as "his driver." (SMF ¶ 173).

In distributing *The Sacramento Bee*, Langford ran his own business, and in his own words, "[he] could hire and fire anybody [he] want[ed] . . . which [he did] because it made [his] life easier." "It [was] not up to the Bee, but it [was his] decision, [his] discretion." (SMF ¶ 174). During the four months he distributed newspapers, he engaged seven different individuals (using up to three separate vehicles).[8] (SMF ¶ 175).

Langford exercised his discretion in negotiating what to pay his substitutes and helpers; for example, his wife, Named Plaintiff Gallardo, received no pay on the few occasions that she helped him, but he paid his mother a flat fee of $20 per day (SMF ¶¶ 176-177).[9] Garcia, Sorrells and Brian Meyers agreed to assist Langford for a flat fee of $5 per day, along with a meal or snacks and soda that Langford provided them each day they assisted (SMF ¶ 178) Langford paid Raymond Meyers a flat fee of $10 per day, plus food and drinks, to substitute one day a week for Kelly (*Id.*). Langford didn't pay Kelly money, but instead the two exchanged services; Kelly drove a delivery vehicle for Langford and Langford assisted Kelly to distribute newspapers and provided substitutes and helpers for Kelly (SMF ¶ 179). On busy holidays, like Thanksgiving, Langford engaged up to seven people, including himself to provide the contracted-for distribution results (SMF ¶ 180).

In addition to engaging his own helpers and substitutes, Langford sought to increase his distribution efficiency and maximize his profits in other critical ways. He proactively minimized subscriber complaints by asking subscribers to contact him directly, in which case he would purchase newspapers and deliver them himself (SMF ¶ 181). He made special efforts to expand the subscriber base in his delivery areas by asking friends and family to subscribe to *The Sacramento Bee*, and by going door-to-door at least twice a month to offer subscription deals to potential subscribers (SMF ¶ 182). Finally, to distribute newspapers more

[8] To "make his life easier," Langford engaged Frank Garcia on Mondays and Tuesdays to throw newspapers while Kelly drove, he arranged for Arnold Sorrells to assist Garcia and Kelly a few times a month, he arranged for Raymond Meyers to substitute for Kelly on Wednesdays, he arranged for Brian Meyers to assist him and Raymond Meyers on Wednesdays, and he arranged for his wife and mother to occasionally assist (SMF ¶ 176).

[9] Gallardo had also contracted to deliver *The Sacramento Bee* for approximately three months in 2007, but she either drove a vehicle while someone else delivered the newspapers, or oftentimes left all the work to others (SMF ¶ 184). When she did do some driving and others threw newspapers, she and her helpers "would make their own [delivery] route . . . whatever was easiest for [them]" without any input or approval from The Sacramento Bee (SMF ¶ 185).

efficiently, Langford, and is helpers and substitutes, would prepare newspapers "on the fly" in their cars as they distributed to save time (SMF ¶ 183).

B. Named Plaintiff Merle Renslow

Renslow, the only Named Plaintiff who is a current carrier, began delivering *The Sacramento Bee* before the class period began (SMF ¶ 186). In 2009, he contracted with Large Distributor Sealey News, and later Large Distributor THL Distribution Corporation ("THL") (SMF ¶ 187). **Renslow has no disagreements with The Sacramento Bee, Sealey, or THL, and does *not* wish to represent other carriers** (SMF ¶ 188). The varying identity of his contracting parties has affected the terms of his contracts with respect to supply costs, complaint charges, quick throw list charges, fees, and the cost of supplies (SMF ¶ 189).

Renslow's delivery operations have been unique. He has, through "trial and error," integrated his two delivery areas to save time and increase his profits, and purchased specific tools to speed his operation (including tape machines, flashlights and scissors) and incurred copying costs for letters he provides directly to subscribers asking them to contact him directly with any delivery service issues (SMF ¶ 190). Regarding subscriber letters he distributes to subscribers to reduce complaints, he never showed those to the Large Distributor he contracted with because "it was our own business... it was for us to know and it was for nobody else. I mean, us and our customers." (SMF ¶ 191).

Since 2009, he has personally provided the services under his agreement (with assistance from others) on weekdays only, while having two family members provide the services at his request on Saturdays and Sundays (SMF ¶ 192). Thus, although he has delivery obligations to fulfill under his contracts on Saturday and Sunday, he does not perform any services himself on these days, by his own choice (*Id*)

Renslow confirms his independence: "You do your own thing in your own way and that's the way it's done." (SMF ¶ 193). His contracts make him responsible for his own equipment, expenses, and gas (SMF ¶ 194): "[E]verybody would know that," because it's common sense. And "[y]ou always have to have a substitute to take your place." (*Id*). He did not receive training on the delivery of his newspapers and had no rules to follow under his contracts with The Sacramento Bee, Sealy and THL (and chose to bag newspapers regardless of any information given to him based on weather reports) (SMF ¶ 195).

C. Named Plaintiff Lorraine Sawin

Sawin contracted with The Sacramento Bee (in 2004, 2005, and 2006), and later with Large Distributor

WSNA (in a number of contracts beginning in 2006 to their termination in late, 2010) (SMF ¶ 196). Over that time frame, Sawin sought out and entered into contracts to expand her distribution territory to encompass a total of seven different delivery areas, and up to 650 subscribers (*Id.*).

Sawin operated her distribution business with Anne Gilbert, whom she viewed as her business partner (SMF ¶ 197). Gilbert had her own newspaper distribution contract with The Folsom Telegraph, a competitor of The Sacramento Bee, to distribute approximately 1,600 copies of *The Telegram* one day per week. (SMF ¶ 198). Although Gilbert did not sign any of Sawin's contracts with The Sacramento Bee or WSNA, and Sawin didn't sign any of Gilbert's contracts with The Folsom Telegraph, the two prepared and delivered *The Sacramento Bee* and *The Telegram* together as part of their joint distribution operation (SMF ¶ 199). Sometimes, Ms. Gilbert and others distributed these newspapers without any assistance from Sawin (SMF ¶ 201). Sawin and Gilbert developed their own "master" delivery order of all their various routes, and they split up delivery areas and the assembly and distribution work between themselves, to create efficiencies so that all the newspapers could be delivered in no more than five or five and half hours (Sawin sometimes engaged two or three others besides Gilbert to distribute the newspapers) (SMF ¶ 200). She purchased supplies and tools, including a new minivan, binder clips, folders, flashlights and batteries, razor blades, an internet weather application ("WeatherBug") to determine whether or not to bag her newspapers (SMF ¶ 330).

D. Named Plaintiff Billy Trahin

Trahin entered into independent contractor agreements with The Sacramento Bee to distribute its newspaper before February 2005 (the start of the class period) through April, 2006 (SMF ¶ 202). While contracting with The Bee, Trahin was also on active duty in the Air Force and later worked full-time at Franklin Templeton Investments (SMF ¶ 203). Trahin contrasted the terms and conditions that he worked under as an employee at Franklin Templeton Investments with the freedom and lack of training, handbook, and benefits that he received as a contracted carrier with The Bee (SMF ¶ 204). He contracted to provide home delivery distribution to subscribers in two delivery areas convenient to him, including a delivery area that he proposed to The Sacramento Bee (SMF ¶ 205). It took him less than three hours to perform all services relating to the home delivery of newspapers each day (SMF ¶ 206). He sometimes assembled newspapers in his car, not a distribution center (SMF ¶ 207). He gave subscribers his telephone number to resolve complaints and made his own economic decision as to whether to "eat a dollar complaint charge" or make a redelivery

himself (SMF ¶ 208). And, unlike many carriers, he bagged all his newspapers on Sundays, regardless of rain and delivered in an order that was his "choice" and that gave him "peace of mind" (SMF ¶ 209).

E. Named Plaintiff Kimberly Holliman

Holliman contracted with The Bee to deliver newspapers before February 2005 through late 2006, when she began contracting with R&A (SMF ¶¶ 201-211). She contracted for two delivery areas at a time and understood she no longer had a contract with The Bee when she entered into a contract with R&A (SMF ¶ 212). She admits conclusions cannot be drawn from her personal situation— though she typically delivered every day, the time that she arrived at the center for newspaper pickup varied widely between 2:00 a.m. and 4:30 a m. based on her personal commitments (SMF ¶ 213). She usually "folded on the fly" and spent little time in any distribution center (SMF ¶ 214). She selected, used and paid helpers and also assisted other carriers at rates she negotiated (*Id*). Her rural delivery area was atypical: it took her longer to deliver the same number of houses than in urban areas because (a) rural houses were farther apart and farther off the road, (b) customers had more special delivery requests, and (c) she chose to bag everyday even if it did not rain (SMF ¶ 215).

As detailed above, each Named Plaintiff has a unique story, revealing differences among themselves and from the putative class. The only similarities among them either defeat their claims or are irrelevant. For example, all Named Plaintiffs had Independent Contractor Agreements under which they provided services, earned per-piece delivery fees regardless of whether they delivered personally or through others, and received an IRS Form 1099 Misc recording the money they were paid as non-employee compensation (SMF ¶ 161). None experienced typical employee experiences such as drug tests, employee handbooks, Codes of Conduct, Performance Evaluations, hourly pay rates, IRS Form W-2s, or employee benefits (SMF ¶ 162).

F. Former Named Plaintiffs Richard Galindo, Glenda Compton, and Barbara Fincham Demonstrate Unique and Independent Indicia of their Status as Carriers

Former Named Plaintiff Galindo has not contracted with The Bee during the class period; he delivered *The Sacramento Bee* only while under contract with Large Distributor WSNA, for less than eight months until Galindo gave WSNA a written termination notice (SMF ¶ 216). Galindo understood that Pete and Joy Cavaghan jointly owned WSNA and dealt with them exclusively about his contract (SMF ¶ 217).

Before contracting with WSNA, Galindo had obtained considerable academic training, certifications, and business experience, including: an associate's degree (completing commercial and contract law courses as well as additional business courses towards a 4-year degree); California real estate, life and casualty insurance

and income tax preparer licenses; and considerable contracting, independent contractor management, and on-the-job business experience (SMF ¶¶ 218-219). Galindo's experience included holding the positions of: Branch Manager for Security Pacific Bank (where he supervised 14 employees and entered into and explained loan agreements to Bank customers), various manager titles for First Interstate Bank (entering into contracts with various auto dealers on behalf of the Bank and overseeing conditional sales contracts for 26 branch locations), Manager of the Stockton Auto Dealer Center, Mortgage Underwriter for The Money Store, and Corporate Property Manager for Bruce Mulhearn & Associates (overseeing management and financial aspects of corporate investments and commercial buildings where he ensured that rental, lease and maintenance contracts were enforced, and explained contract provisions to individuals contracting with his employer) (*Id.*).

Galindo testified he would never enter into a contract that he did not intend to abide by or that he did not agree with unless he was under duress, and that he has never entered into a contract while he was under duress (SMF ¶ 220). He understood the differences between an independent contractor and an employee. As to employees he himself managed, he used his relationship skills to provide specific "direction and guidance," whereas, with respect to the independent contractors with whom he dealt, he focused only on the final results (SMF ¶ 221). Indeed, when his wife contracted with The Bee, she used him as a resource to interpret various contract terms (SMF ¶ 222). And at the same time Galindo delivered newspapers under his contract with Large Distributor WSNA, he also subcontracted assembly of another carrier's delivery area three to four days a week (SMF ¶ 223). Galindo entered into a contract with WSNA that described him as an independent contractor, leaving the manner and means of distribution to his sole discretion. As a contractor he purchased his own tools, such as flashlights (SMF ¶ 224). And, likewise, former Named Plaintiffs Compton and Fincham understood contractual obligations and were well-versed in business relationships. Both owned and ran other businesses, including Paulette's Restaurant and Glenda's Coffee Shop (SMF ¶ 225). Compton knew her only obligation as a carrier was to ensure timely delivery (SMF ¶ 226).

