

CODORUS VALLEY BANCORP INC
Form DEF 14A
April 06, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

SCHEDULE 14A

**Proxy Statement Pursuant to Section 14(a) of the Securities
Exchange Act of 1934 (Amendment No.)**

Filed by the Registrant
Filed by a Party other than the Registrant
Check the appropriate box:

Preliminary Proxy Statement
Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
Definitive Proxy Statement
Definitive Additional Materials
Soliciting Material Pursuant to § 240.14a-12

Codorus Valley Bancorp, Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the
Registrant)

Payment of Filing Fee (Check the appropriate box):

No fee required
Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

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- 2) Form, Schedule or Registration Statement No.:

- 3) Filing Party:

- 4) Date Filed:

April 6, 2018

Dear Fellow Shareholders of Codorus Valley Bancorp, Inc.:

On behalf of the Corporation's Board of Directors, I am pleased to invite you to attend Codorus Valley Bancorp, Inc.'s Annual Meeting of Shareholders to be held on Tuesday, May 15, 2018, at 9:00 a.m., prevailing time. The location of the Annual Meeting is the Codorus Valley Corporate Center, 105 Leader Heights Road, York, Pennsylvania 17403. At the Annual Meeting, you will have the opportunity to ask questions and to make comments. Enclosed with the Proxy Statement and Notice of Meeting is a proxy card and the Corporation's 2017 Annual Report to Shareholders on Form 10-K.

The principal business of the meeting is:

To elect three Class A directors, each to serve for a term of three years and until their successors are elected and qualified;

To approve an advisory, non-binding resolution regarding executive compensation;

To amend the Codorus Valley Bancorp, Inc.'s Articles of Incorporation to increase the aggregate number of shares of the Corporation's common stock that the Corporation may issue from 15 million to 30 million;

To ratify the appointment of BDO USA, LLP as Codorus Valley Bancorp, Inc.'s Independent Registered Public Accounting Firm for the fiscal year ending December 31, 2018; and

To transact any other business that is properly presented at the Annual Meeting.

The Notice of Meeting and Proxy Statement accompanying this letter describe the specific business to be acted upon in more detail.

I am delighted that you have invested in Codorus Valley Bancorp, Inc., and I hope that, whether or not you plan to attend the Annual Meeting, you will vote as soon as possible, either electronically through the Internet, by telephone or by following the instructions on the enclosed proxy card and returning the proxy in the envelope provided. The prompt return of your proxy will save the Corporation expenses involved in further communications, and will ensure your representation at the Annual Meeting if you do not attend in person.

We continue to evaluate the benefits of moving toward the electronic delivery of proxy materials in the future. If you would be strongly opposed to receiving proxy materials via the Internet, please let us know. We appreciate your feedback.

Thank you for your continued support and I look forward to seeing you on May 15, 2018.

Sincerely,

Larry J. Miller

Chairman, President and Chief Executive Officer

CODORUS VALLEY BANCORP, INC.

NASDAQ TRADING SYMBOL: CVLY

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

AND

PROXY STATEMENT

2018

www.peoplesbanknet.com

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PROXY STATEMENT

Dated and to be mailed on or about April 6, 2018

Codorus Valley Bancorp, Inc.

Codorus Valley Corporate Center

105 Leader Heights Road

York, Pennsylvania 17403

ANNUAL MEETING OF SHAREHOLDERS

TO BE HELD ON MAY 15, 2018

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CODORUS VALLEY BANCORP, INC.

CODORUS VALLEY CORPORATE CENTER

105 LEADER HEIGHTS ROAD

YORK, PENNSYLVANIA 17403

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

TO BE HELD ON MAY 15, 2018

TO THE SHAREHOLDERS OF CODORUS VALLEY BANCORP, INC.:

NOTICE IS HEREBY GIVEN that the Annual Meeting of the Shareholders of Codorus Valley Bancorp, Inc. will be held at the Codorus Valley Corporate Center, 105 Leader Heights Road, York, Pennsylvania, on Tuesday, May 15, 2018, at 9:00 a.m., prevailing time, for the purpose of considering and voting upon the following matters:

1. To elect three Class A directors, each to serve for a three-year term and until their successors are elected and qualified;
2. To approve an advisory, non-binding resolution regarding executive compensation;
3. To amend the Codorus Valley Bancorp, Inc.'s Articles of Incorporation to increase the aggregate number of shares of the Corporation's common stock that the Corporation may issue from 15 million to 30 million;
4. To ratify the appointment of BDO USA, LLP as Codorus Valley Bancorp, Inc.'s Independent Registered Public Accounting Firm for the fiscal year ending December 31, 2018; and
5. To transact such other business as may properly come before the meeting and any adjournment or postponement thereof.

Only those shareholders of record at the close of business on February 28, 2018, are entitled to notice of and to vote at the meeting. Please vote as soon as possible, either electronically through the Internet, by telephone or by following

the instructions on the enclosed proxy card and returning the proxy in the envelope provided. Your proxy is revocable at any time by voting again through the Internet or by telephone, or by delivering notice of revocation or a later dated proxy to the Secretary of the Corporation before the vote at the meeting.

Your vote is important and voting electronically through the Internet, by telephone or by written proxy, will ensure your representation at the Annual Meeting if you do not attend in person.

We enclose with this Notice of Annual Meeting and Proxy Statement a proxy card (with voting instructions) and a copy of the Corporation's 2017 Annual Report on Form 10-K.

BY ORDER OF THE BOARD OF DIRECTORS

Timothy J. Nieman, Esq.
Secretary

York, Pennsylvania

April 6, 2018

YOUR VOTE IS IMPORTANT. PLEASE VOTE PROMPTLY, EITHER ELECTRONICALLY THROUGH THE INTERNET, BY TELEPHONE, OR BY COMPLETING, SIGNING AND RETURNING YOUR PROXY CARD.

Important Notice Regarding the Availability of Proxy Materials for the Shareholder Meeting to Be Held on May 15, 2018. This Notice of Annual Meeting and Proxy Statement, proxy card and 2017 Annual Report are available at: www.proxyvote.com.

GENERAL

Introduction

This Proxy Statement is furnished in connection with the solicitation of proxies by the Board of Directors (the “Board”) of Codorus Valley Bancorp, Inc. (the “Corporation”) to be used at the 2018 Annual Meeting of Shareholders. This Proxy Statement and the related proxy card are being first distributed to shareholders on or about April 6, 2018.

The Corporation will bear the expense of soliciting proxies. In addition to the use of the mail, the directors, officers and employees of the Corporation and its subsidiaries may, without additional compensation, solicit proxies in person or by telephone, e-mail, Internet or facsimile.

The Annual Meeting of Shareholders will be held on Tuesday, May 15, 2018, at 9:00 a.m. at the Codorus Valley Corporate Center, 105 Leader Heights Road, York, Pennsylvania. Shareholders of record at the close of business on February 28, 2018, are entitled to vote at the meeting.

At the Annual Meeting, shareholders will vote:

To elect three Class A directors, each to serve for a three-year term and until their successors are elected and qualified;

To approve an advisory, non-binding resolution regarding executive compensation;

To amend the Corporation’s Articles of Incorporation to increase the aggregate number of shares of the Corporation’s common stock which the Corporation may issue from 15 million to 30 million;

To ratify the appointment of BDO USA, LLP as the Corporation’s Independent Registered Public Accounting Firm for the fiscal year ending December 31, 2018; and

To transact any other business that may properly come before the meeting and any adjournment or postponement of the meeting.

In addition, the Corporation may ask shareholders to approve the minutes of the prior shareholders’ meeting. However, approval of such minutes is an administrative action and does not constitute approval of, or a vote for, any of the matters set forth in the minutes.

Proxies and Voting Procedures

You can vote your shares by completing and returning a written proxy card. You can also vote in person at the meeting. Alternatively, you may vote by telephone or electronically through the Internet by following the instructions on the proxy card. Submitting your voting instructions through one of these methods will not affect your right to attend the meeting and will not limit your right to vote at the annual meeting if you later decide to attend in person.

If your shares are held in a brokerage account or by a bank or other nominee, you are considered the beneficial owner of shares held in street name, and these proxy materials are being forwarded to you by your broker or nominee, who is considered, with respect to those shares, the shareholder of record. As the beneficial owner, you may have the right to direct your broker or nominee how to vote, and you are also invited to attend the meeting. However, because you are not the shareholder of record, you may not vote your street-name shares in person at the meeting unless you obtain a proxy executed in your favor from the holder of record. Please contact your broker or nominee for a voting instruction card for you to use in directing the broker or nominee how to vote your shares. **Please note that brokers or nominees may not cast a vote on your behalf for the election of directors or on any other matter that is not routine without instruction from you.**

By properly completing a proxy, you appoint Cindy L. Baugher, Jann Allen Weaver and Wanda Waugh as proxy holders to vote your shares as indicated on the proxy card. Any signed proxy card not specifying to the contrary will be voted FOR election of the director nominees identified in this Proxy Statement, FOR approval of

the advisory, non-binding resolution regarding executive compensation, FOR approval of amending the Corporation's Articles of Incorporation to increase the aggregate number of shares of the Corporation's common stock which the Corporation may issue from 15 million to 30 million and FOR ratification of BDO USA, LLP as the Corporation's independent registered public accounting firm for the fiscal year ending December 31, 2018.

You may revoke a previously delivered proxy by delivering written notice of revocation to Timothy J. Nieman, Esq., Secretary of the Corporation, or by executing a later dated proxy and giving written notice of the revocation to Mr. Nieman at any time before the proxy is voted at the Annual Meeting. If you submitted your proxy by Internet or by telephone, you can vote again by voting over the Internet or by telephone. We will honor the latest vote received. Proxy holders will vote shares represented by written proxies, if properly signed and returned to the Secretary, in accordance with instructions of the shareholders.

If you are a participant in the Codorus Valley Bancorp, Inc. Dividend Reinvestment and Stock Purchase Plan, the enclosed proxy will serve as a voting instruction card for your shares held in the Plan. Equiniti Trust Company, the Plan administrator, will vote your shares held in the Dividend Reinvestment and Stock Purchase Plan in the same manner as you indicate on your proxy card.

