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Chapter E

## **Working With Independent Contractors in Today's Business Environment — Do's & Don'ts**

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*Beth Lincow Cole, Esq.*

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# WORKING WITH INDEPENDENT CONTRACTORS IN TODAY'S BUSINESS ENVIRONMENT – DO'S & DON'TS

ASTOR, WEISS, KAPLAN & MANDEL, LLP

BETH LINCOW COLE, ESQUIRE

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## I. INTRODUCTION

Independent contractor is the term for a person or company providing services to another company as distinguished from an employee. The challenge when examining whether an independent contractor is properly classified is there are *different laws* using *different tests* considering *different factors* to determine whether the person or company is an independent contractor.

In recent years, the government has increased its efforts to reduce the incidence of misclassification of employees. Whether a federal or state misclassification audit (1099 independent contractor versus W2 employee) or worse -- a civil class action lawsuit -- the end result of misclassification can be devastating. Your client could find itself owing back wages for overtime, payment for employee and retirement benefits, workers' compensation and unemployment compensation contributions, significant payroll tax liabilities, fines, penalties and attorneys' fees.

## II. WORKING WITH INDEPENDENT CONTRACTORS IN TODAY'S BUSINESS ENVIRONMENT

### A. The current landscape

- The United States Department of Labor (US DOL) has regularly increased its budget to allow more resources to focus on employers who are misclassifying employees as independent contractors. The DOL's FY 2013 budget includes \$14 million for independent contractor misclassification which includes special funding for the DOL to "detect and deter" the misclassification of workers as independent contractors.

- Federal and state enforcement initiatives targeting misclassification have been on the rise during the Obama Administration. State governments have been at the forefront conducting studies on the consequences (dollars lost) of misclassifying employees as independent contractors.
- The IRS has also increased its resources conducting random employment tax audit of 2000 companies a year over a three-year period.
- Sharing arrangements have been instituted between state and federal agencies, as well as between federal agencies. For example, in September 2011, the IRS and the US DOL signed a Memorandum of Understanding (MOU) allowing the sharing of information regarding worker misclassification. Various states have agreed to share information with the U.S. DOL (as of the date of this publication Pennsylvania and New Jersey were not included).
- Several states, including Pennsylvania, New Jersey and Delaware have enacted legislation imposing steep penalties on employers who misclassify. See Pennsylvania Construction Workplace Misclassification Act, 43 P.S. § 933.1, New Jersey Construction Industry Independent Contractor Act, N.J.S.A. 34: 20-1, Delaware Workplace Fraud Act of 2009, 77 Del. Laws. c192 §1. The penalties that accompany intentional misclassification of workers under recent state legislation can be steep. For example, It was reported in 2011 Massachusetts collected \$10.9 million in restitution, penalties, fines and taxes connected to misclassification.
- There have been many state legislative initiatives. According to the National Conference of State Legislators (NCSL), legislation regarding employee misclassification, or the use of independent contractors, was introduced in thirty states and the District of Columbia, during the 2011 legislative session, and during the same session fifteen states passed laws.

- Federal legislative initiatives include amending and expanding the Fair Labor Standards Act. For example, the “Employee Misclassification Prevention Act of 2011” would make misclassification of employers as independent contractors a federal offense. This bill was reintroduced as H.R. 3178, The Employee Misclassification Prevention Act, on October 13, 2011.
- This focus on worker misclassification is not limited to specific industries. Multiple Industries are being audited including financial, staffing, health care, courier, construction, janitorial, technology, transportation and more.
- Lawsuits for misclassification are on the rise, including individual suits and class actions.
- In short, independent contractor status can be challenged in many different ways. Companies can be audited by various agencies including the Department of Labor, Internal Revenue Service, equivalent state agencies, and workers’ compensation insurance carriers. An employer can also have the independent contractor status challenged if a contractor files an unemployment claim when the contract ends, which also may result in an audit by either the unemployment compensation division or the state DOL. Further, the contractor can bring a private lawsuit, or a class action, challenging its status seeking remedies such as employee benefits, retirement benefits and payment for failure to pay minimum wage and overtime.