Fincham is also unique in many ways: (1) her newspaper distribution included not only home delivery distribution of numerous newspapers but also single copy distribution to numerous newsracks and corporate accounts under her business name—B&G Ranch; (2) she had a risk of loss of stolen newspapers and coins from newsracks (where her gross collections alone totaled about $2,200 a month in 2009); (3) she contracted with The Sacramento Bee and also Large Distributor MCC News and Large Distributor, Dow Jones

Community Newspaper Group, a subsidiary of Dow Jones & Company; (4) she contracted to deliver newspapers while she was a Bee employee, in violation of the Bee's employee policies that barred employees from providing newspaper delivery services as an independent contractor for any other entity with a contract with the Bee; (5) as part of her separation agreement from the Bee she received $7,771.84 in exchange for her release of claims against The Bee and its agents and her covenant not to sue (and thus, her claims here are released and barred); and (6) in deposition, she described negotiations and counterproposals she exchanged with Large Distributor, Dow Jones Community Newspaper Group, and her intention to continue to contract only if she could negotiate still higher fees than under her last contract (SMF ¶¶ 227-232). Like other carriers, she exercised her right as an independent contractor to resolve subscriber disputes directly with customers, she encouraged subscribers to contact her directly to eliminate any complaints, and she used others to provide home delivery results (SMF ¶ 233). And, to the best of her estimation, her deliveries, from start to finish (picking up papers through the last delivery) took only three hours Monday through Saturday and only five hours on Sunday (SMF ¶ 234). These estimates include the time taken to distribute single-copy newspapers and service corporate drop locations, which are activities beyond the scope of Plaintiffs' lawsuit (*Id.*).

Similarly, Compton used her business acumen to achieve economies of scale. She delivered single copy and home delivery newspapers for not just The Sacramento Bee, but also two other entities—*The Stockton Record* and *The Ledger Dispatch* (SMF ¶ 235). She contracted with those newspapers to deliver at the same time she contracted with The Bee to deliver. Since February 2005, she has received no training from anyone as to how to perform work related to her contracts (SMF ¶ 236). Compton created customized maps with her own legends to designate home delivery versus single copy deliveries, and to identify the various publications she provided (SMF ¶ 237). Similarly, she contacted customers directly by written notes to resolve delivery issues and to collect tips (*Id.*). Her small business structure allowed her to deliver multiple publications to different locations all at once, and spread out her time and expenses across three different newspaper companies with whom she contracted to maximize her efficiencies (SMF ¶ 238). As a consequence, however, she is unable to unscramble the amount of time or expenses incurred with respect to any one publication on any one day or over time (SMF ¶ 239).

LEGAL ARGUMENT

I. This Court Has Authority To Deny Class Certification

A. Defendant Can Move For An Order Denying Class Certification

California Rules of Court 3.764 and 3.767 authorize a motion to strike class allegations. Any party can seek an order determining whether an action can properly proceed as a class action. *City of San Jose v Super Ct*, 12 Cal. 3d 447, 453-54 (1974) (motion to deny class certification is procedurally proper); *In re BCBG Overtime Cases,* 163 Cal. App. 4th 1293 (2008) ("either party may initiate the class certification process").

B. Plaintiffs Bear The Burden To Justify Class Certification

Section 382 authorizes class suits only when "the question is one of a common or general interest, of many persons, or when the parties are numerous, and it is impracticable to bring them all before the court." Plaintiffs must demonstrate "both an ascertainable class and a well-defined community of interest among the class members." *Lockheed Martin Corp. v. Superior Court*, 29 Cal. 4th 1096, 1103-04 (2003). A community of interest embodies three factors: (1) predominant common questions of law or fact, (2) class representatives with claims typical of the class, and (3) class representatives who can adequately represent the class. *Id* at 1104. Plaintiffs must show that "questions of law or fact common to the class predominate over the questions affecting the individual members," *id*, so that "each member must not be required to individually litigate numerous and substantial questions to determine his right to recover following the class judgment, and the issues which may be jointly tried, when compared with those requiring separate adjudication, must be sufficiently numerous and substantial to make the class action advantageous to the judicial process and to the litigants." *Washington Mutual Bank v Super Ct*, 24 Cal. 4th 906, 913-14 (2001).

C. The Predominance Inquiry Requires Examination Of Claims And Defenses

Class suitability necessarily considers the issues the trier of fact will decide. *Fireside Bank v Superior Court*, 40 Cal. 4th 1069, 1091-92 (2007) (trial court deciding class certification must consider how "various claims and defenses relate and may affect the course of the litigation"). Hence a court analyzing certification must determine whether the elements of the claims and defenses "can be properly resolved as a class action." *Sepulveda v. Wal-Mart Stores, Inc.*, 237 F.R.D 229, 233 (C.D. Cal. 2006). Here, the Court first must examine what class-wide proof is available on the elements of the threshold claim of whether the carriers are employees of The Sacramento Bee. Then, if necessary, it must examine what class-wide proof is available on the Labor

Code claims and defenses as they relate to The Sacramento Bee. *Jimenez v. Domino's Pizza, Inc*, 238 F.R.D. 241, 251 (C.D. Cal. 2006) ("To determine whether common issues predominate, this Court must first examine the substantive issues raised by Plaintiffs and second inquire into the proof relevant to each issue.").

Unless Plaintiffs can explain how to effectively manage the predominant issues, they fail to justify class certification. *See Dunbar v. Albertsons, Inc*, 141 Cal. App. 4th 1422, 1432-33 (2006) (affirming denial of certification where plaintiff failed to set forth a workable plan of using collective proof to try the case on a class basis); *Marlo v UPS, Inc*, 251 F.R.D. 476, 480-87 (C.D. Cal. 2008) (same). Plaintiffs cannot establish that common issues predominate over individual ones on the threshold issue of employment status, much less on the elements and defenses that determine liability under the Labor Code.

II. There Is No Ascertainable Class

Plaintiffs propose a class of: "All persons presently of formerly engaged by Defendants as newspaper home delivery carriers of The Sacramento Bee newspaper in the State of California during the class period, whether engaged directly by The Sacramento Bee or an intermediary." (3AC ¶ 20, 8:6-9). Plaintiffs have not defined any of the terms contained in the proposed class definition. The definition cannot be identified by reference to documents or information found within the business records of Defendants. Further, because the definition is vague, the class is unascertainable, and on that basis alone cannot be certified: (1) Do Plaintiffs intend to include carrier Kevin Goosby as an "intermediary" in the class definition (given that he had 10 - 11 subcontractors while he himself contracted with a Large Distributor for 30 delivery areas)? (2) If Plaintiffs intend to exclude Goosby, how would they distinguish him from Named Plaintiff Langford, who ensured results were provided in multiple delivery areas and regularly used and managed up to seven subcontractors? (3) Regardless of whether Goosby and Langford belong in the class, do Plaintiffs also intend to include Langford's and Goosby's subcontractors – individuals who may have delivered *The Sacramento Bee* for a relatively long period of time (but for whom The Bee has no records and who have no connection with The Bee or any Large Distributor)? (4) Does Former Named Plaintiff Fincham belong in the class definition or is she an intermediary who is outside the class definition? Though she distributed only in a small delivery area under a contact with The Sacramento Bee, at the same time she also contracted with other companies to distribute other newspapers to single copy locations and subscribers The Sacramento Bee paid her business—B&G Ranch—for the delivery results she provided.

As detailed in the earlier discussions regarding helpers, substitutes and subcontractors of carriers, there are many putative class members included within this definition who have assembled or delivered a newspaper based upon their relationship with other carriers or Large Distributors, but who never signed a contract and do not appear in The Sacramento Bee's records. Thus, because Defendants do not have objective evidence of the putative class members' names and other information, in their records, here as in *Sotelo*, the identification of persons who contend that they folded, bagged, or delivered newspapers will necessarily "devolve into a disputed mini-hearing, requiring sworn statements and/or deposition testimony from that class member, the evaluation of circumstantial evidence, and credibility determinations."[10] *Sotelo*, Slip op. at 9 Similar factual issues will predominate here on the issue of carrier status, the number of minutes, hours, and days they worked, fees earned, and whether they incurred any mileage or other expenses (especially if individuals were subcontracted by carriers to only assemble or bag newspapers on certain dates - but even if they delivered newspapers it will not be clear whether monies paid to them included reimbursement by carriers, such as Plaintiff Langford for gas expenses). For this reason alone, the lack of objective evidence (such as business records) establishing class membership, fees, expenses, and/or dates of work, leaves the class, as defined by Plaintiffs, with significant ascertainability concerns. *Sotelo*, Slip op. at 7 – 9 (with no business records that objectively establish the date when putative class members joined or left the class, plaintiffs' proposed class of newspapers carriers raises significant ascertainability concerns).

Since filing the 3AC, Plaintiffs have represented that the proposed class includes only "relatively permanent carriers" and excludes Large Distributors. This proposal is grossly overbroad, as it meshes together all Large Distributor subcontractors, all carrier substitutes, and all carrier helpers with no clarity on why Large Distributors are excluded or how "relatively permanent" is defined. Plaintiff Langford was under contract for only four months, and Plaintiff Gallardo for only two months. Do they qualify under Plaintiffs' definition of "relatively permanent"?

Indeed, the discovery referee in this case, Judge Cecily Bond, concluded in her December 9,

[10] Defendants disagree on various grounds with the decision to certify in *Dalton v Lee Publ'ns, Inc.*, No. 08cv1072 BTW (NLS) 2009 U.S. Dist. LEXIS 937 (S.D. Cal. Jan. 7, 2009), a case not involving a Large Distributor hybrid or pure Large Distributor model. It is important to note that the class definition in *Dalton* is very different. In *Dalton*, Plaintiffs sought certification of a class of newspaper home delivery carriers engaged by Lee Publications, Inc. for the *North County Times* newspaper who, as a condition of such engagement, signed a written agreement for the home delivery of newspapers that categorized them as independent contractors.

2011 "Recommendation of Discovery Referee Report," which was adopted by this Court, that Plaintiffs' class definition was vague and problematic.[11] Plaintiffs' inclusion of "relatively permanent carriers" in the proposed class was "not clear" and "somewhat ambiguous." *Id* at 2:8-10. Because Plaintiffs fail to distinguish among carriers, helpers, substitutes, and Large Distributors, certification must be denied for such a grossly overbroad, ambiguous, and in many ways unknown purported class.[12]

III. Class Certification Must Be Denied As Factors Determining Whether Carriers are Employees of The Sacramento Bee Require Substantial Individualized Inquiries

A. The Standard For Determining Independent Contractor Status

California law requires the trier of fact to consult many factors to see if a worker is an employee. The most "decisive" factor is the "right to control the mode and manner in which the work is done." *D A R E America v Rolling Stone Magazine,* 101 F. Supp. 2d 1270, 12769 (C.D. Cal. 2000) (holding journalist was not employee, where magazine "did not exercise sufficient control over ["journalist]") (citing *Brose v Union-Tribune Publ'n Co* , 183 Cal. App. 3d 1079, 1081 (1986)).[13] But the control must be "complete and unqualified control." *Bohanon v. James McClatchy Publ'n Co* , 16 Cal. App. 2d 188, 199 (1936) (finding Sacramento Bee carriers were not employees.)

The right to control is not itself dispositive. The trier of fact also considers secondary factors: (1) who supplied the equipment, tools, and place of work, (2) whether pay is by the hour rather than by the job, (3) whether the work was part of the defendant's regular business, (4) whether the defendant had an unlimited right to end the relationship, (5) whether the work was the individual's only occupation, (6) whether the work was usually done under supervision rather than a specialist working without supervision, (7) whether the work required specialized skill, (8) whether the services were performed over a long time, and (9) whether the parties acted as if they had an employer-employee relationship. CAL. CIV. JURY INSTR. No. 3704.