At the close of business on February 28, 2018, the record date for the Annual Meeting, the Corporation had 8,913,098 shares of common stock, par value \$2.50 per share, issued and outstanding. Each share is entitled to one vote on all matters submitted to a vote of the shareholders.

Quorum

A majority of the outstanding shares of common stock, represented in person or by proxy, constitutes a quorum for the conduct of business at the Annual Meeting. Under Pennsylvania law and the Corporation's Bylaws, the presence of a quorum is required for each matter to be acted upon at the meeting. Votes withheld and abstentions, while not votes cast, will be counted as present for purposes of determining the presence of a quorum. Shares of common stock represented by "broker non-votes" (i.e., shares of common stock held in record name by brokers or nominees as to which (i) instructions have not been received from the beneficial owners or persons entitled to vote, (ii) the broker or nominee does not have discretionary voting power under applicable rules of the New York Stock Exchange or the instrument under which it serves in such capacity, or (iii) the record holder has indicated on the proxy or otherwise notified the Corporation that it does not have authority to vote such shares on that matter) will be counted as present for purposes of determining the presence of a quorum only if such shares have been voted at the meeting on a matter other than a procedural motion.

Required Vote

In the case of the election of directors, the three nominees receiving the highest number of votes shall be elected. A “Withhold” vote will have the effect of a vote against the election of the nominee. Abstentions and broker non-votes will have no effect on the election of directors.

Approval of each of the other proposals identified in this Proxy Statement requires the affirmative vote of a majority of the votes cast at the meeting, in person or by proxy. Abstentions and broker non-votes that are counted only for purposes of determining a quorum will have the effect of a vote against each of these other proposals.

Although the Board knows of no other business to be presented at the Annual Meeting, in the event that any other matters are properly brought before the meeting, any proxy given pursuant to this solicitation will be voted in accordance with the instructions of the Board as permitted by Securities and Exchange Commission (SEC) Rule 14a-4(c).

Cautionary Statement Regarding Forward-Looking Statements

This Proxy Statement and the documents that have been incorporated herein by reference may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. In some cases, these statements can be identified

by the use of words such as “anticipate,” “believe,” “can,” “could,” “estimate,” “expect,” “intend,” “may,” “plan,” “potential,” “should,” “target,” “will,” “would” and similar expressions. Actual results and trends could differ materially from those set forth in such statements due to various risks, uncertainties and other factors. Such risks, uncertainties and other factors that could cause actual results and experience to differ from those projected include, but are not limited to, the following: ineffectiveness of our business strategy due to changes in current or future market conditions; the effects of competition, and of changes in laws and regulations, including industry consolidation and development of competing financial products and services; interest rate movements; changes in credit quality; inability to achieve merger-related synergies; difficulties in integrating distinct business operations, including information technology difficulties; volatilities in the securities markets; and deteriorating economic conditions, and other risks and uncertainties, including those detailed in our filings with the SEC.

Although forward-looking statements help provide additional information about us, investors should keep in mind that forward-looking statements are only predictions, at a point in time, and are inherently less reliable than historical information. You are urged not to place undue reliance on these forward-looking statements, which speak only as of the date of this Proxy Statement. We assume no obligation to update any forward-looking statement in order to reflect any event or circumstance that may arise after the date of this Proxy Statement, other than as may be required by applicable law or regulation.

GOVERNANCE OF THE CORPORATION

Our Board of Directors believes that the purpose of corporate governance is to maximize long-term shareholder value in a manner consistent with applicable law and with the highest standards of integrity. The Board adheres to corporate governance practices that the Board and management believe promote this purpose, are sound and represent best practices. We continually review these governance practices against changes in applicable federal and Pennsylvania (the state in which we are incorporated) law, the rules and listing standards of the NASDAQ Stock Market, and the rules and regulations of the SEC, as well as best practices suggested by recognized governance authorities.

Director Independence

Currently, our Corporate Board of Directors has eight (8) members. The Board has determined that the following seven (7) directors are independent in accordance with the independence standards of the NASDAQ Stock Market: Harry R. Swift, Esq., Lead Director; Brian D. Brunner; Cynthia A. Dotzel, CPA; John W. Giambalvo, Esq.; Jeffrey R. Hines, P.E.; MacGregor S. Jones; and Dallas L. Smith.

In determining the directors' independence, in addition to matters disclosed under "Related Person Transactions", the Board of Directors considered each director's beneficial ownership of Corporation common stock and loan transactions between the Corporation's wholly-owned bank subsidiary, PeoplesBank, a Codorus Valley Company (the "Bank"), and the directors, their family members and businesses with whom they are associated, as well as any contributions made by the Bank to non-profit organizations with whom such persons are associated. In each case, the Board determined that none of the transactions above impaired the independence of the director.

Board Structure

The Corporation's senior leadership is currently shared between the Board's Chairman, President and Chief Executive Officer and the Board's Vice Chairman and Lead Director.

The Board believes that Mr. Miller's service as President and Chief Executive Officer of the Bank from 1981 to 2016 and the Corporation since its incorporation in 1986 uniquely qualifies him for this role, and that the addition of several key members to the Corporation's executive management team in recent years allows Mr. Miller the time necessary to perform the additional duties of Chairman. The Board of Directors also believes that Mr. Miller's leadership of the Corporation over the last thirty years, together with his knowledge of the current business and regulatory environment, will ensure that management is aligned with the Board and positioned to effectively implement the business strategy endorsed by the Board.

Our Chairman is currently responsible for ensuring the smooth functioning and efficient operation of our Board by guiding the processes of our Board, presiding at Board meetings and at shareholder meetings, and acting as a liaison between our Board and our management team. In this regard, our Chairman consults regularly with our executives over business matters and provides our executives with consultation and advice on matters that require prompt attention.

The Corporation has designated Harry R. Swift, Esq., as the independent Lead Director. As Lead Director, Mr. Swift presides at any Board meeting at which the Chairman is not present, including executive sessions of the independent directors; serves as a liaison between the Chairman and the independent directors; reviews and consults with the Chairman regarding meeting agendas and meeting schedules of the Board; has the authority to call meetings of the independent directors; receives and responds directly to shareholder and other stakeholder questions and comments that are directed to the Lead Director or to the independent directors as a group; assists with the identification and recommendation of Board candidates; serves as a member of the Corporate Governance and Nominating Committee; and serves as a member of the Compensation Committee and participates in its evaluation and discussion of the Corporation's Chief Executive Officer's performance with the Chief Executive Officer.

Moreover, on at least a semi-annual basis, when the independent directors meet in executive session, without the presence of management, the independent directors meet under the leadership of the independent Lead Director.

Meetings and Committees of the Board of Directors

The Board of Directors of Codorus Valley Bancorp, Inc. met fourteen (14) times during 2017. During 2017, all directors attended at least 75% of the meetings of the Board of Directors and of the various committees on which they served. While the Corporation has no formal policy in place, directors are strongly encouraged to attend the Annual Meeting of Shareholders. All of our then serving directors attended the 2017 Annual Meeting of Shareholders with the exception of Mr. Swift, and we anticipate that all directors will attend this year's meeting.

The Board of Directors of the Corporation has a standing Audit Committee, Compensation Committee, Corporate Governance and Nominating Committee and Enterprise Risk Management Committee, each of which is described below.

Audit Committee. The Audit Committee of the Board of Directors is comprised solely of directors who meet the applicable standards for independence of audit committee members of the NASDAQ Stock Market and possess the requisite knowledge or experience to serve on the Audit Committee. The current members of the Audit Committee are: Cynthia A. Dotzel, CPA (Chair); Jeffrey R. Hines, P.E. (Vice Chair); John W. Giambalvo, Esq.; and Dallas L.

Smith. The Audit Committee met four (4) times during 2017.

The principal duties of the Audit Committee, as set forth in its charter, include reviewing significant audit and accounting principles, policies and practices, reviewing performance of internal auditing procedures and recommending to the Board the engagement of the Corporation's independent registered public accounting firm. The Audit Committee has the authority to engage legal counsel or other experts or consultants as it deems appropriate to carry out its responsibilities.

Cynthia A. Dotzel, CPA, Chair of the Committee, has been designated by the Board as the Audit Committee financial expert. In designating Ms. Dotzel as the Audit Committee financial expert, the Board considered her more than 35 years' experience as a practicing certified public accountant, and her prior audit committee experience. Furthermore, the Board of Directors believes that each Audit Committee member has sufficient knowledge in financial and auditing matters to serve on the committee.

The Audit Committee operates under a written charter, which is available on the Corporation's website at www.peoplesbanknet.com. Click on the "Investor Relations" link at the bottom of the home page, click on "Governance Documents" in the right-hand margin, and then click on the "Audit Committee Charter" link.

Compensation Committee. All members of the Compensation Committee are independent under applicable independence standards of the NASDAQ Stock Market. The current members of the Compensation

Committee are: Jeffrey R. Hines, P.E. (Chair); John W. Giambalvo, Esq. (Vice Chair); Brian D. Brunner; Cynthia A. Dotzel, CPA; MacGregor S. Jones; Dallas L. Smith; and Harry R. Swift, Esq. The Compensation Committee met eight (8) times during 2017.

The principal duties of the Compensation Committee include evaluating and recommending to the Board compensation plans, policies, and programs for the executive officers of the Corporation and its subsidiaries. The Compensation Committee may delegate any of its responsibilities to a subcommittee comprised of three or more members of the committee.

The Compensation Committee's processes and procedures for consideration and determination of executive compensation are described below in the section titled "Compensation Discussion and Analysis" entitled "Role of the Compensation Committee, Management and Compensation Consultant in the Executive Compensation Process."

The Compensation Committee operates pursuant to a written charter, which is available on the Corporation's website at www.peoplesbanknet.com. Click on the "Investor Relations" link at the bottom of the home page, click on "Governance Documents" in the right-hand margin, and then click on the "Compensation Committee Charter" link. The Committee has the authority under its charter to select, retain and terminate counsel, consultants and other experts. For information concerning Meridian Compensation Partners, LLC, the compensation consultant currently retained by the committee, see the section of "Compensation Discussion and Analysis" entitled "Role of the Compensation Consultant."