**B. Why the increasing focus on independent contractor misclassification?**

- Studies show millions upon millions of dollars lost to state and federal government. For example, a federal study in 2009 by



the Government Accountability Office (GAO) provided an estimate that the federal government loses \$2.72 billion a year (using inflation-adjusted dollars) because of employees misclassified as independent contractors. The study additionally provided state governments lose an estimated \$200 million in unemployment insurance taxes for every 1 % of employees who are misclassified.

- Loss of federal income and payroll taxes.
- Loss of state income and payroll taxes.
- Loss of Medicare and Social Security payments.
- Loss of payments into state unemployment and workers' compensation.
- Employees (nonexempt employees) are entitled to overtime after forty hours worked in a workweek, where as independent contractors are not.
- Employees who prevail in a private lawsuit can be awarded significant damages, as well as attorney fees and costs.

### **III. REVIEW OF THE VARIOUS TESTS TO DETERMINE INDEPENDENT CONTRACTOR STATUS**

#### **A. Independent Contractor Versus Employee**

1. The challenge is there is not one test to determine who is an independent contractor and who is an employee. Each test uses various factors with no factor being controlling. Thus, an individual or company can be deemed an independent contractor under one law and an employee under another.
2. Who is Looking?
  - United States Department of Labor.
  - State Departments of Labor.
  - The Internal Revenue Service.

- Division of Unemployment Compensation.
- Division of Workers' Compensation.
- Courts.

## **B. Factors Examined by the United States Department of Labor**

1. Under the Fair Standard Labor Acts (enforced by the U.S. DOL) if an individual is determined an independent contractor the employer is not required to provide minimum wage and overtime at one and half times the regular rate for any hours worked more than forty hours per week.
2. Factors are commonly known as the Economic Reality Test.
  - The extent to which the services are an integral part of the employer's business.
  - The permanency of the relationship.
  - The extent of the independent contractor's investment in facilities and equipment.
  - The nature and degree of control by the employer.
  - The independent contractor's opportunities for profit and loss.
  - The amount of initiative, judgment, or foresight in open market competition with others required for the independent contractor's success.
  - The independent contractor's degree of independent business organization operation.

## **C. Internal Revenue Service Independent Contractor Test**

1. No brightline test. The IRS follows the common law rules wherein all information that provides evidence of the degree of control and independence must be considered. Historically, these factors were commonly referred to as the "Twenty Factor Test."

2. The IRS, attempting to simplify and refine the test, consolidated the twenty factors into eleven main tests, and organized them into three main groups: behavioral control, financial control, and the type of relationship of the parties. The challenge, as indicated on the IRS Independent Contractor Fact Sheet, is “[b]usinesses must weigh all these factors when determining whether a worker is an employee or an independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no “magic” or set number of factors that “makes” the worker an employee or an independent contractor and no one factor stands alone in making this determination.”
3. “The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally to document each of the factors used in coming up with the determination.”
- a. **Behavioral Control.** Facts that show whether the business has a right to direct or control how the worker does the task for which the worker is hired, including:
- The type and degree of instructions the Company gives the worker.
  - Evaluating systems.
  - Training the Company gives the worker.
- b. **Financial Control.** Facts that show whether the Company has a right to control the Company aspects of the worker’s job includes:
- The extent to which the worker has unreimbursed business expenses.
  - The extent of the worker’s investment.
  - The extent to which the worker makes services available to the relevant market.

- How the Company pays the worker.
- The extent to which the worker can realize a profit or loss.

c. **Type of Relationship.** Facts that show the parties' type of relationship include:

- Written contracts describing the relationship the parties intended to create.
- Whether the Company provides the worker with employee-type benefits, such as insurance, retirement, vacation pay, or sick pay.
- The permanency of the relationship.
- The extent to which the services performed by the worker are a key aspect of the regular business of the Company.

**D. Common Law Test/"Right to Control"**

- The *United States Supreme Court in Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992) when reviewing the definition of the term "employee" for ERISA purposes identified the following factors relevant to this inquiry:
  - The skill required.
  - The source of the instrumentalists and tools.
  - The location of the work.
  - The duration of the relationship between the parties.
  - Whether the hiring party has the right to assign additional projects to the hired party.
  - The extent of the hired party's discretion over when and how long to work.
  - The method of payment.
  - The hired party's role in hiring and paying assistants.
  - Whether the work is part of the regular business of the hiring party.
  - Whether the hiring party is in business.