B. The Independent Contractor Standard Is Highly Individualized

As our high court has observed, the factors are not "applied mechanically as separate tests; they are ***intertwined*** and their weight depends often on ***particular combinations***." *S G Borello & Sons, Inc v.*

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[11] See Exhibit B to Defendants' Request for Judicial Notice.

[12] *Akkerman v Mecta Corp , Inc* , 152 Cal. App. 4th 1094, 1100-01 (2007); *see also* MANUAL FOR COMPLEX LITIGATION (FOURTH) § 21.222 at 270 (2004) (class definition must be "precise, objective, and presently ascertainable"); *Simer v Rios*, 661 F.2d 655, 659, 664 (7th Cir. 1981), *cert. denied*, 102 S. Ct. 1773 (1982).

[13] *See also Cristler v Express Messenger Sys , Inc* , 171 Cal. App. 4th 72, 77 (2009) (most important factor in determining employment status is whether the person to whom service is rendered has the right to control the manner and means of accomplishing the desired result).

Department of Indus. Relations, 48 Cal. 3d 341, 350-51 (1989) (emphasis added).[14] With relevant factors so numerous and varied, it is no surprise that California cases considering whether delivery providers are employees inevitably find some facts favoring employment status and some favoring independent contractor status. In *Fleming v Foothill Montrose Ledger*, 71 Cal. App. 3d 681 (1977), the court affirmed a defense summary judgment on the basis that a newspaper carrier was an independent contractor, emphasizing that while the company "delineates the carriers' route," the carrier "may deviate from that area." Moreover, "no suggestions are made regarding delivery procedure," and the written contract provides for prior written notice of termination.[15] Similarly, in *Milsap v Federal Express Corp* , 227 Cal. App. 3d 425 (1991), the court affirmed a summary judgment for the defendant, ruling that a package delivery driver was an independent contractor, not an employee, where both parties "operated on the assumption that [the worker] was an independent contractor," the worker "used his own car to deliver the packages, furnished his own gas and oil, furnished own liability insurance, and paid for whatever car repairs were necessary," and the company "did not instruct [the worker] as to how to make the deliveries or how to drive his car."[16] These conclusions were reached in *Milsap* and *Fleming* even though certain factors weighed towards employment status, including that the worker had to "obtain a signed confirmation of delivery which he then returned to [the company]," and "the company would tell him to "be careful" and "give him directions to a particular location." *Id*

California courts thus have repeatedly made clear that distinguishing employees from independent contractors entails a fact-intensive exercise that depends on numerous factors: "in the last analysis each case must turn on its own peculiar facts and circumstances."[17] Most recently confirming this point is *Arzate v. Bridge Terminal Transp , Inc* , __ Cal. App. 4th __ (2011), which overturned a summary judgment ruling in favor of the defendant on independent contractor status, reasoning that no one factor determines a worker's status. The plaintiffs in *Arzate* were truck drivers who claimed unpaid wages due them because Bridge

[14] Because *Borello* was decided "in light of the history and remedies and social purposes of the Workers' Compensation Act," *id* at 351-56, the court's ultimate conclusion that certain agricultural workers were employees is of no relevance here.

[15] *Id.* at 687. Factors favoring employment status included a provision that a carrier's failure to deliver newspapers "at a reasonable hour would result in a discussion" with the company. *Id.* at 685.

[16] *Id.* at 431. Similarly, in *FedEx Home Delivery v NLRB*, 563 F.3d 492 (D.C. Cir. 2009), the court held that package delivery drivers were independent contractors, not employees, because the relevant Operating Agreements, negotiated by the drivers, specified they were not employees, gave them discretion in hours worked and how they delivered, whether and when they took breaks, and whether they used helpers, and made them responsible for their costs. *Id.* at 498, 504.

[17] *Brose*, 183 Cal. App. 3d at 1085.

Terminal had misclassified them as independent contractors. The Court of Appeal reversed summary judgment, reasoning that the trier of fact must consider the totality of the evidence in determining whether an individual is an independent contractor. While acknowledging that control over the "manner and means" is the most significant factor, the Court of Appeal held that the trial court had erred in failing to consider secondary factors regarding the plaintiffs' status. Considering these factors, the Court of Appeal concluded, might lead to a finding that the plaintiffs were employees

C. In Recent Similar Cases Courts Have Denied Class Certification

The complex standard for independent contractor status discussed above influences greatly any proper approach to class certification. Here, significant differences among the Plaintiffs and the putative class on factors critical to independent contractor status confound any effort to establish common proof—such differences preclude any fair extrapolation of a finding about employee status for one individual to a conclusion regarding other members of a diverse class.

A number of cases illustrate how courts properly consider the independent contractor standard in deciding class certification. In *Edwards v. Publishers Circulation Fulfillment*, 268 F.R.D. 181 (S.D.N.Y. 2010), a federal district court denied class certification in a suit by newspaper-delivery drivers challenging their classification as independent contractors, because the drivers failed to show predominance of common issues.[18] The drivers had argued that their employee status could be proved on a class-wide basis through delivery agreements and training materials, allegedly showing the defendant had reserved control over the means used to accomplish defendant's stated goals. *Id* at 183. In particular, the agreements specified the result of daily delivery to customers by a designated time. In denying certification, the court reasoned that because the agreements dictated only the contractual results, and not how to effect them, there was no common evidence of employee status. *Id* at 186. Plaintiffs also failed to show the defendant used training materials in a common manner, as they were never used in a consistent fashion. *Id.* at 186.

More recently, in *Sotelo v Medianews Group, Inc.*, California Superior Court, Alameda County, No. HG06 287184 (Nov. 5, 2010),[19] a case closely analogous to this one, Judge Steven Brick denied class certification in a suit brought by newspaper carriers who challenged their classification as independent

[18] The predominance requirement under federal class action law is essentially the same as the community-of-interest requirement under Section 382 of the California Code of Civil Procedure.

[19] The *Sotelo* Order denying class certification is attached to Defendants' Request for Judicial Notice.

contractors.[20] On the threshold issue of employee status, Judge Brick concluded: "Given the nature of the multi-factor test for the employment relationship, which requires that the factors be examined together, even if certain issues were tried jointly as to a class or subclasses, the remaining individualized issues would have to be determined and then weighed along with the already-determined common issues in order to resolve whether each class member was an employee or independent contractor. It does not appear that trying common issues first would result in any appreciable savings of the Court's or the litigants' time." Slip op. at 20:4-9. Specifically, there were significant variations among carriers as to (1) whether they effectively operate a distinct occupation or business (e.g., whether they delivered competing products), (2) the opportunity for profit (e.g.. through the use of helpers), and (3) the parties' belief in the nature of their relationship. *Id.* at 18:8-19:20.

Judge Brick employed similar reasoning in concluding that the newspaper carriers failed to demonstrate common evidence on their Labor Code claims. For example, there was no common evidence as to whether plaintiffs worked enough days and hours to qualify for overtime pay. *Id.* at 11:17-18, 12:8-13:3. Similarly, there was no common evidence as to whether plaintiffs worked long enough to qualify for meal and rest breaks and whether the company denied breaks. *Id.* at 12:1-7. Such lack of common evidence gave Judge Brick "significant pause" and contributed to his ultimate denial of class certification. *Id.* at 9:13-15.

Ali v USA Cab Ltd, 176 Cal. App. 4th 1333 (2009), is another instructive recent case. The trial court denied certification of a class of taxi drivers claiming the cab company had misclassified them as independent contractors. The appellate court found predominating individual liability-related issues: whether drivers had to use the defendant's dispatch service; whether they assumed entrepreneurial risk; whether they provided significant tools or instrumentalities; whether they independently promoted their services, giving out business cards and personal phone numbers; and whether they set their own rates. *Id.* at 1349. Individual issues also predominated as to damages—whether drivers suffered on-the-job injuries, earned the minimum wage, and used a credit-card system that imposed a fee. *Id* at 1350. "There can be no cognizable class unless it is first

[20] While Plaintiffs may cite class certification in *Dalton*, that case is distinguishable in many ways. The case featured no intervening Large Distributors. Moreover, the *Dalton* court, in using the carrier contracts as common proof, failed to appreciate that they proved only an intent to create an independent contractor relationship. More instructive here is the *denial* of class certification in the better reasoned *Edwards v Publishers Circulation Fulfillment, Inc*, 268 F.R.D. 181, (S.D.N.Y. 2010)–another case in which newspaper-delivery drivers challenged their independent contractor classification. See Section III.C.

determined that members who make up the class have sustained the same or similar damage." Because the proof of harm varied, "the requisite community of interest is missing and class certification is improper." *Id*

D. Certification Must Be Denied For Lack Of Commonality As To Control

1. The Agreements are not sufficient common proof.

The Agreements themselves cannot be common proof of employee status because they show only that carriers generally are independent contractors. Moreover, there is not even a "common" contract: while Bee Agreements were similar, Large Distributors have used their own, distinct contracts, which vary greatly, ranging from 2 page contracts used by Moonlighting and D&L to the lengthy WSNA contract (SMF ¶¶ 30-43).

In any event, even a uniform use of a standard independent contractor agreement would not itself support certification. Courts have rejected over-reliance on a purported uniform classification scheme as a basis for class certification. The Ninth Circuit issued two decisions to that effect—*Vinole v. Countrywide Home Loans, Inc*, 571 F.3d 935 (9th Cir. 2009) (upholding denial of class certification for group of outside salespersons with similar job descriptions whom defendants uniformly categorized as exempt from overtime; policy of uniform exemption does not, without more, support a finding of predominance) and *In re Wells Fargo Home Mortgage Overtime Pay Litig*, 571 F.3d 953 (9th Cir. 2009) (reversing class certification, on same principles as *Vinole*). Three principles emerge from these decisions. First, a uniform policy is but one factor to consider in assessing predominance of common issues. Second, if a class member's legal entitlement is fact-intensive, then the trail court must weigh the complexity of that inquiry in analyzing predominance. Third, when the employer's defense concerns how and where and when the plaintiffs work, common issues are unlikely to predominate unless the plaintiffs propose a form of common proof, such as a standard policy governing their activities.[21] Accordingly, Plaintiffs must show far more than merely that carriers all signed similar delivery contracts.[22] The necessity of individualized inquiry negates any assertion of common proof.

2. There is no commonality as to control over who performs services.

A major factor indicating independent contractor status here is the carriers' contractual freedom to

[21] *See also Marlo*, 2008 WL 2485175, at *7 ("a classwide determination of misclassification generally cannot be provided [sic] from the existence of an exemption policy alone"); *Dunbar*, 141 Cal. App. 4th at 1427 (decision to classify class of employees as exempt across the board "may be improper as to some putative class members, but proper as to others").

[22] *See In re FedEx Ground Package Sys Inc, Employment Practices Litig.*,No. 3:05-MD-527 RM (MDL 1700), 2010 U.S. Dist. LEXIS 82216 *3, *7-8 (N.D. Ind. Aug. 11, 2010) (California law) (granting summary judgment against delivery drivers claiming employment status and contending that their Operating Agreements gave FedEx authority to direct the manner of work); *see also Brinker* at *10, 14-16, 20, 23..

select employees and subcontractors to achieve the contractual result of timely delivering a readable paper. 22 Cal. Code Regs. § 4304-6(c)(7) ("[t]hat the carrier can obtain his or her own substitute without the principal's approval shall be evidence of independence."); *see Taylor v Industrial Acc Comm'n*, 216 Cal. App. 2d 466, 475 (1963) (freedom to engage others to do deliveries supported independent contractor status).[23]

Evidence of that freedom abounds here, for most carriers have used helpers or substitutes without permission: some carriers have paid someone to help them fold newspapers (everyday or just weekends) while delivering the newspapers on their own (SMF ¶ 240); some have delivered areas under a spouse's name (SMF ¶ 241); some have utilized family members to help them (SMF ¶ 242); some have paid substitutes to deliver areas without informing either The Sacramento Bee or Large Distributors (SMF ¶243).