Corporate Governance and Nominating Committee. All members of the Corporate Governance and Nominating Committee are independent under applicable independence standards of the NASDAQ Stock Market. The current members of the Corporate Governance and Nominating Committee are: Jeffrey R. Hines, P.E. (Chair); Harry R. Swift, Esq. (Vice Chair); Brian D. Brunner; Cynthia A. Dotzel, CPA; John W. Giambalvo, Esq.; MacGregor S. Jones; and Dallas L. Smith. The Corporate Governance and Nominating Committee met two (2) times during 2017.

The principal duties of the Corporate Governance and Nominating Committee include developing and recommending to the Board criteria for selecting qualified director candidates, identifying individuals qualified to become Board members, evaluating and selecting, or recommending to the Board, director nominees for each election of directors, considering committee member qualifications, appointment and removal, recommending codes of conduct and codes of ethics applicable to the Corporation and providing oversight in the evaluation of the Board and each committee.

The Corporate Governance and Nominating Committee operates pursuant to a written charter, which is available on the Corporation's website at www.peoplesbanknet.com. Click on the "Investor Relations" link at the bottom of the home page, click on "Governance Documents" in the right-hand margin, and then click on the "Corporate Governance and

Nominating Committee Charter” link.

Role of the Board in Risk Oversight

The Board of Directors is responsible for oversight of the various risks facing the Corporation. In this regard, the Board seeks to understand and oversee the most critical risks relating to the Corporation’s business, to allocate responsibilities for the oversight of risks among the full Board and its committees, and to see that management has in place effective systems and processes for managing risks facing the Corporation. Overseeing risk is an ongoing process, and risk is inherently tied to strategy and to strategic decisions. Accordingly, the Board considers risk throughout the year and with respect to specific proposed actions. While the Board oversees risk, management is charged with identifying and managing risk within the risk appetites set by the Board.

The Board implements its risk oversight function both as a whole and through delegation to various committees. These committees meet regularly and report back to the full Board. The following committees play particularly significant roles in carrying out the risk oversight function.

The Enterprise Risk Management Committee: The Enterprise Risk Management Committee operates pursuant to a written charter, and provides general risk oversight and is generally responsible for risk management, which includes monitoring and ensuring that credit risk, interest rate risk, liquidity risk, price risk, transaction risk, compliance risk, strategic risk and reputation risk assumed by the Corporation is consistent with the levels established by the Board.

The committee is comprised of the Chief Risk Officer (Chair), Executive Chairman of the Bank, President and Chief Executive Officer of the Bank, General Counsel, Chief Financial Officer, Chief Credit Officer, BSA and Security Officer, and Loan Review Officer, as well as representatives from the Board of Directors (currently MacGregor S. Jones and Harry R. Swift, Esq.). The Enterprise Risk Management Committee met six (6) times during 2017. The Enterprise Risk Management Committee takes minutes at each of its meetings, and those minutes are reviewed and accepted by the Board of Directors.

The Compensation Committee: The Compensation Committee evaluates the risks and rewards associated with the Corporation's compensation philosophy and programs.

The Audit Committee: The Audit Committee oversees the Corporation's processes for assessing risks and the effectiveness of the Corporation's system of internal controls. In performing this function, the Audit Committee considers information from the Corporation's independent registered public accounting firm, internal auditors, and other consultants as it determines appropriate, and discusses relevant issues with management and the independent registered public accounting firm.

Director Nomination Process

The Corporate Governance and Nominating Committee is responsible for identifying and evaluating individuals qualified to become members of the Board of Directors and to recommend such individuals to the Board of Directors for consideration and nomination. The Corporate Governance and Nominating Committee and the Board of Directors endeavor to recruit and retain Board members who demonstrate intellectual capacity, strong interpersonal skills, good business instinct, objectivity and the highest level of personal and professional integrity. When evaluating current members of the Board of Directors and prospective candidates for the Board of Directors, the Committee seeks to balance the skill sets and attributes of existing Board members with the need for other complementary skills, talents and qualities that will position the Corporation to successfully implement its strategic vision.

In addition to requiring that each existing director and candidate for nomination possesses unquestionable character and a commitment to contribute to the success of the Corporation and the stewardship of the community, the Corporate Governance and Nominating Committee's evaluation of director candidates includes an assessment of issues and factors regarding the individual's education, business experience, accounting and financial expertise, age, diversity, reputation, civic and community relationships and knowledge and experience in matters that impact diversified community financial institutions. The Committee will also take into account the director candidate's ability

to devote adequate time to corporate matters, including being prepared for, and participating in, all meetings of the Board of Directors and any committees to which he or she may be assigned. When the Corporate Governance and Nominating Committee is considering current members of the Board of Directors for nomination for reelection, the Committee considers prior performance, as well as meeting attendance records.

The current practice of the Corporate Governance and Nominating Committee is to identify potential director candidates through a variety of sources. The Committee considers recommendations made by current or former directors or members of management. Potential candidates may also be identified through contacts in the business, civic, academic, legal and non-profit communities served by the Corporation. The Chair of the Corporate Governance and Nominating Committee determines how best to approach director candidates regarding a potential nomination.

Regarding new director candidates, the Corporate Governance and Nominating Committee will evaluate whether the nominee is independent, as independence is defined under applicable standards of the NASDAQ Stock Market, and whether the nominee meets the qualifications for directors outlined above, as well as any special qualifications applicable to membership on any committee to which the nominee may be appointed to serve if

elected. A majority of the Board of Directors must meet the criteria for “independence” established by the NASDAQ Stock Market, and the Committee will consider any conflicts of interest that might impair that independence prior to making a decision.

The Corporate Governance and Nominating Committee will consider recommendations received from Corporation shareholders. Shareholders may recommend qualified director candidates by writing to:

Timothy J. Nieman, Esq.

Corporate Secretary

Codorus Valley Bancorp, Inc.

P.O. Box 2887

York, PA 17405-2887

Submissions must include information regarding a candidate’s citizenship, age, background, business and personal addresses, qualifications, experience, principal occupation or employment, directorships and other positions held by the candidate in business, charitable and community organizations and his/her willingness to serve as a member of the Board of Directors. Based on a preliminary assessment of the candidate’s qualifications, the Corporate Governance and Nominating Committee may conduct interviews with, and request additional information from, the candidate.

The Board does not have a formal policy for considering director candidates recommended by shareholders due to the infrequency of nominations, but its policy is to give due consideration to any and all candidates and there are no differences in how the Corporate Governance and Nominating Committee evaluates a candidate for director based on whether the candidate is recommended by the Committee or by a shareholder.

Nomination of Directors

Article 10, Section 10.1 of the Corporation’s Bylaws requires that nominations for election as a director be made pursuant to timely notice in writing to the Secretary. To be timely, a shareholder’s notice must be delivered to or received at the principal executive office of the Corporation not less than 90 days prior to the one year anniversary date of the preceding meeting of shareholders called to elect directors. The notice must provide the specific information required by Section 10.1 of the Bylaws. The Board is required to determine whether nominations have

been made in accordance with the requirements of the Bylaws. If the Board determines that a nomination was not made in accordance with the Bylaws, the shareholder may be given an opportunity to cure any deficiency in accordance with the Bylaws.

You may obtain a copy of the Corporation's Bylaws by writing to Timothy J. Nieman, Esq., Corporate Secretary, Codorus Valley Bancorp, Inc., P.O. Box 2887, York, PA 17405-2887. Additionally, a copy of the Corporation's current Bylaws has been filed with the SEC as Exhibit 3.1 to Form 8-K filed January 12, 2016.

Deadline for Submission of Shareholder Proposals

In order for a shareholder to include a proposal in the Corporation's Proxy Statement for presentation at the 2019 Annual Meeting of Shareholders, the proposal must be received by the Corporation at its principal executive offices c/o Timothy J. Nieman, Esq., Corporate Secretary, Codorus Valley Bancorp, Inc., P.O. Box 2887, York, PA 17405-2887, no later than December 7, 2018. Any such proposal must comply with Rule 14a-8 of Regulation 14A of the proxy rules of the SEC. If a shareholder proposal is submitted to the Corporation after December 7, 2018, it will not be included in the Corporation's 2019 Proxy Statement.

For any proposal that is not submitted for inclusion in next year's proxy statement (as described in the preceding paragraph), but is instead sought to be presented directly at the next Annual Meeting, the Corporation's Bylaws require shareholders to give advance notice of such proposals. The required notice, which must include the information and documents set forth in Section 2.6(b) of the Bylaws, must be given not less than 120 days prior to the first anniversary of the date of the Corporation's proxy statement released to shareholders in connection with the preceding year's Annual Meeting. If notice is not received by the Corporation within this timeframe, the

Corporation will consider such notice untimely. Under Rule 14a-4(c)(1) of the Securities Exchange Act of 1934, as amended, if any shareholder proposal intended to be presented at the Annual Meeting without inclusion in our proxy statement is received within the required timeframe and is properly presented, then a proxy will have the ability to confer discretionary authority to vote on the proposal.

Communicating with Directors

The Board of Directors has established a process for shareholders and other interested parties to communicate directly with the Chairman of the Board of Directors or its independent directors, individually, or the Board of Directors, collectively, by submitting written correspondence to the following address:

Chairman of the Board of Directors (or name of individual, independent director)

c/o Timothy J. Nieman, Esq.

Corporate Secretary

Codorus Valley Bancorp, Inc.

Any notice, demand, request, report or proxy material required or permitted to be given or made to record holders of common units under our partnership agreement will be delivered to the record holder by us or by the transfer agent.

Status as Limited Partner

By the transfer of common units in accordance with our partnership agreement, each transferee of common units shall be admitted as a limited partner with respect to the common units transferred when such transfer and admission is reflected in our books and records. Except as described under Limited Liability, the common units will be fully paid, and unitholders will not be required to make additional contributions.