- The provision of employee benefits.
- The tax treatment of the hired party.

### **E. Unemployment Compensation**

- Many states follow what is commonly referred to as the “ABC test” for determining whether an individual is an independent contractor or employee.
- New Jersey, for unemployment compensation purposes, looks at factors ABC:
  - The worker has been and will continue to be free from control or direction over the performance of the work, both under contract and in fact;
  - The work is either outside the usual course of business, or the work is performed outside of all the places of employer’s places of business; and
  - The worker is customarily engaged in an independently established trade, occupation, profession, or business.
- Pennsylvania, for unemployment compensation purposes, looks at A and C:
  - Is free from direction and control over the performance and service, both under his contract and in fact; and
  - The worker is an independently established business.

### **F. Workers’ Compensation**

- Factors vary state by state;

- Independent contractors are not covered within the definition of employee under the Pennsylvania Workers' Compensation Act. The Pennsylvania Workers' Compensation Act views employment as a master/servant relationship and defines employee as synonymous with servant including "all natural persons who perform services for another for a valuable consideration, exclusive of persons whose employment is casual in character and not in their regular course of business of the employment..." 77 P.S. §22.
- Again, no one factor is determinative of the factors to be considered under the Pennsylvania Workers' Compensation Act include:
  - Control of manner work is to be done.
  - Responsibility for result only.
  - Terms of Agreement between the parties.
  - Nature of the work or occupation.
  - Skill required for performance.
  - Whether one is engaged in a distinct occupation or business.
  - Which party supplied the tools?
  - Whether payment is by the time or by the job.
  - Whether the work is part of the regular business of the employer.
  - The right to terminate the employment at any time.

#### IV. BEST PRACTICES – INDEPENDENT CONTRACTOR ADMINISTRATION

A. Control and Independence are key factors.

##### CONTROL

EMPLOYEE	vs.	INDEPENDENT CONTRACTOR
Supervisors		Not Supervised
Expected Attendance		Controls own schedule and hours of work
Permanency of Relationship		Can accept or reject work
Expenses paid for by Company		Contractor pays own expenses (though may charge business)
Will receive formal training		No training, just general orientation
Receives supervision		No monitoring except for results or for administrative purposes such as billing
Performance Issues → Warning		Complaint → Resolved jointly by Company and independent contractor
Generally works at employer location or at location determined by employer		Contractor generally controls when and where he wants, though nature of work may require contractor to work onsite
Employee Handbook		None

**INDEPENDENCE**

<b>EMPLOYEE</b>	<b>vs.</b>	<b>INDEPENDENT CONTRACTOR</b>
Earn Salary/Pay		Negotiated Fee – not set
Must do work himself		Can hire or subcontract others
Company Business Card		Own Business Card
Provided company equipment/property, i.e., phone, computer, etc.		Owens their equipment
Timesheet		Invoices
Employer provides insurance		Provides own insurance
Application for Employment		None
W-4		W-9
Health Insurance, Paid Time Off, Holiday Pay, other benefits		Provides own benefits
Job Title		No company title
-----		Incorporated/dba
Hired/employed by copy		Contracts with company



**B. Train the company's managers, who work with the independent contractors on a daily basis**

- The manner in which company managers speak to the independent contractors, and their word choice, are key. For example, an independent contractor does not work *for* the company, but works *with* the company. Another example, the company does not hire the independent contractor, but contracts with the independent contractor. By way of further example, an independent contractor cannot be fired, but rather their contract can be terminated for breach of their agreement.
- Managers must be very familiar with the terms of the independent contractor agreement.
- Managers need to make sure their operations and day-to-day practices follow the terms of the independent contractor agreement.
- Managers must understand their role is not to supervise the independent contractors.
- Independent contractors must not be requested to perform services outside the scope of their contract.
- An independent contractor's sub-contractors or employees are not employees of the company and should not be addressed or treated as such.
- Managers should understand the distinction between training and orientation.
- When an independent contractor engagement ends, i.e. the contract is terminated, the managers must follow the termination provisions set forth in the agreement.
- Managers should be involved in making sure the company has the appropriate up-to-date documents for each independent contractor. Any changes to the terms of the relationship between the contractor and Company should result in an amended agreement.