Some specific examples are illustrative. Carrier Pete Mitrou has subcontracted his entire delivery area so that he performs no work other than managing substitutes (SMF ¶ 244). Carrier Kevin Goosby typically did not deliver himself but rather used 10-11 subcontractors (SMF ¶ 245). He decided how much to pay them and which areas they would service (SMF ¶ 246). He had his contractors deliver in contiguous delivery areas and paid them the equivalent of over $20 per hour (SMF ¶ 247). He also had them sign contracts he prepared himself (SMF ¶ 248). Plaintiff Langford, instead of personally delivering newspapers, teamed with another carrier, Kelly, to create a combined delivery area, serviced by Langford and Kelly and Langford's subcontractors (SMF ¶ 249). Langford and Renslow testified they only worked five days a week (*Id*). Plaintiff Sawin, like Langford, also regularly teamed with another person to fulfill her contract (SMF ¶ 250).

And of course there is evidence the other way. Plaintiff Trahin personally delivered his own newspapers (SMF ¶ 206). And some Plaintiffs contend that The Sacramento Bee controlled their use of substitutes and helpers (SMF ¶ 324).

Thus, carrier experiences have ranged from those who never used substitutes or helpers (SMF ¶ 252) to those who, like carrier Kevin Goosby, use many helpers daily (*Id.*). Even as to those carriers who never enlisted any help, individual testimony is needed to see if they did so by choice. Whether carriers actually had the right to select substitutes and helpers can be established only on a case-by-case basis.

[23] *See also In re FedEx Ground Package Sys* at *4 (finding that the ability to use helpers and substitutes was a factor favoring independent contractor status of delivery drivers and supported summary judgment against drivers claiming they were employees).

3. There is no commonality as to control over when results are performed.

When each carrier chooses to arrive at distribution centers to pick up newspapers (if at all) can range from as early as midnight to as late as 3:00 a.m. (e.g., Alfred Caraveo) (SMF ¶ 12). While there is a delivery deadline, that is simply a function of the contractual result bargained for. Contrary to what Plaintiffs may argue, a delivery deadline does not demonstrate control over the means of achieving contractual results; rather, delivery by a deadline *is* a result. *Bohannon*, 16 Cal. App. 2d at 200-01 (obligation to deliver paper at earliest possible time was a feature of the final result); 22 Cal. Cal. Code Regs. § 4304-6(c)(4) ("Timeliness of delivery may be indicated by agreement for delivery or completion of a route by a certain hour.").

4. There is no commonality as to control over where services are performed.

Deliveries obviously must be to the subscriber's home, but that is merely a function of the contractual result, not common proof of the newspaper's control. Determining how carriers allocate their time (on premises and off), and why, depends critically on individualized testimony. The Bee does not record actual hours worked, and thus does not record how much time carriers have spent on or off distribution center premises (SMF ¶ 253). Some carriers would enter distribution centers only to pick up their newspapers and would "fold on the fly," spending virtually no time on Bee or Large Distributor premises, while others spent more time inside the centers preparing their newspapers (SMF ¶ 123). Only individualized proof could determine whether The Sacramento Bee dictated where services were to be performed.

Nor is there common proof that The Sacramento Bee assigned delivery areas. There is a difference between assigning a delivery area (which indicates control) and offering a delivery area that a prospective carrier is free to accept or reject (which does not indicate control). 22 Cal. Code Regs. § 4304-6(c)(4).

5. There is no commonality as to control over how services are performed.

Plaintiffs allege that The Sacramento Bee "exercised control" over newspaper delivery (3AC ¶ 7), but carriers were free to prepare and deliver their newspapers as they wished (SMF ¶¶ 7, 10, 11). The obligation to deliver newspapers is simply a contractual result, which independent contractors can be expected to achieve without making them employees. The Bee Agreements placed "the manner and means of obtaining [contractual results] ... entirely within the authority and discretion of the Contractor." (SMF ¶ 7.) The Agreements empowered carriers to operate their businesses as they choose, leaving them "free to accept or reject any suggestions, tips, or instructions provided by [The Bee] regarding the manner and means by which

[they] perform [their] obligations." (SMF ¶ 10.) *See Isenberg v. California Employment Stabilization Commission*, 30 Cal. 2d 34, 39 (1947) (right to control manner and means is most important test; whether the parties believe they are creating an employment relationship is also a factor to consider).

Sequence of delivery. One manner of completing the contract left entirely to the carriers is the sequence of delivery. Some carriers do not vary their delivery order, yet others, like carriers Renslow, Langford, Gallardo, and Triplett, have spent significant time mapping routes to improve efficiency (SMF ¶ 131, 172, 185, 190, 254). This ability to determine delivery sequence cuts against a finding of employee status. *See Fleming*, 71 Cal. App. 3d at 687 (factor suggesting independent contractor status was that the carrier could "deviate from" delivery route provided by company).

Plaintiffs themselves believe that The Sacramento Bee uses "computer systems and other means to instruct class members on exactly how and when to deliver newspapers" (3AC ¶ 7 at 7:10), but many other carriers (i) never follow "right left lists," (ii) follow them but know they do not have to, or (iii) follow them until they discover a better sequence (SMF ¶ 254). And carriers know they can change the order of delivery (SMF ¶ 254). Whether carriers could determine order of delivery is an issue for individual, not common, proof.

Interaction with distribution employees The Plaintiffs suggest that The Sacramento Bee gives "instructions" on newspaper deliveries. Yet there is little uniformity in the nature and extent of carrier interactions with The Bee or with Large Distributors in preparing and delivering newspapers. Many carriers have very little contact with The Bee or Large Distributors, and many receive no direction from The Bee or Large Distributors as to the manner and means of contractual performance (SMF ¶ 255). While some Plaintiffs claim they interfaced routinely with The Bee and/or Large Distributors, many carriers had little or no interaction with The Bee or Large Distributors (*Id*.).

Subscriber information The act of telling carriers who subscribers are and their final delivery orders is an act enabling a party to achieve a contractual result already bargained for—delivery of papers to subscribers, complaint-free; this act is not, contrary to Plaintiffs, an instruction on the means or manner of accomplishing that result. Thus, the issue of whether The Sacramento Bee or Large Distributors instructed carriers on how to perform is not a matter of common proof. Even if some Plaintiffs received "instructions" that went beyond merely identifying subscribers and their stated expectations, most carriers did not. There is simply no way to address this issue on a class-wide basis—individualized testimony is required.

6. Further undermining commonality is the existence of various Large Distributors and the lack of standard operating procedures.

The diverse nature of any asserted common carrier experience becomes more fractured still when one considers that many putative class members contracted with Large Distributors whose operations differ from those of The Sacramento Bee's. As noted, throughout the class period, some carriers contracted only with The Sacramento Bee, some contracted only with Large Distributors, and some contracted with both (see *supra*, Section III). As to The Bee itself, each distribution center has had different operations resulting in differences among the experiences of their carriers. The Bee never had standard operating procedures for distribution centers with regard to circulation practices; nor have the Large Distributors. Each center operated independently, with variations depending on individualized methods and practices (see *supra*, Section II.E.). Authorities recognize the difficulty in certifying a class that involves geographically disperse operations operating in a decentralized manner.[24]

Second, as to the carriers who have contracted with Large Distributors, the disparate nature of the carrier experiences are further compounded (see *supra*, Section II.D.). Each Large Distributor has its own contracts, facilities, and practices, implemented in an autonomous way, with no uniformity in operations vis-à-vis carriers. A carrier's experience would necessarily differ depending on the Large Distributor with whom the carrier contracted. What is still more, a carrier who contracted with a Large Distributor could not establish liability for The Sacramento Bee without proving an agency or joint-employer relationship between The Bee and the Large Distributor. Attempts to muster that proof will be ill-suited to class treatment, because no common evidence supports an argument that Large Distributors are either (1) agents of The Bee[25] or (2) joint

[24] *See Castaneda v. Burger King Corp.*, 264 F.R.D. 557, 566 (N.D. Cal. 2009) (no commonality for proposed 92-store class because each location unique); *Walsh v IKON Office Solutions, Inc.*, 148 Cal. App. 4th 1440, 1454-55 (2007) (in misclassification action the variance from office to office, based on unique features and management styles, resulted in no commonality). *See also McReynolds v. Merrill Lynch, Pierce, Fenner & Smith Inc*, 2010 U.S. Dist. LEXIS 80002, at *14-15 (N.D. Ill. Aug. 9, 2010) (denying class certification where each plaintiff's experiences varied based on management of various branches); *Puffer v. Allstate Ins Co*, 255 F.R.D. 450, 460-61 (N.D. Ill. 2009) (class certification denied given "decisions made by hundreds of managers, across varied business divisions and segments, with employees who perform entirely different functions, who hold hundreds of different jobs, and who are scattered across a multitude of regions and office locations"); *Tracy v. Dean Witter Reynolds, Inc*, 185 F.R.D. 303, 305 (D. Colo. 1998) (nation-wide discovery outside of facility where plaintiffs worked not permitted where plaintiffs could not establish uniform policy or practice).

[25] As to agency, "[a]n agent is one who represents another, called the principal, in dealings with third persons." Civ. Code § 2295. "An agency is either actual or ostensible." Civ. Code § 2298. Actual agency occurs "when the agent is really employed by the principal." Civ. Code § 2299. Ostensible agency occurs when "the principal intentionally, or by want of ordinary care, causes a third person to believe another to be his agent who is not really employed by him." Civ. Code § 2300. No Large Distributor is employed by The Bee; each is an

employers with The Bee.[26] For this separate and sufficient reason alone, the class allegations should be stricken.

E. Class Certification Must Be Denied For Lack Of Common Proof On Secondary Factors Evidencing Control

1. There is no commonality as to whether carriers service multiple customers, including competitors, at the same time.

Carriers have been free to engage in other businesses, including the delivery of competing newspaper products (SMF ¶ 261); *see Taylor*, 216 Cal. App. 2d at 475 (carrier's delivery of newspaper published by other companies cited as evidence of independent contractor status). Many carriers deliver other publications, including those of Bee competitors, without any information of such deliveries in The Bee's business records. Carrier Katherine Potts-Sanker delivers *Contra Costa Times*, *Vacaville Reporter*, the *Times Herald*, *N Y Times*, *USA Today*, and *The Oakland Tribune* under her contract with Large Distributor D&L; she also delivers

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independent business that contracts with carriers on its own terms with no influence from The Bee, and without holding itself out as a Bee agent (SMF ¶ 256). Plaintiffs, in contracting with Large Distributors, knew they were independent businesses, not Bee agents (SMF ¶ 257). Moreover, there is no indication that The Bee caused carriers to believe Large Distributors were its agents. To show an ostensible agency relationship, the third party must have dealt with the purported agent under a "belief in the agent's authority and this belief must be a reasonable one." *Hartong v. Partake, Inc*, 266 Cal. App. 2d 942, 960 (1968). There is no evidence that Plaintiffs, in contracting with Large Distributors, thought they were contracting with The Bee (SMF ¶ 257).