Non-Citizen Assignees; Redemption

If we are or become subject to federal, state or local laws or regulations that, in the reasonable determination of our general partner, create a substantial risk of cancellation or forfeiture of any property that we have an interest in because of the nationality, citizenship or other related status of any limited partner, we may redeem the

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units held by the limited partner at their current market price. In order to avoid any cancellation or forfeiture, our general partner may require each limited partner to furnish information about his nationality, citizenship or related status. If a limited partner fails to furnish information about his nationality, citizenship or other related status within 30 days after a request for the information or our general partner determines after receipt of the information that the limited partner is not an eligible citizen, the limited partner may be treated as a non-citizen assignee. A non-citizen assignee, is entitled to an interest equivalent to that of a limited partner for the right to share in allocations and distributions from us, including liquidating distributions. A non-citizen assignee does not have the right to direct the voting of his units and may not receive distributions in kind upon our liquidation.

Indemnification

Under our partnership agreement, we will indemnify the following persons (each, an Indemnitee), to the fullest extent permitted by law but subject to limitations in our partnership agreement, from and against all losses, claims, damages, liabilities, joint or several, expenses (including legal fees and expenses), judgments, fines, penalties, interest, settlements or other amounts arising from any and all claims, demands, actions, suits or proceedings, whether civil, criminal, administrative or investigative in which the Indemnitee may be involved, or is threatened to be involved, as a party or otherwise, by reason of its status as an Indemnitee:

our general partner;

any departing general partner;

any person who is or was an affiliate of a general partner or any departing general partner;

any person who is or was a director, officer, member, partner, fiduciary or trustee of any entity set forth in the preceding three bullet points;

any person who is or was serving as director, officer, member, partner, fiduciary or trustee of another person at the request of our general partner or any departing general partner; and

any person designated by our general partner;

provided, that we will not indemnify an Indemnitee if there has been a final and non-appealable judgment entered by a court of competent jurisdiction determining that, in respect of the matter for which the Indemnitee is seeking indemnification, the Indemnitee acted in bad faith or engaged in fraud, willful misconduct or, in the case of a criminal manner, acted with knowledge that the Indemnitee's conduct was unlawful.

Any indemnification under these provisions will only be out of our assets. To the fullest extent permitted by law, we may advance expenses (including legal fees and expenses) incurred by an Indemnitee who is indemnified in defending any claim, demand, action, suit or proceeding prior to a determination that the Indemnitee is not entitled to be indemnified upon receipt by us of an undertaking by or on behalf of the Indemnitee to repay such amount if it is determined that the Indemnitee is not entitled to be indemnified as authorized in the partnership agreement. Unless it

otherwise agrees, our general partner will not be personally liable for, or have any obligation to contribute or loan funds or assets to us to enable us to effectuate, indemnification.

We may purchase insurance against liabilities asserted against and expenses incurred by persons for our activities, regardless of whether we would have the power to indemnify the person against liabilities under our partnership agreement.

Reimbursement of Expenses

Our partnership agreement requires us to reimburse our general partner for all direct and indirect expenses it incurs or payments it makes on our behalf and all other expenses allocable to us or otherwise incurred by our general partner in connection with operating our business. These expenses include salary, bonus, incentive compensation and other amounts paid to persons who perform services for us or on our behalf and expenses allocated to our general partner by its affiliates. The general partner is entitled to determine in good faith the expenses that are allocable to us.

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Books and Reports

Our general partner is required to keep appropriate books of our business at our principal offices. The books will be maintained for both tax and financial reporting purposes on an accrual basis. For tax and financial reporting purposes, our fiscal year is the calendar year.

We will furnish or make available to record holders of common units, within 120 days after the close of each fiscal year, an annual report containing audited financial statements and a report on those financial statements by our independent public accountants. Except for our fourth quarter, we will also furnish or make available summary financial information within 90 days after the close of each quarter.

We will furnish each record holder of a unit with information reasonably required for tax reporting purposes within 90 days after the close of each calendar year. This information is expected to be furnished in summary form so that some complex calculations normally required of partners can be avoided. Our ability to furnish this summary information to unitholders will depend on the cooperation of unitholders in supplying us with specific information. Every unitholder will receive information to assist him in determining his federal and state tax liability and filing his federal and state income tax returns, regardless of whether he supplies us with information.

Right to Inspect Our Books and Records

Our partnership agreement provides that a limited partner can, for a purpose reasonably related to his interest as a limited partner, upon reasonable demand and at his own expense, have furnished to him:

a current list of the name and last known address of each partner;

a copy of our tax returns;

information as to the amount of cash, and a description and statement of the agreed value of any other property or services, contributed or to be contributed by each partner and the date on which each partner became a partner;

copies of our partnership agreement, our certificate of limited partnership, related amendments and powers of attorney under which they have been executed;

information regarding the status of our business and financial condition; and

any other information regarding our affairs as is just and reasonable.

Our general partner may, and intends to, keep confidential from the limited partners trade secrets or other information the disclosure of which our general partner believes in good faith is not in our best interests or that we are required by law or by agreements with third parties to keep confidential.

Registration Rights

Under our partnership agreement, we have agreed to register for resale under the Securities Act of 1933, as amended (the Securities Act), and applicable state securities laws any common units or other partnership securities proposed to be sold by our general partner or any of its affiliates or their assignees if an exemption from the registration requirements is not otherwise available. These registration rights continue for two years following any withdrawal or removal of our general partner. We are obligated to pay all expenses incidental to the registration, excluding underwriting discounts and commissions.

Additionally, under a separate registration rights agreement dated as of February 3, 2014 between us and Hoover, we have agreed to register for resale under the Securities Act the 4,040,471 common units issued to Hoover in connection with our acquisition of Hoover s business. We filed a registration statement on Form S-3 on March 24, 2014 registering such common units.

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HOW WE MAKE CASH DISTRIBUTIONS

Operating Surplus and Capital Surplus

Overview. All cash distributed to unitholders will be characterized as either operating surplus or capital surplus. We treat distributions of available cash from operating surplus differently than distributions of available cash from capital surplus. Within 45 days after the end of each quarter, we will distribute all available cash to unitholders of record on the applicable record date.

The Class F units will neither receive nor accrue distributions prior to their conversion into common units. The Series A units receive the distribution preference described below. References to unitholders made in the context of the recipients of cash distributions refer to common unitholders.

Characterization of Cash Distributions. We will treat all available cash distributed as coming from operating surplus until the sum of all available cash distributed since we began operations equals the operating surplus as of the most recent date of determination of available cash. We will treat any amount distributed in excess of operating surplus, regardless of its source, as capital surplus. We do not anticipate that we will make any distributions from capital surplus.

Definition of Available Cash. Available cash generally means, for each fiscal quarter all cash and cash equivalents on hand at the end of the quarter:

less the amount of cash reserves established by our general partner:

to provide for the proper conduct of our business (including reserves for future capital expenditures and for our anticipated credit needs);

to comply with applicable law, any of our debt instruments or other agreements; and

to provide funds for distribution to our unitholders and to our general partner for any one or more of the next four quarters;

plus all cash on hand on the date of determination of available cash for the quarter resulting from working capital borrowings made after the end of the quarter for which the determination is being made.

Working capital borrowings are generally borrowings that will be made under our credit facilities and in all cases are used solely for working capital purposes or to pay distributions to partners.

Definition of Operating Surplus. Operating surplus for any period generally means:

our cash balance on the closing date of our initial public offering; plus

\$20.0 million (as described below); plus

all of our cash receipts since the closing of our initial public offering, excluding cash from (1) borrowings that are not working capital borrowings, (2) sales of equity and debt securities and (3) sales or other dispositions of assets outside the ordinary course of business; plus

working capital borrowings made after the end of a quarter but before the date of determination of operating surplus for the quarter; less

operating expenses; less

the amount of cash reserves established by our general partner for future operating expenditures.

Operating surplus includes a provision that will enable us, if we choose, to distribute as operating surplus up to \$20.0 million of cash we receive in the future from non-operating sources, such as asset sales, issuances of securities and long-term borrowings, that would otherwise be distributed as capital surplus.

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Definition of Capital Surplus. Capital surplus will generally be generated only by:

borrowings other than working capital borrowings;

sales of debt and equity securities; and

sales or other disposition of assets for cash, other than inventory, accounts receivable and other current assets sold in the ordinary course of business or non-current assets sold as part of normal retirements or replacements of assets.

Distributions of Available Cash from Operating Surplus

We will make distributions of available cash from operating surplus in the following manner:

first, to the holders of our Series A units to the extent of the distribution preference on the Series A units, as described below;

second, 100% to all unitholders and our general partner, in accordance with their respective percentage interests, until we distribute for each outstanding unit an amount equal to the minimum quarterly distribution for that quarter; and

thereafter, in the manner described in **Incentive Distribution Rights** below.

The Series A units will receive distributions at a rate of \$0.445 per Series A unit, payable quarterly on the same date as the distribution payment date for the common units. The record date for the determination of holders entitled to receive distributions of the Series A units will be the same as the record date for determination of common unit holders entitled to receive quarterly distributions.

Distributions on the Series A units were accrued for the first two quarters following their issuance, which resulted in an increase in the number of common units issuable upon conversion of the Series A units. If on any distribution payment date occurring with respect to a quarter ending after December 31, 2009, we (x) fail to pay distributions on the Series A units, (y) reduce the distributions on the common units to zero (\$0.00) and (z) are prohibited by our material financing agreements from paying cash distributions, then until the distributions that were to be paid on the Series A units on such distribution payment date are paid in cash, such distributions shall automatically accrue and accumulate. If we fail to pay cash distributions in full for two quarters (whether or not consecutive) from and including the quarter ended on March 31, 2010, then to the extent that we fail to pay cash distributions on the Series A units thereafter, all future distributions on the Series A units that are accrued rather than being paid in cash by us will consist of the following: (i) \$0.35375 per Series A unit per quarter, (ii) \$0.09125 per Series A unit per quarter (the **Common Unit Distribution Amount**), payable solely in common units, and (iii) \$0.09125 per Series A unit per quarter (the **PIK Distribution Additional Amount**), payable solely in common units. The total number of common units payable in connection with the Common Unit Distribution Amount or the PIK Distribution Additional Amount cannot exceed 1,600,000 in any period of twenty consecutive fiscal quarters.