### C. Self-audit

- Carefully look at every person deemed a contractor.
- Look at *actual* control exercised over the contractor. Consider speaking to the involved parties.
- Carefully review practical issues companies face which could affect independent contractor status. Some issues include:
  - Email access;
  - Signing in and out;
  - Company equipment (rent or provide to independent contractor);
  - Company business cards;
  - Uniforms;
  - Independent contractor has been contracting with the company for a long period of time;
  - Independent contractor does not work for other companies although *can* work for other companies;
  - Badges; and
  - Background screenings.
- Review current contractor agreements for each contractor.
- When counsel is involved there is the benefit of the attorney – client privilege.
- Review independent contractor documentation. Information maintained for independent contractors can include items such as business cards, federal EIN Number, copies of insurance certificates, signed independent contractor agreements and invoices.
- Review whether the company has a system in place to make sure insurance certificates are up to date and new contracts are negotiated at the end of an independent contractor's term.
- If a company remains unclear whether a worker is an employee or independent contractor, it can file Form SS-8

with the IRS, and the IRS will determine officially the worker's status. It can take at least six months to receive a determination.

- If self-audit reveals independent contractors are actually employees, companies can consider the IRS Voluntary Classification Settlement Program (VCSP), a relatively new program providing tax payers an opportunity to reclassify workers as employees for future tax periods for employment tax purposes should they agree to treat the individuals in question as employees.

#### **D. An audit notice arrived – steps to take:**

- The company attorney should make contact with the auditor investigator and arrange for any contact to be through their office.
- The production of documents requested should be coordinated through the attorney.
- Often times an audit can be triggered by an individual's complaint. Generally the individual's identity is not made known, but should it become known, or should the Company have a suspicion, it is imperative the Company does not do anything to "retaliate" against the employee. This scenario should be carefully addressed and analyzed between the Company and its attorney.
- The company attorney should conduct a mini review, random selection recommended, to assist in determining potential exposure.
- Ideal to arrange for the audit to occur outside the workplace to avoid interruption.
- Should the audit result in the investigator contacting employees, consider alerting employees with a carefully crafted script.
- Be prepared to take this up the agency chain of command especially if a difficult investigator is assigned.

- Prepare to litigate if necessary.

**E. Key provisions for independent contractor agreements**

- Relationship of the parties.
- Define the engagement/work to be performed.
- Termination of the agreement.
- Responsibilities of contractor.
- Payment terms.
- Contractor responsible for taxes.
- Not entitled to benefits.
- No guarantee of work.
- Ownership of work product/confidentiality (as applicable).
- Indemnification.

**F. Sample independent contractor agreement  
(See Appendix A)**

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**Independent Contractor Agreement**

**(agreement for drivers in the delivery industry)**

This Agreement made this \_\_\_ day of \_\_\_\_\_, 2012, by and between Packages to You, Inc., (herein "Company") and \_\_\_\_\_ (herein "Contractor") for the provision of services by Contractor to Company as described herein.

**WHEREAS**, Company is in the business of brokering delivery services, including pick up, transporting and delivery of letters, parcels, packages and other items on behalf of its customers; and

**WHEREAS**, Contractor offers his services to pick up, transport and deliver letters, parcels and packages and desires to do so for the customers of Company.

**NOW, THEREFORE**, parties hereto intend to be legally bound hereby agree as follows:

1. Company hereby engages the Contractor to provide the services as more specifically described in paragraph 2 hereof, on behalf of the customers of Company (hereinafter "Customers").

2. Contractor will provide the services of picking up, transporting and delivery of letters, parcels, packages and other miscellaneous items from, for and to Customers of Company. In carrying out his obligations under the Agreement, the Contractor reserves the right, at all times, to:

(a) Operate an agreed upon territory which he selects in performing services under this Agreement by himself and his contractors and/or employees.

(b) Select such time schedules and sequence as he deems best, provided the same comply with the needs and requirements of the Customers.

(c) Employ and/or contract any qualified person selected by him to operate his drivers motor vehicle(s) and/or work for him, of his own choice and selection, and to supervise, discipline, discharge, or otherwise deal with any such qualified person and to fix and establish rates of pay for such qualified persons.