[26] As to joint employment, carriers contracting with Large Distributors lack common proof that The Bee had (1) control over their wages, hours, or working conditions, (2) the power to cause them to work or prevent them from working, or (3) "control of details" sufficient to create common law employment. *Martinez v Combs*, 49 Cal. 4th 35, 50 (2010) (analyzing employment relationship under Section 1194); *Futrell v Payday California*, 190 Cal. App. 4th 1419, 1430-35 (2010) (determining that payroll company was not a Labor Code employer). First, Plaintiffs cannot show by common proof that The Bee controlled their wages, hours, or working conditions: " 'control over wages' means that a person or entity has power or authority to negotiate and set an employee's rate of pay, and not that a person or entity is physically involved in the preparation of an employee's paycheck." *Id* at 1432. Here, each Large Distributor negotiated with carriers on rates, hours of warehouse operation, and how to interact, with no Bee oversight (SMF ¶ 258). Next, The Bee has no power to cause carriers to contract with, or prevent carriers from contracting with, Large Distributors (SMF ¶ 259). Each Large Distributor contracts with carriers with no influence from The Bee (*Id*). Finally, The Sacramento Bee has no "control of details" that would trigger the common law test of employment. Rather, carriers had their own delivery businesses, not under The Bee's control, providing their own supplies and tools, earning piece rates for deliveries, and agreeing to be independent contractors, not employees (SMF ¶ 260).

Resolving these issues would require distributor-by-distributor assessments as to whether each was an agent or joint employer. *Gerhard v Stephens*, 68 Cal. 2d 864, 913 (1968) (not only would each putative class member need to prove title to mineral rights, but "defendants would undoubtedly raise the defense of abandonment of the mineral interests as to each alleged member of the class, which . . . creates a factual issue as to the individual owner's intent"); *Kennedy v Baxter Healthcare Corp.*, 43 Cal. App. 4th 799, 811 (1996) (as to class of users of latex gloves, "defenses will require individual litigation of claims. Health care workers may have been using latex gloves for a period of time exceeding the statute of limitations, thus requiring an examination of the viability of each plaintiff's claim. Questions will arise concerning assumption of the risk and comparative negligence"); *Block v Major League Baseball*, 65 Cal. App. 4th 538, 544 (1998) ("affirmative defenses of consent, waiver, or estoppel" would not be common; "trial court would be obligated to evaluate each of these defenses for each member of the class," which "weighed heavily against certification").

Daily Republic, *San Francisco Chronicle*, *WSJ*, and *Sing Tao* for The Daily Republic (SMF ¶ 261). Kevin Goosby has contracted with The Sacramento Bee and several Large Distributors, including South County News, North County News, and M & M News (SMF ¶ 261). Some carriers delivered competing newspapers, others did not (*Id.*). The lack of common proof on this issue further reflects that certification is inappropriate, and would require mini-trials as this evidence can only be obtained through individual testimony.

2. There is no commonality as to the degree carriers demonstrate business acumen to maximize profit.

There is no uniformity in the contract terms negotiated (SMF ¶ 262). Because carriers vary in sophistication, business acumen, and language skills, some have negotiated changes to contracts (SMF ¶ 263); others knew they could negotiate terms of their contracts, but chose not to because they were satisfied with the terms (*id.*). Carrier Pete Mitrou negotiated with WSNA for an additional $400 per month (in addition to a per piece rate) (SMF ¶ 264). Carrier Kevin Goosby negotiated for higher per-piece rates for his contracts that included apartment deliveries (SMF ¶ 265). Carrier Tony Loveless negotiated for additional delivery areas (SMF ¶ 266). Carrier Ray Eddy negotiated for a higher rate on Thanksgiving (SMF ¶ 263).

Whether agreements were subject to negotiation is another factor that cannot be shown through common proof, but is proven through individual testimony.[27] The Sacramento Bee contracted with carriers through dozens of different managers at numerous distribution centers, and the identity of those managers changed over the class period (SMF ¶ 267). Likewise, carriers have contracted with about 35 different Large Distributors at numerous distribution centers (SMF ¶ 268). (See section II. B *supra* regarding differences in contracts used by Large Distributors.)

The number of delivery areas a carrier has been able to manage has varied considerably, from a single area to as many as 30, as in the case of Kevin Goosby (SMF ¶ 269). At one point, Goosby earned $8,000 to $8,500 every two weeks for all of his delivery services (SMF ¶ 270).

Further reflecting differences among carriers in their level of business acumen are their differing interaction with subscribers. The Bee Agreements did not prohibit carriers from contacting subscribers to resolve complaints and provided that carriers would use best efforts to increase circulation (SMF ¶ 275). While Plaintiffs claim that their interaction with subscribers was limited, Plaintiff Langford engaged in door-to-door solicitations to sell subscriptions (*Id*). Other carriers interacted with subscribers frequently, providing

[27] 22 Cal. Code Regs. § 4304-6(c)(1).

telephone numbers and unique written communications to avoid complaints, while others did not (*Id*). Indeed, the levels of subscriber interaction vary from very little to extensive (*Id*). Many deal with subscribers to increase profits or for other reasons; others do not (*Id*). This is yet another factor for case-by-case analysis.

A final factor reflecting variation in business acumen is the decision of how to obtain supplies. Many carriers choose to buy their supplies from The Sacramento Bee (when it contracted with carriers) or Large Distributors, while others have decided to buy supplies elsewhere or from various depending on the supply (e.g., Ray Eddy) (SMF ¶ 277).

3. There is no commonality as to the duration carriers provide results.

Plaintiff Sawin was under contract for years, while Plaintiffs Langford and Gallardo were under contract for only a few months (SMF ¶ 278). Carrier Kevin Goosby, meanwhile, delivered newspapers for over 20 years (SMF ¶ 279). The duration of single contracts also vary, from just a few weeks (e.g., WSNA's contracts) to over a year (SMF ¶ 280).

4. There is no commonality regarding the proposal, versus assignment of delivery areas.

Whether the selection of delivery areas was subject to negotiation is another factor relevant to employment status.[28] Plaintiffs may suggest that their delivery areas were assigned, and that they had no choice in their selection. But other carriers state that they had discretion in selecting them (SMF ¶ 281). There is no way to determine on a class-wide basis which carriers selected their delivery areas and which forcibly had delivery areas assigned to them. Thus, this issue also requires a case-by-case determination.

5. There is no commonality as to intent to be engaged in delivery as an independent contractor.

EDD regulations on the independent contractor status of newspaper carriers state: "A written agreement signed by both parties shall be evidence of intent."[29] Every contract relevant here says the carrier is an independent contractor. The Sacramento Bee Agreements recite that carriers are "independently established

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[28] 22 Cal. Code Regs. § 4304-6(c)(4) (providing that assignment of area evidences employment, while offer of area with opportunity to negotiate is evidence of independent contractor status).

[29] 22 Cal. Code Regs. § 4304-6(c)(1); *see also Tieberg v. Unemployment Ins. Appeals Board*, 2 Cal. 3d 943, 952 (1970) (existence of agreement setting forth nature of relationship is "significant factor"); *Isenberg*, 30 Cal. 2d at 39 (parties' belief they are creating employment relationship is factor to consider); *Milsap*, 227 Cal. App. 3d at 431 (same); *see also In re FedEx Ground Package Sys. Inc., Employment Practices Litig.*, No. 3:05-MD-527 RM (MDL 1700), 2010 U.S. Dist. LEXIS 82216, at *3 (N.D. Ind. Aug. 11, 2010) (California law) (parties' intent favored independent contractor status).

business[es] and ... contract with [The Bee]... as [] independent contractor[s]." (SMF ¶ 7.)[30]

Issues of carrier intent cannot be decided on a class-wide basis because carrier understandings diverge. Some Plaintiffs may claim they never read their contracts and that The Sacramento Bee never explained the contractor relationship. Yet many carriers clearly understood, per the Agreement language, that they were independent contractors, not employees (SMF ¶ 283). Former Plaintiff Richard Galindo, an experienced businessman who negotiated contracts as a banker and property manager (SMF ¶ 284), shared that understanding. Determining this issue requires an examination of each Bee-carrier and Large Distributor-carrier negotiation and interaction. Some Large Distributors had prospective carriers complete questionnaires confirming carrier understanding of independent contractor status; some did not (SMF ¶ 285).

These reasons make individual case-by-case analysis necessary to determine what each carrier understood about the relevant contract and other documents, such as questionnaires.

F. There Are No Relevant Commonalities That Demonstrate Employee Status

1. Enforcing Contractual Results

A principal's efforts to enforce contractual results do not evidence a right to control the manner and means of performance.[31] In *Doe I v. Wal-Mart Stores, Inc.*, 572 F.3d 677 (9th Cir. 2009) (California law), employees of suppliers to Wal-Mart sued Wal-Mart for unlawful employment practices in the suppliers' factories. The suppliers' employees claimed that Wal-Mart was liable as a joint employer because it had "the 'right to control and direct the activities of the person rendering service, or the manner and method in which the work is performed'." *Id* at 682 (quoting *Service Empl Int'l Union v. County of Los Angeles,* 225 Cal. App. 3d 761 (1990)). The court rejected this claim: "'A finding of the right to control employment requires ... a comprehensive and immediate level of "day-to-day" authority over employment decisions.'" *Id.* (quoting *Vernon v. State of Cal.*, 116 Cal. App. 4th 114, 127-28 (2004)). The plaintiffs could not prove that authority by noting the Wal-Mart supplier contract dictated deadlines, product quality, materials to use, and prices. *Id* Nor could right to control be inferred from Wal-Mart's monitoring of suppliers "to determine whether suppliers

[30] While each Large Distributor contract is unique, all Large Distributor contracts likewise make plain that the carriers are independent contractors (SMF ¶ 282).

[31] *See also In re FedEx Ground Package Sys.*, 2010 U.S. Dist. LEXIS 134959 (N.D. Ind. Dec. 13, 2010) (control of overall process with pricing and results-oriented controls to ensure proper package delivery is not determinative, because "what is dispositive here is the drivers' class-wide ability to own and operate distinct businesses, own multiple areas, and profit accordingly").

were meeting their contractual obligations, not to direct the daily work activity of the suppliers' employees." *Id*

The EDD regulations apply this legal principle to the newspaper industry: "The fact that a principal and carrier agree that the carrier shall deliver a newspaper to each customer on his or her area in a timely manner and in a readable condition shall not be evidence of an employment relationship as long as other factors indicate the absence of control by the principal of the manner and means of such delivery." 22 Cal. Code Regs. § 4304-6(c)(4). Thus, when Plaintiffs focus on carrier mail, complaint charges, and exchanges of information regarding subscriber needs, Plaintiffs confuse enforcing contract results with controlling how to achieve those results. Thus, a newspaper can facilitate a carrier's successful performance of contractual obligations by alerting the carrier to customer complaints, without thereby controlling the means and manner of delivery.[32]

2. Responsibility For Expenses

Carriers and Large Distributors have been exclusively responsible to pay their own expenses and maintain their own vehicles (SMF ¶ 286); *see Milsap*, 227 Cal. App. 3d at 431 (employment status rejected because delivery driver "furnished his own gas and oil" and "paid for whatever car repairs were necessary"). Bee Agreements have required carriers to indemnify The Sacramento Bee and post a bond (SMF ¶ 287); 22 Cal. Code Regs. § 4304-6(c) (1) (contract provisions requiring carrier to post a bond and to indemnify the newspaper provides evidence of independent contractor status). This commonality does not support class certification, as it simply indicates that Plaintiffs are independent contractors.

3. Carrier Responsibility For Taxes

Carriers are not paid employee benefits, and The Sacramento Bee has not withheld taxes or provided social security or a W-2 statement (SMF ¶ 288); *Fleming*, 71 Cal. App. 3d at 685 (not withholding taxes supports independent contractor status). This commonality does not support class certification, as it is simply indicates the Plaintiffs are independent contractors.