For as long as the Series A units are outstanding (or until we receive an investment grade rating from either Moody's Investor Service, Inc. or Standard & Poor's Ratings Services on our 9-3/8% Senior Notes due 2016), upon our breach of certain covenants (a Covenant Default) contained in our Indenture, dated as of May 20, 2009, among us, Regency Energy Finance Corp., the Guarantors (as defined therein) and Wells Fargo Bank, National Association, the holders of the Series A units will be entitled to an increase of \$0.1825 per quarterly distribution, payable solely in common units (the Covenant Default Additional Amount).

All accumulated and unpaid distributions will accrue interest (i) at a rate of 2.432% per quarter, or (ii) if we have failed to pay all PIK Distribution Additional Amounts or Covenant Default Additional Amounts or any Covenant Default has occurred and is continuing, at a rate of 3.429% per quarter while such failure to pay or such Covenant Default continues.

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Additionally, the holders of the Series A units are entitled to a make-whole distribution and allocation equal to 60% of the tax cost of the rate differential between ordinary income and long term capital gains with respect to any gross income allocation resulting from a forced conversion of the Series A units, grossed up for the additional tax due with respect to such make-whole allocation.

Incentive Distribution Rights

Incentive distribution rights represent the right to receive an increasing percentage of quarterly distributions of available cash from operating surplus after the minimum quarterly distribution and the target distribution levels have been achieved. Our general partner currently holds the incentive distribution rights, but may transfer these rights separately from its general partner interest, subject to restrictions in the partnership agreement. For purposes of this section Incentive Distribution Rights, the term unitholders does not include holders of Class F units, which are not entitled to participate in distributions, and holders of Series A units.

If for any quarter:

we have distributed available cash from operating surplus to the common unitholders in an amount equal to the minimum quarterly distribution;

we have distributed available cash from operating surplus on outstanding common units in an amount necessary to eliminate any cumulative arrearages in payment of the minimum quarterly distribution; and

we have distributed available cash from operating surplus to the holders of our Series A units to the extent of the distribution preference on the Series A units;
then, we will distribute any additional available cash from operating surplus for that quarter among the unitholders and our general partner in the following manner:

first, 100% to all unitholders and our general partner, in accordance with their respective percentage interests, until each unitholder receives a total of \$0.4025 per unit for that quarter (the first target distribution);

second, 87% to all unitholders and our general partner, in accordance with their respective percentage interests, and 13% to the holders of incentive distribution rights, pro rata, until each unitholder receives a total of \$0.4375 per unit for that quarter (the second target distribution);

third, 77% to all unitholders and our general partner, in accordance with their respective percentage interests, and 23% to the holders of incentive distribution rights, pro rata, until each unitholder receives a total of \$0.5250 per unit for that quarter (the third target distribution); and

thereafter, 52% to all unitholders and our general partner, in accordance with their respective percentage interests, and 48% to the holders of incentive distribution rights, pro rata.

In each case, the amount of the target distribution set forth above is exclusive of any distributions to common unitholders to eliminate any cumulative arrearages in payment of the minimum quarterly distribution.

Distributions from Capital Surplus

How Distributions from Capital Surplus Will Be Made. We will make distributions of available cash from capital surplus, if any, in the following manner:

first, 100% to all unitholders and our general partner, in accordance with their respective percentage interests, until we distribute for each outstanding common unit issued in our initial public offering an amount of available cash from capital surplus equal to the initial public offering price;

second, to our general partner, in accordance with its percentage interest, and to the common unitholders, pro rata, a percentage equal to 100% less the general partner's percentage interest, until we

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distribute for each common unit, an amount of available cash from capital surplus equal to any unpaid arrearages in payment of the minimum quarterly distribution on the common units; and

thereafter, we will make all distributions of available cash from capital surplus as if they were from operating surplus.

Effect of a Distribution from Capital Surplus. The partnership agreement treats a distribution of capital surplus as the repayment of the initial unit price from the initial public offering, which is a return of capital. The initial public offering price less any distributions of capital surplus per unit is referred to as the unrecovered initial unit price. Each time a distribution of capital surplus is made, the minimum quarterly distribution and the target distribution levels will be reduced in the same proportion as the corresponding reduction in the unrecovered initial unit price. Because distributions of capital surplus will reduce the minimum quarterly distribution, after any of these distributions are made, it may be easier for the general partner to receive incentive distributions. Any distribution of capital surplus before the unrecovered initial unit price is reduced to zero cannot be applied to the payment of the minimum quarterly distribution or any arrearages.

Once we distribute capital surplus on a unit in an amount equal to the initial unit price, we will reduce the minimum quarterly distribution and the target distribution levels to zero and we will make all future distributions from operating surplus, with 50% being paid to the holders of units, and 50% to the general partner.

Adjustment to the Minimum Quarterly Distribution and Target Distribution Levels

In addition to adjusting the minimum quarterly distribution and target distribution levels to reflect a distribution of capital surplus, if we combine our units into fewer units or subdivide our units into a greater number of units, we will proportionately adjust:

the minimum quarterly distribution;

the target distribution levels; and

the unrecovered initial unit price;

For example, if a two-for-one split of the common units should occur, the minimum quarterly distribution, the target distribution levels and the unrecovered initial unit price would each be reduced to 50% of its initial level. We will not make any adjustment by reason of the issuance of additional units for cash or property.

In addition, if legislation is enacted or if existing law is modified or interpreted by a governmental taxing authority so that we become taxable as a corporation or otherwise subject to taxation as an entity for federal, state or local income tax purposes, we will reduce the minimum quarterly distribution and the target distribution levels for each quarter by multiplying each distribution level by a fraction, the numerator of which is available cash for that quarter and the denominator of which is the sum of available cash for that quarter plus our general partner's estimate of our aggregate liability for the quarter for such income taxes payable by reason of such legislation or interpretation. To the extent that the actual tax liability differs from the estimated tax liability for any quarter, the difference will be accounted for in subsequent quarters.

Distributions of Cash Upon Liquidation

Overview. If we dissolve in accordance with the partnership agreement, we will sell or otherwise dispose of our assets in a process called liquidation. Upon dissolution, subject to Section 17-804 of the Delaware Act, the holders of the Series A units will be entitled to receive any accrued and unpaid distributions in respect of the Series A units, if any, and will have the status of, and will be entitled to all remedies available to, a creditor of the Partnership, and will have priority over any entitlement of any other unitholders with respect to any distributions by us. We will distribute any remaining proceeds to the unitholders and our general partner in accordance with their capital account balances, as adjusted to reflect any gain or loss upon the sale or other disposition of our assets in liquidation.

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Manner of Adjustments for Gain. The manner of the adjustment for gain is set forth in the partnership agreement. Upon liquidation, we will allocate any gain to the partners in the following manner:

First, to our general partner and the holders of units who have negative balances in their capital accounts to the extent of and in proportion to those negative balances;

second, to the holders of our Series A units, pro rata, until the capital account for each Series A unit is equal to the sum of:

- (1) the initial unit price for that Series A unit; and
- (2) all accrued but unpaid distributions on that Series A unit;

third, 100% to the common unitholders and our general partner, in accordance with their respective percentage interests, until the capital account for each common unit is equal to the sum of:

- (1) the unrecovered initial unit price for that common unit; and
- (2) the amount of the minimum quarterly distribution for the quarter during which our liquidation occurs;

fourth, 100% to all unitholders and our general partner, in accordance with their respective percentage interests, until we allocate under this paragraph an amount per unit equal to:

- (1) the sum of the excess of the first target distribution per unit over the minimum quarterly distribution per unit for each quarter of our existence; less
- (2) the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the minimum quarterly distribution per unit that we distributed 100% to the unitholders and our general partner, in accordance with their respective percentage interests, for each quarter of our existence;

fifth, 87% to all unitholders and our general partner, in accordance with their respective percentage interests, and 13% to the holders of incentive distribution rights, pro rata, until we allocate under this paragraph an amount per unit equal to:

- (1) the sum of the excess of the second target distribution per unit over the first target distribution per unit for each quarter of our existence; less
- (2) the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the minimum quarterly distribution per unit that we distributed 87% to the unitholders and our general partner, in accordance with their respective percentage interests, and 13% to the holders of incentive distribution rights, pro rata, for each quarter of our existence;

sixth, 77% to all unitholders and our general partner, in accordance with their respective percentage interests, and 23% to the holders of incentive distribution rights, pro rata, until we allocate under this paragraph an amount per unit equal to:

(1) the sum of the excess of the third target distribution per unit over the second target distribution per unit for each quarter of our existence; less

(2) the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the minimum quarterly distribution per unit that we distributed 77% to the unitholders and our general partner, in accordance with their respective percentage interests, and 23% to the holders of incentive distribution rights, pro rata, for each quarter of our existence; and

thereafter, 52% to all unitholders and our general partner in accordance with their respective percentage interests, and 48% to the holders of incentive distribution rights, pro rata.

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Manner of Adjustments for Losses. Upon liquidation, we will generally allocate any loss to our general partner and the unitholders in the following manner:

first, 100% to the holders of common units and our general partner, in accordance with their respective percentage interests, until the capital accounts of the common unitholders have been reduced to zero;

second, 100% to the holders of our Series A units, pro rata, until the capital accounts of the holders of our Series A units have been reduced to zero; and

thereafter, 100% to our general partner.

Adjustments to Capital Accounts. We will make adjustments to capital accounts upon the issuance of additional units (including as a result of the conversion of our Series A units into common units). In doing so, we will allocate any unrealized and, for tax purposes, unrecognized gain or loss resulting from the adjustments to the unitholders and our general partner in the same manner as we allocate gain or loss upon liquidation; provided, that for purposes of determining the amount of such unrealized gain or loss, we will reduce the fair market value of our property (to the extent of any unrealized income or gain in our property that has not previously been reflected in the capital accounts) to reflect the incremental share of such fair market value that would be attributable to the holders of our outstanding Series A units if all of such Series A units were converted into common units as of such date. If we make positive adjustments to the capital accounts upon the issuance of additional units, we will allocate any later negative adjustments to the capital accounts resulting from the issuance of additional units or upon our liquidation in a manner which results, to the extent possible, in our general partner's capital account balance equaling the amount that it would have been if no earlier positive adjustments to the capital accounts had been made.