(d) Contractor has and maintains the right to accept or decline any assignment presented to him by Company. Contractor understands he is solely responsible for determining, negotiating and setting his fee, hours and working conditions. He understands he is solely responsible for the direction and control of himself and his employees or contractors, if applicable. Contractor recognizes he has the potential to realize a profit or loss by providing services for Customers on behalf of and as may be requested by Company. Once Contractor accepts an assignment, he agrees to perform his services competently, in a prompt, efficient, safe and businesslike manner, and in the best interest of Company. Once Contractor accepts an assignment he agrees to complete it within the parameters set up for that assignment pursuant to the needs and requirements of Customers. However, this is not to be construed as anything other than for the purpose of maintaining applicable results and/or timeframes are met. In performing the services hereunder, Contractor acknowledges that he functions independently and nothing contained in this Agreement shall be interpreted or construed as creating or establishing the relationship of employer and employee between Company and Contractor or Company's Customers and Contractor.

3. In providing the services hereunder, Contractor may or may not use a motor vehicle or vehicles in the performance of services and may subcontract out the performance of services to be performed. In the event a Contractor subcontracts the services, the Contractor shall remain responsible and liable in all ways relating to the performance of the services contracted for under this Agreement.

4. In circumstances where Contractor employs the use of a motor vehicle or engages a subcontractor who uses a motor vehicle, the Contractor:

(a) Agrees that during the term of this Agreement he shall maintain service and keep his vehicles(s), in good repair, provide all gas, oil, maintenance parts, and equipment necessary and appropriate for the vehicle(s) competent and safe operation.

(b) Warrants that driver(s) furnished with such motor vehicle(s) is/are competent and qualified to operate said equipment, have a valid driver's license, and meet(s) all of the requirements of all applicable laws, rules and regulations.

(c) Contractor has and agrees to maintain in force, motor vehicle insurance no less than \$100,000, with an aggregate of \$300,000 and shall, provide proof of such current insurance to Company, and as applicable provide such coverage for his employees or require such coverage of his contractors.

(d) Contractor warrants that motor vehicles used by it or its subcontractors meet all the requirements, if and as applicable, of all applicable governmental agencies, including any and all state regulatory agency regulations which may apply to the subject transportation.

5. Contractor shall be solely responsible for the payment of his and all employees and/or contractors, wages, social security, federal, state and local taxes, and any and all other forms of taxes and related benefits, if any, including sole responsibility for insurance in event of injury.

6. Contractor expressly understands and agrees that the Company will provide no benefits of any nature whatsoever to Contractor. Without limiting the generality of the foregoing, Contractor expressly understands and agrees that the Company will not provide him any health insurance, pension benefits, paid vacation, holidays or sick leave, disability insurance, workers' compensation insurance, unemployment compensation, stock options or any other benefit that may be made available to Company's employees from time to time.

7. Contractor shall be responsible for all costs and expenses incurred by Contractor in the performance of services of this Agreement. Contractor agrees to pay for all tools, parking, fines, etc., incurred in the performance of the services hereunder.

8. The compensation to be paid to Contractor shall be as negotiated between Company and Contractor and as set forth in Schedule "A" attached hereto, which amount shall constitute full and complete payment by Company for all services provided by Contractor. Contractor agrees to submit weekly invoices to Company.

9. Contractor understands and agrees Company's Customers may require certain background checks of Contractor for security precaution. Contractor acknowledges consenting to submit to such background check and



permitting Company to disclose results to Customers as requested is a requirements under this Agreement.

10. Contractor understands and agrees that Company does not guarantee work will be available during the term of the Agreement, and when work is not available, there will be no payment or any form of compensation made by Company to Contractor. Likewise, Contractor reserves the right to provide services for other companies.