[32] 22 Cal. Code Regs. § 4304-6(c)(5) ("Subscriber complaints as to missed delivery, late delivery or delivery in an unreadable condition may be taken by the principal and referred to the carrier without giving rise to the inference of either an employment or an independent contractor relationship. The fact that the principal requires the carrier to respond to or correct such problems shall tend to indicate an employment relationship. The fact that the principal responds to or corrects such problems directly and charges the carrier with a penalty or with the principal's cost of corrective action shall tend to indicate the existence of an independent contractor relationship; the absence of such a charge will be evidence of employment. The fact that the principal gives the carrier the option of either personally correcting the problem or being charged with a penalty or with the principal's cost of correction shall tend to indicate an independent contractor relationship."). Here, too, Large Distributor operations differ: Moonlighting and D&L do not charge for re-deliveries; Sactown and others do.

4. Carriers Earn Through Results Achieved, Not Hours Worked

Carrier fees are on a basis other than the amount of hours worked (SMF ¶ 289); *see Isenberg*, 30 Cal. 2d at 39 (noting that method of payment whether by job or time spent is a factor for consideration); 22 Cal. Code Regs. § 4304-6(c)(2) ("Compensation to the carrier in the form of a flat fee per area *or per copy delivered* shall be evidence of an independent contractor relationship." (emphasis added)). This commonality does not support class certification, as it is simply a factor indicating the Plaintiffs are independent contractors.

5. Agreements Have Been For Fixed Durations

Agreements have been for fixed durations, terminable for material breach with advance notice (SMF ¶ 290). These provisions suggest an independent contractor, not an employee. *See, e g , Fleming*, 71 Cal. App. 3d at 687 (noting that contract provided for advance written notice of termination in holding that newspaper carrier was independent contractor); 22 Cal. Code Reg. § 4304-6(c)(6) (only termination with less than 30 days' notice provides evidence of employment status).

All of the individualized differences among carriers discussed above make class treatment inappropriate, and would require hundreds of individual mini-trials, defeating the purpose of class treatment.[33]

G. Individualized Experiences Makes Class Certification Inappropriate

The foregoing demonstrates that variations predominate among carriers on the major factors relevant to employee status.[34] Because California law requires that all these factors be considered, with the relationship determined from the whole situation, not just isolated facts,[35] the result is that " '[e]ach case must turn upon its own peculiar facts and circumstances.'"[36] The Court of Appeal has noted that a trial court's need "to evaluate each of [defendant's] defenses for each member of the class, weighed heavily against certification"). *See Block v. Major League Baseball*, 65 Cal. App. 4th 538, 541 (1998).

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[33] In *Ali*, 176 Cal. App. 4th 1333, the court upheld the denial of class certification in an action alleging that a cab company wrongfully classified drivers as independent contractors rather than employees. Common questions of fact did not predominate, because there were variations in the drivers' conduct, and because the cab company did not exercise "pervasive control" over the drivers, who had latitude in managing schedules and taking breaks, provided some of their own tools (different drivers used different tools), and negotiated their contracts, creating variation in their contracts. *Id* at 1349-50. Those same factors exist here.

[34] Given space constraints it is impossible to restate the significant differences amongst carrier subcontractors as well, but it should be noted that as the class definition includes them, each of their individual relationships with carriers is also relevant, and are contained in information outside any business records of The Sacramento Bee.

[35] *Brose*, 183 Cal. App. 3d at 1086 (quoting *Burlingham v Gray*, 22 Cal. 2d 87, 103 (1943)).

[36] *Id.* (quoting *Schaller v Industrial Acc Comm'n*, 11 Cal. 2d 46, 52 (1938)).

IV. Elements And Defenses Of Labor Code Claims Are Not Subject To Common Proof

The foregoing alone makes clear that class certification is inappropriate. Yet there are still more individualized inquiries that would make any class action unmanageable: the numerous Labor Code elements and defenses raise predominating individual issues with respect to carriers and their contractors.

A. Outside-Salesperson Status Depends On Individualized Inquiries

One defense—asserted against claims for missed breaks, minimum wage, overtime, and recordkeeping violations—is that the carriers are outside salespersons. California IWC Wage Order No. 1, § (1)(C), codifies an "outside salesperson" exemption. Section (2)(M) defines "outside salespersons" as those "who customarily and regularly work[] more than half the working time away from the employer's place of business selling tangible or intangible items or obtaining orders or contracts for products, services, or use of facilities." In California, a sale of a newspaper to a home-delivery subscriber occurs upon delivery. Sales and tax regulations of the California Board of Equalization recognize newspaper industry practice: "Each delivery of a newspaper or periodical pursuant to a subscription sale is a separate sale transaction."[37] Because delivering a paper is the sale of the paper, under California law, The Bee contends that the carriers, even if employees, would be outside salespersons on the basis that they spend most of their working time outside The Sacramento Bee premises engaged in sales and sales-related activities—here the delivery of a newspaper pursuant to a subscription sale. The merits of this defense are not subject to review here, as opposed to the determination of whether the elements of the defense are subject to common proof.[38]

The court in *In re Wells Fargo Home Mortgage Overtime Pay Litig*, 268 F.R.D. 604, (N.D. Cal. 2010), noted that the plaintiffs had failed to set forth a trial plan that would accurately separate those employees who had suffered wage and hour violations from those who had not. That court knew of no case "in which a court certified an overbroad class that included both injured and noninjured parties." *Id* at 612. Similarly here, only hundreds of mini-trials would identify whether each carrier is subject to the outside-salesperson defense.

B. Plaintiffs Lack Common Proof On Meal And Rest Claims

Employers must provide a meal break only for employees who work shifts of more than five hours, and meal breaks can be waived by mutual consent when the shift does not exceed six hours. Lab. Code § 512.

[37] California Board of Equalization Sales and Use of Regs. § 1590(b) (3).

[38] *United Steel, Paper & Forestry v ConocoPhillips Co*, 593 F.3d 802 (9th Cir. 2010) (mere possibility that party might be unable to prove allegation is not determinative for purposes of class certification).

Employers must authorize and permit rest breaks only for employees who work shifts of at least 3.5 hours, and rest breaks need not be taken or recorded.[39]

There is no common proof to sustain class-wide claims of denied meal breaks. Plaintiffs cannot show that each carrier provided delivery services more than five hours daily (a predicate for a meal claim). Lab. Code § 512. Delivery can take as little as an hour (e.g., Alfred Caraveo), and as much as seven (e.g., Katherine Potts-Sanker) (SMF ¶ 291). The amount of time also varies depending on the day of the week (*Id.*).

There is also no common proof to sustain a class-wide claim of denied rest breaks. Plaintiffs cannot show that all or even most putative class members worked at least 3.5 hours a day (a predicate for any rest claim). There is conflict even among named Plaintiffs: Trahin, Langford, and Gallardo delivered their newspapers in three hours or less (SMF ¶ 292), while Sawin took about five hours (*Id.*).

Moreover, even as to carriers working at least 3.5 hours, individualized inquiries still predominate because employers need not ensure that breaks occur but rather need only make them available.[40] Because the specific reason for a missed break could vary—was it an individual choice or manager command?—it is impossible to tell which carriers would be entitled to damages without individualized testimony, which precludes class treatment.[41]

Several Plaintiffs claim they never took a break, yet other carriers stop for breakfast (e.g., Candice Evans) or other breaks (SMF ¶ 293). Others know they can take breaks but choose not to (e.g., Regina Villaforte) (SMF ¶ 294). Neither The Sacramento Bee nor a Large Distributor records carrier breaks. Carrier experiences in taking breaks vary greatly, from Plaintiffs who claim they rarely took breaks to other carriers who took breaks of varying lengths (SMF ¶ 293). Some carriers, like Langford, provided their subcontractors breaks, but the only way to discern whether this happened and the length of the break is by testimony provided by individual subcontractors of each carrier. The individualized inquiries needed to assess liability preclude class treatment of these claims. Additionally, because many carriers delivered different products, not just *The Sacramento Bee*, individualized inquiry is required to break down the hours for each alleged "employer."

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[39] Wage Order No. 1, § 12(A). Moreover, because the time spent performing contractual services varies with the number and type of areas, individualized inquiries would be needed to see if any particular Large Distributor worked enough hours to qualify for a break.

[40] *See, e g, Brown v. Federal Express Corp*, 249 F.R.D. 580, 584-86 (C.D. Cal. 2008) (plaintiffs must prove that FedEx forced them to forego breaks, a burden that, to meet, would cause trial of individualized issues, making class treatment inappropriate).

[41] *See Walsh*, 148 Cal. App. 4th at 1458 (decertifying class).

C. Plaintiffs Lack Common Proof For Overtime Claims

Plaintiffs allege that The Sacramento Bee owes them seventh-day overtime (3AC ¶ 31 at 11:15-19). But carriers who use substitutes to distribute on just one day per week are not entitled to seventh-day overtime. As the facts show, it is not unusual for carriers to use others to deliver on one or more days per week. For example, Plaintiff Langford and, since 2009, Plaintiff Renslow, routinely used subcontractors, as did carrier Goosby. Because overtime entitlement necessarily differs among carriers, with no common proof available in The Bee's business records, the overtime claim is not amenable to class treatment. *See Walsh v. IKON Office Solutions, Inc*, 148 Cal. App. 4th 1440, 1458 (2007) (affirming decertification where "each individual [class] member would have to establish entitlement to damages (liability) as well as the amount of damages"). This factor was critical in *Sotelo*, which cites this ground in denying class certification on an overtime claim. Slip op. at 11-13. In addition, because many carriers delivered several products, not just *The Sacramento Bee*, individualized inquiry would be required to break down the hours for each alleged "employer."

D. Plaintiffs Lack Common Proof For Minimum-Wage Claims

Plaintiffs allege that The Sacramento Bee has "a consistent policy of failing to pay minimum wages" (3AC ¶ 30 at 11:11-12). But individualized testimony is the only evidence regarding how many hours any carrier worked in exchange for how much pay where, as here, no one recorded which individuals worked which hours (SMF ¶ 254). There is no common proof of damages on these highly individualized claims.[42] While Plaintiffs contend that they were denied minimum wage, other carriers state that they were paid effective wages well in excess of minimum wage (SMF ¶ 295). Carriers Katherine Potts-Sanker and Lorenzo Soria, for example, estimate that, based on the time they spend on delivery services, their effective hourly rates have exceeded $20.00 an hour, carrier Michael Huffstutler estimates his effective hourly rate has exceeded $42.00 an hour, and carrier Kevin Goosby has paid substitutes in excess of $20.00 an hour (*Id*). Thus, entitlement to minimum wages, as well the amount of damages, necessarily differs among class members and depends upon individual proof in the form of oral testimony that would be subject to credibility challenges.[43]

[42] *See, e g, Block*, 65 Cal. App. 4th at 541 (certification denied where damages assessment would require analysis of each class members' claim).

[43] *See Walsh*, 148 Cal. App. 4th at 1458 (affirming decertification where "each individual [class] member would have to establish entitlement to damages (liability) as well as the amount of damages")

E. Plaintiffs Lack Common Proof For Reimbursement Claims

Invoking Section 2802, Plaintiffs seek reimbursement for mileage expenses incurred in their deliveries (3AC ¶ 41 at 13:23-14:6). The Sacramento Bee never tracked carriers' or their substitutes' estimated mileage for delivery area(s) (SMF ¶ 296), and presumably, Plaintiffs' common proof would be route mileage estimates and IRS standard mileage allowances,[44] to compute money owed. That facile assumption ignores several points. First, IRS rates simply aggregate a national average of various vehicle costs, including depreciation, oil and gasoline, maintenance, accessories, parts, tires, and insurance. Actual figures for each item would vary from carrier to carrier, location to location. Depreciation allowance, for example, would vary with the initial cost of purchase or lease: a used car costs less and depreciates less than a new car. Other costs vary by locality. Thus, the IRS standard mileage may overstate or understate actual expenses. Indeed, the consulting firm the IRS contracted with to calculate the Business Mileage Reimbursement Rate cautions against using the rate in the case of drivers who use their vehicles for business on a daily basis, because that results in overcompensation. Second, The Sacramento Bee can use actual and necessary expenses to challenge presumptions based on IRS allowances. *See Gattuso v Harte-Hanks Shoppers, Inc* , 42 Cal. 4th 554, 568-70 (2007) (employers may reimburse employees for business-related expenses under Section 2802 by paying them increased compensation, if employers apportion between compensation for work performed and reimbursement for business-related expenses). Third, entitlement to mileage expenses requires proof that the carrier, not a substitute, actually incurred the mileage.