Additionally, if in the year of liquidation, any holder's capital account in respect of any Series A units is less than an aggregate amount equal to the sum of (i) \$18.30 per Series A unit, plus (ii) all accrued and accumulated but unpaid distributions on such Series A units, or together the Preferred Liquidation Value, then prior to any other allocation for that year and prior to any distribution to the holders of the Series A unit upon liquidation, items of gross income and gain will be allocated to all holders of the Series A unit, pro rata, until the capital account in respect of each Series A unit then outstanding is equal to the Preferred Liquidation Value (and no other allocation will reverse the effect of this allocation).

If in the year of liquidation, any holder's capital account in respect of any Series A units is less than the aggregate Preferred Liquidation Value of such Series A units after the application of the allocation described in the paragraph immediately above, then to the extent permitted by law, items of gross income and gain for any preceding taxable period(s) with respect to which Schedule K-1s have not been filed by us will be reallocated to all holders of the Series A units, pro rata, until the capital account in respect of each Series A unit then outstanding is equal to the Preferred Liquidation Value (and no other allocation will reverse the effect of this allocation).

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MATERIAL INCOME TAX CONSIDERATIONS

This section is a summary of the material tax considerations that may be relevant to prospective unitholders who are individual citizens or residents of the United States and, unless otherwise noted in the following discussion, is the opinion of Latham & Watkins LLP, counsel to our general partner and us, insofar as it relates to legal conclusions with respect to matters of U.S. federal income tax law. This section is based upon current provisions of the Internal Revenue Code of 1986, as amended (the Internal Revenue Code), existing and proposed Treasury regulations promulgated under the Internal Revenue Code (the Treasury Regulations) and current administrative rulings and court decisions, all of which are subject to change. Later changes in these authorities may cause the tax consequences to vary substantially from the consequences described below. Unless the context otherwise requires, references in this section to us or we are references to Regency Energy Partners LP and our operating company.

The following discussion does not comment on all federal income tax matters affecting us or our unitholders. Moreover, the discussion focuses on unitholders who are individual citizens or residents of the United States and has only limited application to corporations, estates, entities treated as partnerships for U.S. federal income tax purposes, trusts, nonresident aliens, U.S. expatriates and former citizens or long-term residents of the United States or other unitholders subject to specialized tax treatment, such as banks, insurance companies and other financial institutions, tax-exempt institutions, foreign persons (including, without limitation, controlled foreign corporations, passive foreign investment companies and non-U.S. persons eligible for the benefits of an applicable income tax treaty with the United States), individual retirement accounts (IRAs), real estate investment trusts (REITs) or mutual funds, dealers in securities or currencies, traders in securities, U.S. persons whose functional currency is not the U.S. dollar, persons holding their units as part of a straddle, hedge, conversion transaction or other risk reduction transaction, and persons deemed to sell their units under the constructive sale provisions of the Internal Revenue Code. In addition, the discussion only comments, to a limited extent, on state, local, and foreign tax consequences. Accordingly, we encourage each prospective unitholder to consult his own tax advisor in analyzing the state, local and foreign tax consequences particular to him of the ownership or disposition of common units and potential changes in applicable tax laws.

No ruling has been requested from the IRS regarding our characterization as a partnership for tax purposes. Instead, we will rely on opinions of Latham & Watkins LLP. Unlike a ruling, an opinion of counsel represents only that counsel's best legal judgment and does not bind the IRS or the courts. Accordingly, the opinions and statements made herein may not be sustained by a court if contested by the IRS. Any contest of this sort with the IRS may materially and adversely impact the market for the common units and the prices at which common units trade. In addition, the costs of any contest with the IRS, principally legal, accounting and related fees, will result in a reduction in cash available for distribution to our unitholders and our general partner and thus will be borne indirectly by our unitholders and our general partner. Furthermore, the tax treatment of us, or of an investment in us, may be significantly modified by future legislative or administrative changes or court decisions. Any modifications may or may not be retroactively applied.

All statements as to matters of federal income tax law and legal conclusions with respect thereto, but not as to factual matters, contained in this section, unless otherwise noted, are the opinion of Latham & Watkins LLP and are based on the accuracy of the representations made by us.

For the reasons described below, Latham & Watkins LLP has not rendered an opinion with respect to the following specific federal income tax issues: (i) our method of allocating taxable income and losses to take into account the conversion feature of our Series A units (please read Tax Consequences of Unit Ownership Allocation of Income, Gain, Loss and Deduction); (ii) the treatment of a unitholder whose common units are loaned to a short seller to cover a short sale of common units (please read Tax Consequences of Unit Ownership Treatment of Short Sales);

(iii) whether our monthly convention for allocating taxable income and losses is permitted by existing Treasury Regulations (please read [Disposition of Common Units](#) [Allocations Between Transferors and Transferees](#)); and
(iv) whether our method for taking into account

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Section 743 adjustments is sustainable in certain cases (please read Tax Consequences of Unit Ownership Section 754 Election and Disposition of Common Units Uniformity of Units).

Partnership Status

A partnership is not a taxable entity and incurs no federal income tax liability. Instead, each partner of a partnership is required to take into account his share of items of income, gain, loss and deduction of the partnership in computing his federal income tax liability, regardless of whether cash distributions are made to him by the partnership. Distributions by a partnership to a partner are generally not taxable to the partnership or the partner unless the amount of cash distributed to him is in excess of the partner's adjusted basis in his partnership interest. Section 7704 of the Internal Revenue Code provides that publicly traded partnerships will, as a general rule, be taxed as corporations. However, an exception, referred to as the Qualifying Income Exception, exists with respect to publicly traded partnerships of which 90% or more of the gross income for every taxable year consists of qualifying income. Qualifying income includes income and gains derived from the transportation, storage, processing and marketing of crude oil, natural gas and products thereof. Other types of qualifying income include interest (other than from a financial business), dividends, gains from the sale of real property and gains from the sale or other disposition of capital assets held for the production of income that otherwise constitutes qualifying income. We estimate that less than 4% of our current gross income is not qualifying income; however, this estimate could change from time to time. Based upon and subject to this estimate, the factual representations made by us and our general partner and a review of the applicable legal authorities, Latham & Watkins LLP is of the opinion that at least 90% of our current gross income constitutes qualifying income. The portion of our income that is qualifying income may change from time to time.

The IRS has made no determination as to our status or the status of our operating company for federal income tax purposes. Instead, we will rely on the opinion of Latham & Watkins LLP on such matters. It is the opinion of Latham & Watkins LLP that, based upon the Internal Revenue Code, its regulations, published revenue rulings and court decisions and the representations described below that:

We will be classified as a partnership for federal income tax purposes; and

Our operating company will be disregarded as an entity separate from us for federal income tax purposes. In rendering its opinion, Latham & Watkins LLP has relied on factual representations made by us and our general partner. The representations made by us and our general partner upon which Latham & Watkins LLP has relied include:

Neither we nor the operating company has elected or will elect to be treated, or is otherwise treated, as a corporation for federal income tax purposes; and

For each taxable year, more than 90% of our gross income has been and will be income of the type that Latham & Watkins LLP has opined or will opine is qualifying income within the meaning of Section 7704(d) of the Internal Revenue Code.

We believe that these representations have been true in the past and expect that these representations will continue to be true in the future.

If we fail to meet the Qualifying Income Exception, other than a failure that is determined by the IRS to be inadvertent and that is cured within a reasonable time after discovery (in which case the IRS may also require us to make adjustments with respect to our unitholders or pay other amounts), we will be treated as if we had transferred all of our assets, subject to liabilities, to a newly formed corporation, on the first day of the year in which we fail to meet the Qualifying Income Exception, in return for stock in that corporation, and then distributed that stock to the unitholders in liquidation of their interests in us. This deemed contribution and liquidation should be tax-free to unitholders and us so long as we, at that time, do not have liabilities in excess of the tax basis of our assets. Thereafter, we would be treated as a corporation for federal income tax purposes.

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If we were treated as an association taxable as a corporation in any taxable year, either as a result of a failure to meet the Qualifying Income Exception or otherwise, our items of income, gain, loss and deduction would be reflected only on our tax return rather than being passed through to our unitholders, and our net income would be taxed to us at corporate rates. In addition, any distribution made to a unitholder would be treated as taxable dividend income, to the extent of our current and accumulated earnings and profits, or, in the absence of earnings and profits, a nontaxable return of capital, to the extent of the unitholder's tax basis in his common units, or taxable capital gain, after the unitholder's tax basis in his common units is reduced to zero. Accordingly, taxation as a corporation would result in a material reduction in a unitholder's cash flow and after-tax return and thus would likely result in a substantial reduction of the value of the units.

The discussion below is based on Latham & Watkins LLP's opinion that we will be classified as a partnership for federal income tax purposes.

Limited Partner Status

Unitholders of Regency Energy Partners LP will be treated as partners of Regency Energy Partners LP for federal income tax purposes. Also, unitholders whose common units are held in street name or by a nominee and who have the right to direct the nominee in the exercise of all substantive rights attendant to the ownership of their common units will be treated as partners of Regency Energy Partners LP for federal income tax purposes.

A beneficial owner of common units whose units have been transferred to a short seller to complete a short sale would appear to lose his status as a partner with respect to those units for federal income tax purposes. Please read [Tax Consequences of Unit Ownership - Treatment of Short Sales](#).

Income, gains, losses or deductions would not appear to be reportable by a unitholder who is not a partner for federal income tax purposes, and any cash distributions received by a unitholder who is not a partner for federal income tax purposes would therefore appear to be fully taxable as ordinary income. These holders are urged to consult their tax advisors with respect to the tax consequences to them of holding common units in Regency Energy Partners LP. The references to unitholders in the discussion that follows are to persons who are treated as partners in Regency Energy Partners LP for federal income tax purposes.

Tax Consequences of Unit Ownership

Flow-Through of Taxable Income. Subject to the discussion below under [Entity-Level Collections](#), we will not pay any federal income tax. Instead, each unitholder will be required to report on his income tax return his share of our income, gains, losses and deductions without regard to whether we make cash distributions to him. Consequently, we may allocate income to a unitholder even if he has not received a cash distribution. Each unitholder will be required to include in income his allocable share of our income, gains, losses and deductions for our taxable year ending with or within his taxable year. Our taxable year ends on December 31.