11. Contractor hereby agrees to indemnify, defend, save and hold harmless Company and its respective officers, directors, employees, agents, shareholders, heirs, successors and assigns (collectively, the "Indemnified Party") from and against, and to reimburse the Indemnified Party with respect to, any and all claims, demands, causes of action, losses, damages, liabilities, costs and expenses (including reasonable attorneys' fees and expenses, court costs, and costs of appeals) asserted by third parties or otherwise, for any claims and/or causes of action of whatsoever nature against or incurred by the Indemnified Party by reason of or arising out of the services rendered by Contractor or his employees and contractors, including but not limited to abandonment, damage to property, missing property and personal injury or death to any person, including Contractor and/or Contractor's employees and contractors, regardless of whether or not the Indemnified Party is alleged to be at fault or is alleged to have contributed to the alleged wrong doing in any way. Indemnified Party shall give Contractor prompt notice, in writing, of any such claim, demand, cause of action, loss, damage liability cost and expense. Indemnified Party shall also permit Contractor, through Contractor's counsel to defend the same under his full control and give Contractor all information, assistance and authority, to enable him to do so. Insurance coverage be maintained by Contractor is not intended to and shall not in any manner limit qualify the liabilities and obligations otherwise assumed by Contractor pursuant to this Agreement.

12. The parties agree that the Contractor is an independent contractor and not the agent or employee of Company for any purpose including for federal, state, or local employment or income tax purposes. Contractor shall assume full responsibility for the filing and payment of all federal, state, and local taxes or contributions imposed or required under unemployment insurance, social security, and income tax laws with respect to the services of Contractor. Specifically, Contractor expressly understands and agrees that the Company

will not make any deductions whatsoever from amounts due to Contractor pursuant to this Agreement for federal, state or local taxes, FICA, FUTA, state unemployment tax or any other tax, withholding or payment obligation. Contractor represents and warrants to the Company that he has complied and hereafter will comply with all applicable income and other tax laws of any federal, state or local government authority. Contractor further represents and warrants to the Company that he will indemnify and hold the Company harmless for any damage, loss, cost and expense, including reasonable attorney's fees, arising from his breach of the foregoing.

13. This Agreement shall continue in full force and effect for an initial term of one year from the effective date of this Agreement. This Agreement shall automatically renew for successive terms of one month after expiration of the initial term unless Contractor or Company provides the other party notice of termination or parties enter into another independent contractor agreement. At any time, this Agreement is terminable by either party upon seven (7) calendar days' notice. This Agreement may also be terminated immediately in the event (i) the Contractor's vehicle is permanently unavailable for operation, (ii) the Contractor participates in harassing or discriminatory conduct that violates the rights of employees or contractors of Company or its Customers or other third party, or (iii) the Contractor participates in conduct not in the best interest of Company or its Customers, or engages in any dishonest act, as determined by the Company.

14. Contractor hereby consents and agrees that any action or proceeding against him may be commenced and maintained in any court within the Commonwealth of Pennsylvania or in the United States District Court for any District of Pennsylvania by service of process on him and that the courts of the Commonwealth of Pennsylvania and the United States District Court for any District of Pennsylvania shall have jurisdiction with respect to the subject matter hereof and the Contractor. Contractor acknowledges and agrees that any suit, action or proceeding, whether claim or counterclaim, is brought or instituted by Contractor, on or with respect this Agreement or any other agreement or the dealings of the parties with respect hereto, or thereto, that Contractor waives the right to trial by jury.

15. The parties agree that this Agreement constitutes the entire agreement with respect to this subject matter and may not be changed except in writing, signed by both parties.

16. Failure of any party to this Agreement at any time or times hereafter to require strict performance by the other party of any of the provisions, terms or conditions contained in this Agreement shall not waive, affect, or diminish any right of any party at any time or times thereafter to demand strict performance therewith, and with respect to any other provisions, terms or conditions contained in this Agreement.

17. The words "it," "he," "his," or "him" when used herein with reference to Contractor shall refer to Contractor irrespective of the gender of Contractor, and irrespective of whether Contractor is a proprietor, partner, or a corporation.

18. This Agreement shall be governed by the internal laws of the Commonwealth of Pennsylvania.

19. This Agreement may not be assigned by the Contractor.

20. This Agreement may be signed and is enforceable by electronic signature and facsimile.

**PACKAGES TO YOU, INC.**

\_\_\_\_\_  
(Name, Title)

\_\_\_\_\_  
Date

**INDEPENDENT CONTRACTOR**

\_\_\_\_\_  
(Signature of Contractor)

\_\_\_\_\_  
Date

\_\_\_\_\_  
(Print Name of Contractor)