Thus, the mileage expense for each carrier depends on (1) actual depreciation, (2) gas, repair, and maintenance costs for each vehicle, (3) the miles driven for personal use, third-party business use, or use by a helper or substitute, (4) whether the routes taken and vehicles used were reasonable, (5) whether insurance costs involved excess coverage, whether the carrier had a bad driving record, and whether the vehicle chosen had unusually high insurance rates.

Moreover, individual issues surround whether carrier expenses were reasonable. Was it reasonable to use the vehicle in question for business purposes? Was the insurance selected reasonable? Was the gas used at

[44] The IRS permits individual taxpayers to deduct expenses incurred in driving their own vehicle for business purposes. Taxpayers generally can deduct either actual expenses or amounts computed with the standard mileage rate The IRS, for this purpose, has created a standard mileage allowance, known as the Business Mileage Reimbursement Rate. Some employers use this rate to compute employee reimbursement when an employee operates an employee-owned automobile for business purposes.

a required octane level? Were the routes used reasonable? What other work or personal business was conducted during the use attributed to Bee deliveries? Did the carrier or carriers' subcontractor even use a vehicle? Further, The Sacramento Bee would be entitled, under *Gattuso*, to show that reimbursement of expenses was already included in payments previously made. Likewise, under *Gattuso*, each carriers' knowledge that they were being paid an enhanced amount would require a person-by-person parade of carriers to testify what they understood about their compensation, as well as an examination of Large Distributors' compensation practices.

Determining these facts requires individual inquiries that dwarf common issues. *See, e g , Evans v Lasco Bathware, Inc.*, 178 Cal. App. 4th 1417, 1430 (2009) (court can deny certification when extent of class-member injuries require individualized inquires that defeat predominance); *Ali v U S.A Cab Ltd.*, 176 Cal. App. 4th at 1350 ("When variations in proof of harm require individualized evidence, the requisite community of interest is missing and class certification is improper.").

F. Plaintiffs Lack Common Proof For Wage-Statement Claims

Plaintiffs allege that carrier statements violate Section 226 (3AC ¶¶ 49-54).[45] But Section 226 authorizes damages only for injuries that a violation causes;[46] the mere inadequacy of a wage statement does not constitute injury. The carrier statements cannot provide common proof of injury, because whether an inadequate carrier statement actually injured a carrier requires individualized inquiry. Moreover, carrier statements vary from Large Distributor to Large Distributor (SMF ¶ 297). There is no basis for class-wide damages on this highly individualized claim.[47]

G. Plaintiffs Lack Common Proof For Their Claim Of Training Pay

Plaintiffs allege that The Sacramento Bee owes them pay for their "training" time (3AC ¶¶ 44-45). Plaintiffs refer to the practice of some former Bee Managers and Large Distributors having prospective carriers ride along to see a delivery area before contracting. But Plaintiff Renslow, and former Plaintiff Compton, received no such training (SMF ¶ 298). Moreover, with respect to those carriers who used helpers and

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[45] Section 226 requires itemization of the wage rates and hours worked, among other things. The Sacramento Bee does not record time worked by independent contractors.

[46] Lab Code § 226(e) (injury required).

[47] *See, e g , Walsh*, 148 Cal. App. 4th at 1458 (affirming decertification where "each individual [class] member would have to establish entitlement to damages (liability) as well as the amount of damages"); *Block*, 65 Cal. App. 4th at 541 (certification denied where damages assessment required analysis of each class member claim).

substitutes, like Plaintiff Langford, it is impossible to ascertain the extent to which such substitutes and helpers were trained, if at all, and by whom. The "training pay" claim, much like the overtime and minimum wage claim, needs inherently individualized proof, for there are no records of "training" time. Rather, each carrier claiming pay for "training" time would have to testify to establish any liability on that claim.

V. Plaintiffs Are Not Typical

For typicality, the "crucial inquiry is whether the plaintiffs are truly representative of the unnamed class members." *Bartlett v Hawaiian Village, Inc.*, 87 Cal. App. 3d 435, 438 (1978). Plaintiffs must show that proving their claims would establish the claims of class members. *See Fuhrman v Cal Satellite Sys*, 179 Cal. App. 3d 408, 425 (1986), overruled on other grounds, (certification denied where plaintiffs were not "similarly situated" to purported class and "each member must establish his or her right to recover on the basis of facts peculiar to his or her own case").

The Plaintiffs here are atypical because their experiences differ materially from those of putative class members on core issues that go directly to issues determining liability:[48]

- Some Plaintiffs claim they never fully read the contracts they signed, while most carriers have understood their status as independent contractors (SMF ¶ 299).
- Plaintiffs claim they never negotiated contract terms, while other carriers did (SMF ¶ 300).
- Several Plaintiffs claim they received direction from The Sacramento Bee, while other carriers claim they were never supervised in performing duties (SMF ¶ 301).
- Plaintiffs claim they were trained or instructed on how to prepare and deliver newspapers, while other carriers claim they learned by example or from other carriers (SMF ¶ 302).
- Several Plaintiffs claim they never took a meal or rest break; other carriers claim that they took frequent breaks (SMF ¶ 303).
- Plaintiffs claim that the use of substitutes and helpers was governed by The Bee, while other carriers used who they wanted, without The Bee's approval (SMF ¶ 304).
- Plaintiffs maintain that they had to arrive at their distribution centers at specific times; other carriers came and went as they pleased (SMF ¶ 305).
- Plaintiffs' allege they were not paid minimum wage, while certain carriers testified they earned, after expenses, in excess of the minimum wage (SMF ¶ 295).

Plaintiffs' experiences vary significantly from other carriers (see *supra* § IV). While they can pursue individual claims, they cannot represent carriers they do not resemble and who do not have similar claims.

[48] *See Akkerman*, 152 Cal. App. 4th at 1101 (where named plaintiff's factual circumstances differed from those of absent class members, plaintiff's claims were not typical of the class, nor was plaintiff adequate).

VI. Plaintiffs Are Not Adequate Class Representatives

A. Conflicts Among The Putative Class

The class device is inappropriate (and thus, not superior) where there is a substantial conflict among the putative class as to whether the action should proceed. *Amchem Prods*, 521 U.S. 591, 616 (1997) (superiority factor is "interest of members of the class in individually controlling the prosecution").[49] Generally, class members formerly associated with a defendant are improper representatives of a class of members currently related to the defendant.[50] Former carriers—including five of the six Named Plaintiffs—may never again contract with The Bee or a Large Distributor, and are unaffected by any change to home-delivery contracts, and want the damages available if the suit prevails. Effectively, Plaintiffs demand that the autonomy of current carriers cease.

Many current carriers have contrary interests: they like the freedom they enjoy as independent contractors; they value the ability to control hours and implement efficiencies to increase profitability; and they have no interest in being transformed into hourly laborers deprived of the liberty to select substitutes or helpers (SMF ¶ 306). They have no one to represent them here except a single named Plaintiff—Renslow—who avowedly disclaims any interest in representing them (SMF ¶ 160). Former carrier interests thus conflict with those of current carriers who do not support this lawsuit. Where there is such a conflict between current and former incumbents, courts have denied class certification on the basis of intra-class conflict.[51]

The same conflicts that render Plaintiffs inadequate class representatives also foreclose their counsel's representation. The trial court must assess whether class counsel "is representing the interests of the class as a whole and not simply the interests of the named representative plaintiffs." *Sharp v. Next Entertainment, Inc.*, 162 Cal. App. 4th 410, 433 (2008).[52]

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[49] The superiority requirement imposed by Federal Rule of Civil Procedure 23(b)(3) is essentially identical to the requirement imposed by Section 382 of the California Code of Civil Procedure.

[50] *See Richmond v Dart Industries, Inc*, 29 Cal. 3d 462, 470-71 (1981); *see also Colburn v Roto-Rooter Corp*, 78 F.R.D. 679, 681 (N.D. Cal. 1978) (class certification denied based on intra-class conflict).

[51] *Southern Snack Foods, Inc v J&J Snack Foods Corp*, 79 F.R.D. 678, 681 (D.N.J. 1978) (certification denied for former and current franchisees absent "compelling reason for the court to deviate from the general rule that former class members are not adequate representatives of the class"); *see also Van Allen v Circle K Corp*, 58 F.R.D. 562, 564 (C.D. Cal. 1972) (certification denied when interests of present and former independent operators were adverse); *Matarazzo v. Friendly Ice Cream Corp.*, 62 F.R.D. 65, 68 (E.D.N.Y. 1974) (class denied because "former store managers do not have the same interests of present store managers").

[52] *See Cal Pak Delivery v UPS, Inc.*, 52 Cal. App. 4th 1, 12 (1997) (court must scrutinize counsel "to ensure that all interests, including those of as yet unnamed plaintiffs are adequately represented"); *Janik v Rudy,*

Denying certification here does not preclude any individual right to recover. But requiring that suits be brought individually would avoid the class conflicts rendering this case inappropriate for class treatment.[53]

B. Plaintiffs' Credibility Problems Make Them Inadequate

A certifiable class needs representatives who can adequately represent class interests.[54] An adequate representative must have qualifications and character that Plaintiffs in this case lack.[55] Their credibility is badly damaged because their deposition testimony repeatedly contradicts their sworn written discovery responses on material points. These pervasive discrepancies suggest that their sworn discovery responses are the responses of class counsel, not Plaintiffs themselves, and that they have allowed counsel to usurp their role.

Plaintiff Langford's written discovery responses, for example, state that he only used one helper and that he did so on "rare occasions," but in deposition he admitted he used helpers almost every day, and has had as many as seven different helpers (SMF ¶ 307). He also stated in written discovery responses that he *had to* use string assembling and delivering newspapers, in deposition he admitted he *never* used string. (SMF ¶ 310). Likewise, although his written discovery responses state he typically spent more than 3.5 hours a day providing services, in deposition he admitted that he spent less than 3.0 hours doing so on weekdays (SMF ¶ 308). Further, although his written discovery responses state he generally spent at least five hours on Saturdays and Sundays assembling and delivering newspapers, in deposition he admitted that he actually spent *less than two hours* on Saturdays and *less than three hours* on Sundays, and that on certain days he spent no time assembling or delivering newspapers (the only time he spent was buying snacks – hot-dogs and potato chips – for his distribution workers) (SMF ¶ 309). Langford's credibility is further irreparably damaged, and his inadequacy as a class representative is further underscored, by his admission that he routinely drives his workers to the distribution centers with a suspended driver's license, and his refusal to answer questions directly relevant to

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Exelrod & Zieff, 119 Cal. App. 4th 930, 938 (1994) (duty of class counsel to unnamed class members "no less" than that of class representative).

[53] Each Plaintiff has available prompt remedies for unpaid wages by filing a wage claim with the Labor Commission, under Section 98.

[54] *See Richmond*, 29 Cal. 3d at 471; *see also Cohen v. Beneficial Indust. Loan Corp*, 337 U.S. 541, 549 (1949) (class representative is "a volunteer champion" upon whom absent class members depend for "diligence, wisdom and integrity").