Treatment of Distributions. Distributions by us to a unitholder generally will not be taxable to the unitholder for federal income tax purposes, except to the extent the amount of any such cash distribution exceeds his tax basis in his common units immediately before the distribution. Our cash distributions in excess of a unitholder's tax basis generally will be considered to be gain from the sale or exchange of the common units, taxable in accordance with the rules described under [Disposition of Common Units](#). Any reduction in a unitholder's share of our liabilities for which no partner, including the general partner, bears the economic risk of loss, known as nonrecourse liabilities, will be treated as a distribution by us of cash to that unitholder. To the extent our distributions cause a unitholder's at-risk amount to be less than zero at the end of any taxable year, he must recapture any losses deducted in previous years. Please read

Limitations on Deductibility of Losses.

A decrease in a unitholder's percentage interest in us because of our issuance of additional common units will decrease his share of our nonrecourse liabilities, and thus will result in a corresponding deemed distribution

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of cash. This deemed distribution may constitute a non-pro rata distribution. A non-pro rata distribution of money or property may result in ordinary income to a unitholder, regardless of his tax basis in his common units, if the distribution reduces the unitholder's share of our unrealized receivables, including depreciation recapture and/or substantially appreciated inventory items, each as defined in the Internal Revenue Code, and collectively, Section 751 Assets. To that extent, the unitholder will be treated as having been distributed his proportionate share of the Section 751 Assets and then having exchanged those assets with us in return for the non-pro rata portion of the actual distribution made to him. This latter deemed exchange will generally result in the unitholder's realization of ordinary income, which will equal the excess of (i) the non-pro rata portion of that distribution over (ii) the unitholder's tax basis (often zero) for the share of Section 751 Assets deemed relinquished in the exchange.

Basis of Common Units. A unitholder's initial tax basis for his common units will be the amount he paid for the common units plus his share of our nonrecourse liabilities. That basis will be increased by his share of our income and by any increases in his share of our nonrecourse liabilities. That basis will be decreased, but not below zero, by distributions from us, by the unitholder's share of our losses, by any decreases in his share of our nonrecourse liabilities and by his share of our expenditures that are not deductible in computing taxable income and are not required to be capitalized. A unitholder will have no share of our debt that is recourse to our general partner to the extent of the general partner's net value as defined in regulations under Section 752 of the Internal Revenue Code, but will have a share, generally based on his share of profits, of our nonrecourse liabilities. Please read *Disposition of Common Units* *Recognition of Gain or Loss*.

Limitations on Deductibility of Losses. The deduction by a unitholder of his share of our losses will be limited to the tax basis in his units and, in the case of an individual unitholder, estate, trust, or corporate unitholder (if more than 50% of the value of the corporate unitholder's stock is owned directly or indirectly by or for five or fewer individuals or some tax-exempt organizations) to the amount for which the unitholder is considered to be at risk with respect to our activities, if that is less than his tax basis. A common unitholder subject to these limitations must recapture losses deducted in previous years to the extent that distributions cause his at-risk amount to be less than zero at the end of any taxable year. Losses disallowed to a unitholder or recaptured as a result of these limitations will carry forward and will be allowable as a deduction to the extent that his at-risk amount is subsequently increased, provided such losses do not exceed such common unitholder's tax basis in his common units. Upon the taxable disposition of a unit, any gain recognized by a unitholder can be offset by losses that were previously suspended by the at-risk limitation but may not be offset by losses suspended by the basis limitation. Any loss previously suspended by the at-risk limitation in excess of that gain would no longer be utilizable.

In general, a unitholder will be at risk to the extent of the tax basis of his units, excluding any portion of that basis attributable to his share of our nonrecourse liabilities, reduced by (i) any portion of that basis representing amounts otherwise protected against loss because of a guarantee, stop loss agreement or other similar arrangement and (ii) any amount of money he borrows to acquire or hold his units, if the lender of those borrowed funds owns an interest in us, is related to the unitholder or can look only to the units for repayment. A unitholder's at-risk amount will increase or decrease as the tax basis of the unitholder's units increases or decreases, other than tax basis increases or decreases attributable to increases or decreases in his share of our nonrecourse liabilities.

In addition to the basis and at-risk limitations on the deductibility of losses, the passive loss limitations generally provide that individuals, estates, trusts and some closely-held corporations and personal service corporations can deduct losses from passive activities, which are generally trade or business activities in which the taxpayer does not materially participate, only to the extent of the taxpayer's income from those passive activities. The passive loss limitations are applied separately with respect to each publicly traded partnership. Consequently, any passive losses we generate will only be available to offset our passive income generated in the future and will not be available to offset income from other passive activities or investments, including our investments or a unitholder's investments in

other publicly traded partnerships, or the unitholder's salary, active

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business or other income. Passive losses that are not deductible because they exceed a unitholder's share of income we generate may be deducted in full when he disposes of his entire investment in us in a fully taxable transaction with an unrelated party. The passive loss limitations are applied after other applicable limitations on deductions, including the at-risk rules and the basis limitation.

A unitholder's share of our net income may be offset by any of our suspended passive losses, but it may not be offset by any other current or carryover losses from other passive activities, including those attributable to other publicly traded partnerships.

Limitations on Interest Deductions. The deductibility of a non-corporate taxpayer's investment interest expense is generally limited to the amount of that taxpayer's net investment income. Investment interest expense includes:

- (a) interest on indebtedness properly allocable to property held for investment;
- (b) our interest expense attributed to portfolio income; and
- (c) the portion of interest expense incurred to purchase or carry an interest in a passive activity to the extent attributable to portfolio income.

The computation of a unitholder's investment interest expense will take into account interest on any margin account borrowing or other loan incurred to purchase or carry a unit. Net investment income includes gross income from property held for investment and amounts treated as portfolio income under the passive loss rules, less deductible expenses, other than interest, directly connected with the production of investment income, but generally does not include gains attributable to the disposition of property held for investment or (if applicable) qualified dividend income. The IRS has indicated that the net passive income earned by a publicly traded partnership will be treated as investment income to its unitholders. In addition, the unitholder's share of our portfolio income will be treated as investment income.

Entity-Level Collections. If we are required or elect under applicable law to pay any federal, state, local or foreign income tax on behalf of any unitholder or our general partner or any former unitholder, we are authorized to pay those taxes from our funds. That payment, if made, will be treated as a distribution of cash to the unitholder on whose behalf the payment was made. If the payment is made on behalf of a person whose identity cannot be determined, we are authorized to treat the payment as a distribution to all current unitholders. We are authorized to amend our partnership agreement in the manner necessary to maintain uniformity of intrinsic tax characteristics of units and to adjust later distributions, so that after giving effect to these distributions, the priority and characterization of distributions otherwise applicable under our partnership agreement is maintained as nearly as is practicable. Payments by us as described above could give rise to an overpayment of tax on behalf of an individual unitholder in which event the unitholder would be required to file a claim in order to obtain a credit or refund.

Allocation of Income, Gain, Loss and Deduction. In general, if we have a net profit, our items of income, gain, loss and deduction will be allocated among our general partner and the unitholders in accordance with their percentage interests in us, subject to an allocation of net income to the holders of our Series A units. At any time that incentive distributions are made to our general partner, gross income will be allocated to the recipients to the extent of these distributions. If we have a net loss, that loss will be allocated first to our general partner and the unitholders in accordance with their percentage interests in us to the extent of their positive capital accounts (as adjusted for certain

items in accordance with applicable Treasury Regulations), second, to the holders of our Series A units, pro rata, to the extent of their positive capital accounts (as adjusted for certain items in accordance with applicable Treasury Regulations), and, finally, to our general partner.

Specified items of our income, gain, loss and deduction will be allocated to account for (i) any difference between the tax basis and fair market value of our assets at the time of an offering and (ii) any difference

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between the tax basis and fair market value of any property contributed to us by the general partner and its affiliates (or by a third party) that exists at the time of such contribution, together referred to in this discussion as the

Contributed Property. The effect of these allocations, referred to as Section 704(c) Allocations, to a unitholder purchasing common units from us in an offering will be essentially the same as if the tax bases of our assets were equal to their fair market values at the time of the offering. In the event we issue additional common units (including as a result of the conversion of our Series A units into common units) or engage in certain other transactions in the future, reverse Section 704(c) Allocations, similar to the Section 704(c) Allocations described above, will be made to the general partner and all of our unitholders immediately prior to such issuance or other transactions to account for the difference between the book basis for purposes of maintaining capital accounts and the fair market value of all property held by us at the time of such issuance or future transaction. In addition, items of recapture income will be allocated to the extent possible to the unitholder who was allocated the deduction giving rise to the treatment of that gain as recapture income in order to minimize the recognition of ordinary income by some unitholders. Finally, although we do not expect that our operations will result in the creation of negative capital accounts, if negative capital accounts nevertheless result, items of our income and gain will be allocated in an amount and manner sufficient to eliminate the negative balance as quickly as possible.

In connection with the issuance of additional common units (including as a result of the conversion of our Series A units into common units), we will adjust capital accounts to reflect the fair market value of our property. In doing so, we will allocate any unrealized and, for tax purposes, unrecognized gain or loss resulting from the adjustments to the unitholders and our general partner in the same manner as we allocate gain or loss upon liquidation; provided, that for purposes of determining the amount of such unrealized gain or loss, we will reduce the fair market value of our property (to the extent of any unrealized income or gain in our property that has not previously been reflected in the capital accounts) to reflect the incremental share of such fair market value that would be attributable to the holders of our outstanding Series A units if all of such Series A units were converted into common units as of such date. Consequently, a holder of common units may be allocated less unrealized gain (or more unrealized loss) in connection with an adjustment of the capital accounts than such holder would have been allocated if there were no outstanding Series A units. Following the conversion of our Series A units into common units, items of gross income and gain (or gross loss and deduction) will be specially allocated to the holders of such common units to reflect differences between the capital accounts maintained with respect to such Series A units and the capital accounts maintained with respect to common units. This method of maintaining capital accounts and allocating income, gain, loss and deduction with respect to the Series A units is intended to comply with proposed Treasury Regulations under Section 704 of the Internal Revenue Code. Although these Treasury Regulations have been finalized, we agreed to follow the proposed Treasury Regulations in connection with, among other things, the issuance and conversion of our Series A units. Consequently, Latham & Watkins LLP is unable to opine as to whether our method of allocating income and loss among our unitholders to take into account the conversion feature of our Series A units will be given effect for federal income tax purposes. If our allocations are not respected, a unitholder could be allocated more taxable income (or less taxable loss).