[55] *See Armour v City of Anniston*, 89 F.R.D. 331, 332 (N.D. Ala. 1980) (plaintiff with demonstrated lack of credibility and conscientiousness was inadequate representative); *Cobb v. Avon Prods. Inc*, 71 F.R.D. 652 (W.D. Pa. 1976) (deceptive plaintiff was inadequate representative due to lack of forthrightness and sincerity); *Dubin v Miller*, 132 F R.D. 269, 272 (D. Colo. 1990) ("A plaintiffs lack of credibility and the impurity of his motives can render him an 'inadequate' class representative."); *Howard Gunty Profit Sharing Plan v Super Ct*, 88 Cal App. 4th 572, 577-78 (2001) (class representative must have credibility and adequate knowledge).

this lawsuit regarding his use of a vehicle in connection with newspaper delivery based on his Fifth Amendment right against self-incrimination (SMF ¶ 311).

Likewise, in Plaintiff Trahin's written discovery responses, he states that he spent more than 3.5 hours performing assembly and delivery on Sundays, but in his deposition testimony he admits it took him less than three hours (SMF ¶ 312).

In Plaintiff Renslow's discovery responses, he swore that The Sacramento Bee prohibited communications with subscribers and that his interactions with subscribers were limited to occasional greetings, but at deposition he admits he regularly communicated with subscribers and gave them his telephone number to complain directly to him (SMF ¶ 314). In his discovery responses he suggests that The Bee prohibited carriers from changing the order of delivery areas, but at deposition he admitted to doing so to reduce mileage and time (SMF ¶ 315).

Plaintiff Sawin's written discovery responses state she only used her daughter and husband, but her deposition testimony confirms she used additional substitutes and helpers (SMF ¶ 316). Her discovery responses deny she could develop her own delivery sequence, but in deposition she admits she often did (SMF ¶ 317). Her discovery responses say that she was required to stay at the distribution center to prepare her papers, but her deposition testimony confirms she did so elsewhere (SMF ¶ 318). Sawin's written discovery responses attest that The Sacramento Bee had "strict prohibitions" on carrier contact with subscribers, but at deposition she admits that in practice she had oral and written communications with subscribers (SMF ¶ 319).

Gallardo's written discovery responses state she would generally spend 3.5 or more hours assembling and delivering newspapers, but she admitted at deposition that on Mondays through Saturdays she did not (SMF ¶ 320). Her written discovery responses suggest The Bee dictated her delivery sequence, but at deposition she admits she modified the sequence of deliveries (SMF ¶ 321). Gallardo's written discovery responses state that, as a practical matter, she was required to use The Sacramento Bee's tubs and carts when preparing her papers, but during deposition she said she never used them (SMF ¶ 322).

Finally, Plaintiff Holliman's written discovery responses state that any variance in her newspaper pickup times was minimal due to The Sacramento Bee's control, but at deposition she admits she picked up her newspapers at a time of her choosing over a 2 to 2.5 hour window of newspaper availability (SMF ¶ 323).

The discrepancies between Plaintiffs' written discovery responses and their sworn deposition testimony

are so glaring and pervasive that they cannot honestly be attributed to mistakes. That several of the Named Plaintiffs falsely stated in their written discovery responses that they worked 3.5 hours a day is highly suspect because that is the minimum number of hours to trigger eligibility for a rest break. Plaintiffs' irreparably damaged credibility disqualifies them as representatives.

C. Plaintiffs' Lack Of Knowledge About The Case And Failure To Monitor Class Counsel Precludes Them From Being Adequate Representatives

An adequate class representative must know the case and manage the attorneys who would represent the class.[56] A class representative cannot be adequate with "so little knowledge of and involvement in the class action that [he or she] would be unable or unwilling to protect the interests of the class against the possible competing interests of the attorneys."[57] When class representatives fail to monitor counsel, "the result is indistinguishable from the situation in which an attorney serves as both class counsel and class representative."[58]

The Plaintiffs here are inadequate in these respects. Renslow joined the suit "to go along with the rest of them," even though he "didn't really understand anything" and, when asked if he understood what the lawsuit was about, admitted, "Not really, no." (SMF ¶ 324.) Similarly, Plaintiffs misunderstand what they seek to accomplish. Langford, when asked what he wanted, indicated he did not understand the question and did not know what he could gain. (SMF ¶ 325.)

Plaintiffs' counsel intervened to prevent Plaintiffs from testifying about their duties as class representatives, the significance of a class action, and the class claims (SMF ¶ 326.) When they were permitted to answer, Plaintiffs revealed their ignorance of their role or whom they seek to represent. Renslow has even said he had no problems with The Sacramento Bee or any Large Distributor and *had no interest in representing other carriers* (SMF ¶ 327). Given Plaintiffs' inability to act as true class representatives, they are inadequate.

VII. Class Counsel Are Inadequate

A trial court properly refuses to certify a class where a plaintiff simply "lend[s] his name to a suit

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[56] *In re California Micro Devices Sec. Litig*, 168 F.R.D. 257, 274-75 (N.D. Cal. 1996); *Armour v Network Associates, Inc*, 171 F. Supp 2d 1044, 1048 (N.D. Cal. 2001).

[57] *Kirkpatrick v. J C Bradford & Co*, 827 F.2d 718, 727 (11th Cir. 1987); *see Apple Computer, Inc v Superior Court*, 126 Cal. App. 4th 1253, 1265-66 (2005) (citing *California Micro Devices*, 168 F.R.D. at 275 (class litigation "must be monitored by an informed and independent plaintiff and simply cannot be left for the lawyers to manage."))

[58] *California Micro Devices*, 168 F.R.D. at 260.

controlled entirely by the class attorney."[59] The irresistible inference here is that Plaintiffs have been puppets, with counsel pulling the strings. The written discovery responses, prepared by counsel, systematically falsify testimony. Current counsel should be disqualified, as their reckless behavior in representing individual clients has jeopardized the litigation fate of a putative class that must rely on impaired class representatives.[60]

VIII. A Class Action Is Not Superior And Is Unmanageable

Plaintiffs must present a manageable method of presenting common proof for a trial of both liability and damages.[61] That task is impossible here, where no representative evidence could fairly be extrapolated to all carriers and their helpers and substitutes. Rather, virtually every contested issue affecting liability and damages requires individualized proof, including (1) how each carrier negotiated contracts, (2) whether each carrier contracted with The Bee, with Large Distributors, or some combination, (3) which products each carrier delivered, (4) where each carrier picked up newspapers, (5) when each carrier chose to arrive at pick-up points (if at all) and on what basis that decision was made, (6) the sophistication, business acumen, experience, and outside employment of each carrier, (7) the nature and extent of each carrier's interactions with The Bee or Large Distributors, (8) the extent to which each carrier used substitutes or helpers, (9) the tools and equipment each carrier used and how the carrier procured them, (10) how much and why each carrier varied the order of delivery, (11) the number of areas each carrier managed, (12) the time each carrier and their subcontractors took each day to provide results, (13) the reasonable mileage each carrier and their subcontractors expended, if any, (14) each carrier's level of interaction with subscribers, (15) each carrier's and their subcontractors' expenses and profitability, (16) whether each carrier, substitute, and helper had uncompensated "training" time, and (17) whether each carrier, substitute, and helper could take breaks, did take breaks, and why any breaks were missed. The inevitable result is numerous time-consuming and confusing mini-trials.

Plaintiffs' inability to establish a manageable method of resolving the multitude of individual issues inherent here makes the case unsuitable for class certification.

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[59] *Howard Gunty Profit Sharing Plan v Superior Court*, 88 Cal. App. 4th 572, 579-80 (2001) (citing *Kirkpatrick v J.C Bradford & Co*, 827 F.2d 718, 727 (11th Cir. 1987)).

[60] *See Evans v IAC/Interactive Corp.*, 244 F.R.D. 568 (C.D. Cal. 2007) (finding plaintiffs' counsel inadequate for including statements in plaintiffs' declarations that were false); *see also Byes v Telecheck Recovery Servs., Inc*, 173 F.R.D. 421, 426-27 (E.D. La. 1997) (plaintiff's false affidavit "indicates to the court that [plaintiff] places blind reliance on her attorneys, but even more so, it reflects poorly on the adequacy of counsel").

[61] *Dunbar*, 141 Cal. App. 4th at 1432 (plaintiff must not merely "mention a procedural tool" but "explain how the procedure will effectively manage the issues"); *see Pierce v. County of Orange*, 526 F.3d 1190, 1200 (9th Cir. 2008) (court did not abuse discretion in decertifying damages class and rejecting statistical sampling).

CONCLUSION

The Plaintiffs cannot show that a class should be certified. A properly certified class has a strong community of interest, but the proposed class is so vaguely defined and diverse that it would include:

- long-term carriers with multiple routes who have been successful entrepreneurs,
- short-term carriers who threw but a single route as unsuccessful fly-by-night operators,
- persons who never contracted with either The Sacramento Bee or a Large Distributor,
- persons who never contracted with The Sacramento Bee, and for whom no business records exist for fees paid, expenses incurred, and the days, hours, or type of work they performed,
- carriers who contracted only with The Sacramento Bee,
- carriers who contracted only with one or two Large Distributors, none of whom is a Defendant,
- former carriers interested only in money,
- carriers who contracted with other newspaper companies,
- current carriers wanting to preserve existing arrangements, which would include Named Plaintiff Renslow, who has no complaints against either The Bee or any Large Distributor,
- carriers who never worked enough hours to qualify for rest or meal breaks,
- carriers who never qualified for seventh-day overtime,
- carriers, including substitutes and helpers, who, during the class period, never did a ride-along or otherwise got "training" with respect to delivery of *The Sacramento Bee*,
- carriers who almost always used substitutes and helpers, and carriers who never did.

The only thing putative class members share in common is that they once agreed to help deliver *The Sacramento Bee* Accordingly, The Sacramento Bee respectfully requests that the Court strike the class allegations and permit the Plaintiffs to proceed with their claims individually.

DATED: February 15, 2011

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PROOF OF SERVICE

Ayala, et al., v. Antelope Valley Newspapers, et al.
Court of Appeal Case No. B235484
Supreme Court Case No. S206874

I am employed in the County of Orange, State of California. I am over the age of 18 and not a party to the within action. My business address is 3 Hutton Centre Drive, Ninth Floor, Santa Ana, California 92707.

On **April 29, 2013,** I served the foregoing document(s) entitled:

DECLARATION OF MICHAEL J. WRIGHT IN SUPPORT OF MOTION FOR JUDICIAL NOTICE VOL. II OF II EXHIBITS 5 -13

on the interested parties in this action by placing [ ] the original **[X]** a true copy thereof enclosed in a sealed envelope addressed as follows:

SEE ATTACHED SERVICE LIST

[X] **BY FEDEX:** I deposited such envelope at Santa Ana, California for collection and delivery by Federal Express with delivery fees paid or provided for in accordance with ordinary business practices. I am "readily familiar" with the firm's practice of collection and processing packages for overnight delivery by Federal Express. They are deposited with a facility regularly maintained by Federal Express for receipt on the same day in the ordinary course of business.

[X] **BY MAIL:** I deposited such envelope in the mail at Santa Ana, California. The envelope was mailed with postage thereon fully prepaid. I am "readily familiar" with the firm's practice of collection and processing correspondence for mailing. It is deposited with the United States Postal Service on that same day in the ordinary course of business. I am aware that on motion of party served, service is presumed invalid if postal cancellation date or postage meter date is more than one (1) day after date of deposit for mailing in affidavit.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct. Executed on **April 29, 2013**, at Santa Ana, California.

Elena Richards

Elena Richards

Ayala, et al., v. Antelope Valley Newspapers, et al.
Court of Appeal Case No. B235484
Supreme Court Case No. S206874

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