An allocation of items of our income, gain, loss or deduction, other than an allocation required by the Internal Revenue Code to eliminate the difference between a partner's book capital account, credited with the fair market value of Contributed Property, and tax capital account, credited with the tax basis of Contributed Property, referred to in this discussion as the Book-Tax Disparity, will generally be given effect for federal income tax purposes in determining a partner's share of an item of income, gain, loss or deduction only if the allocation has substantial economic effect. In any other case, a partner's share of an item will be determined on the basis of his interest in us, which will be determined by taking into account all the facts and circumstances, including:

- (a) his relative contributions to us;
- (b) the interests of all the partners in profits and losses;
- (c) the interest of all the partners in cash flow; and
- (d) the rights of all the partners to distributions of capital upon liquidation.

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Latham & Watkins LLP is of the opinion that, with the exception of the issues described above with respect to allocations to take into account the conversion feature of our Series A units, in Tax Consequences of Unit Ownership Section 754 Election and Disposition of Common Units Allocations Between Transferors and Transferees, allocations under our partnership agreement will be given effect for federal income tax purposes in determining a partner's share of an item of income, gain, loss or deduction.

Treatment of Short Sales. A unitholder whose units are loaned to a short seller to cover a short sale of units may be considered as having disposed of those units. If so, he would no longer be treated for tax purposes as a partner with respect to those units during the period of the loan and may recognize gain or loss from the disposition.

As a result, during this period:

- (a) any of our income, gain, loss or deduction with respect to those units would not be reportable by the unitholder;
- (b) any cash distributions received by the unitholder as to those units would be fully taxable; and
- (c) while not entirely free from doubt, all of these distributions would appear to be ordinary income.

Because there is no direct or indirect controlling authority on the issue relating to partnership interests, Latham & Watkins LLP has not rendered an opinion regarding the tax treatment of a unitholder whose common units are loaned to a short seller to effect a short sale of common units; therefore, unitholders desiring to assure their status as partners and avoid the risk of gain recognition from a loan to a short seller are urged to consult a tax advisor to discuss whether it is advisable to modify any applicable brokerage account agreements to prohibit their brokers from borrowing and loaning their units. The IRS has previously announced that it is studying issues relating to the tax treatment of short sales of partnership interests. Please also read Disposition of Common Units Recognition of Gain or Loss.

Alternative Minimum Tax. Each unitholder will be required to take into account his distributive share of any items of our income, gain, loss or deduction for purposes of the alternative minimum tax. Prospective unitholders are urged to consult with their tax advisors as to the impact of an investment in units on their liability for the alternative minimum tax.

Tax Rates. Beginning on January 1, 2013, the highest marginal U.S. federal income tax rate applicable to ordinary income of individuals is 39.6% and the highest marginal U.S. federal income tax rate applicable to long-term capital gains (generally, capital gains on certain assets held for more than twelve months) of individuals is 20%. Such rates are subject to change by legislation at any time.

In addition, a 3.8% Medicare tax, or NIIT, on certain net investment income earned by individuals, estates and trusts applies for taxable years beginning after December 31, 2012. For these purposes, net investment income generally includes a unitholder's allocable share of our income and gain realized by a unitholder from a sale of units. In the case of an individual, the tax will be imposed on the lesser of (i) the unitholder's net investment income and (ii) the amount by which the unitholder's modified adjusted gross income exceeds \$250,000 (if the unitholder is married and filing jointly or a surviving spouse), \$125,000 (if the unitholder is married and filing separately) or \$200,000 (in any other case). In the case of an estate or trust, the tax will be imposed on the lesser of (i) undistributed net investment income and (ii) the excess adjusted gross income over the dollar amount at which the highest income tax bracket applicable to

an estate or trust begins. Recently, the Department of the Treasury and the IRS issued proposed and finalized Treasury Regulations that provide guidance regarding the NIIT that are effective for taxable years beginning after December 31, 2013. Prospective unitholders are urged to consult with their tax advisors as to the impact of the NIIT on an investment in our common units.

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Section 754 Election. We have made the election permitted by Section 754 of the Internal Revenue Code. That election is irrevocable without the consent of the IRS unless there is a constructive termination of the partnership. Please read *Disposition of Common Units* *Constructive Termination*. The election will generally permit us to adjust a common unit purchaser's tax basis in our assets (*inside basis*) under Section 743(b) of the Internal Revenue Code to reflect his purchase price. This election does not apply with respect to a person who purchases common units directly from us. The Section 743(b) adjustment belongs to the purchaser and not to other unitholders. For purposes of this discussion, the inside basis in our assets with respect to a unitholder will be considered to have two components: (i) his share of our tax basis in our assets (*common basis*) and (ii) his Section 743(b) adjustment to that basis.

We have adopted the remedial allocation method as to all our properties. Where the remedial allocation method is adopted, the Treasury Regulations under Section 743 of the Internal Revenue Code require a portion of the Section 743(b) adjustment that is attributable to recovery property that is subject to depreciation under Section 168 of the Internal Revenue Code and whose book basis is in excess of its tax basis to be depreciated over the remaining cost recovery period for the property's unamortized Book-Tax Disparity. Under Treasury Regulation Section 1.167(c)-1(a)(6), a Section 743(b) adjustment attributable to property subject to depreciation under Section 167 of the Internal Revenue Code, rather than cost recovery deductions under Section 168, is generally required to be depreciated using either the straight-line method or the 150% declining balance method. Under our partnership agreement, our general partner is authorized to take a position to preserve the uniformity of units even if that position is not consistent with these and any other Treasury Regulations. Please read *Disposition of Common Units* *Uniformity of Units*.

We depreciate the portion of a Section 743(b) adjustment attributable to unrealized appreciation in the value of Contributed Property, to the extent of any unamortized Book-Tax Disparity, using a rate of depreciation or amortization derived from the depreciation or amortization method and useful life applied to the property's unamortized Book-Tax Disparity, or treat that portion as non-amortizable to the extent attributable to property which is not amortizable. This method is consistent with the methods employed by other publicly traded partnerships but is arguably inconsistent with Treasury Regulation Section 1.167(c)-1(a)(6), which is not expected to directly apply to a material portion of our assets. To the extent this Section 743(b) adjustment is attributable to appreciation in value in excess of the unamortized Book-Tax Disparity, we will apply the rules described in the Treasury Regulations and legislative history. If we determine that this position cannot reasonably be taken, we may take a depreciation or amortization position under which all purchasers acquiring units in the same month would receive depreciation or amortization, whether attributable to common basis or a Section 743(b) adjustment, based upon the same applicable rate as if they had purchased a direct interest in our assets. This kind of aggregate approach may result in lower annual depreciation or amortization deductions than would otherwise be allowable to some unitholders. Please read *Disposition of Common Units* *Uniformity of Units*. A unitholder's tax basis for his common units is reduced by his share of our deductions (whether or not such deductions were claimed on an individual's income tax return) so that any position we take that understates deductions will overstate the common unitholder's basis in his common units, which may cause the unitholder to understate gain or overstate loss on any sale of such units. Please read *Disposition of Common Units* *Recognition of Gain or Loss*. Latham & Watkins LLP is unable to opine as to whether our method for taking into account Section 743 adjustments is sustainable for property subject to depreciation under Section 167 of the Internal Revenue Code or if we use an aggregate approach as described above, as there is no direct or indirect controlling authority addressing the validity of these positions. Moreover, the IRS may challenge our position with respect to depreciating or amortizing the Section 743(b) adjustment we take to preserve the uniformity of the units. If such a challenge were sustained, the gain from the sale of units might be increased without the benefit of additional deductions.

A Section 754 election is advantageous if the transferee's tax basis in his units is higher than the units' share of the aggregate tax basis of our assets immediately prior to the transfer. In that case, as a result of the election, the transferee

would have, among other items, a greater amount of depreciation deductions and his share of any gain or loss on a sale of our assets would be less. Conversely, a Section 754 election is disadvantageous if the

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transferee's tax basis in his units is lower than those units' share of the aggregate tax basis of our assets immediately prior to the transfer. Thus, the fair market value of the units may be affected either favorably or unfavorably by the election. A basis adjustment is required regardless of whether a Section 754 election is made in the case of a transfer of an interest in us if we have a substantial built-in loss immediately after the transfer, or if we distribute property and have a substantial basis reduction. Generally, a built-in loss or a basis reduction is substantial if it exceeds \$250,000.

The calculations involved in the Section 754 election are complex and will be made on the basis of assumptions as to the value of our assets and other matters. For example, the allocation of the Section 743(b) adjustment among our assets must be made in accordance with the Internal Revenue Code. The IRS could seek to reallocate some or all of any Section 743(b) adjustment allocated by us to our tangible assets to goodwill instead. Goodwill, as an intangible asset, is generally nonamortizable or amortizable over a longer period of time or under a less accelerated method than our tangible assets. We cannot assure you that the determinations we make will not be successfully challenged by the IRS and that the deductions resulting from them will not be reduced or disallowed altogether. Should the IRS require a different basis adjustment to be made, and should, in our opinion, the expense of compliance exceed the benefit of the election, we may seek permission from the IRS to revoke our Section 754 election. If permission is granted, a subsequent purchaser of units may be allocated more income than he would have been allocated had the election not been revoked.

Tax Treatment of Operations

Accounting Method and Taxable Year. We use the year ending December 31 as our taxable year and the accrual method of accounting for federal income tax purposes. Each unitholder will be required to include in income his share of our income, gain, loss and deduction for our taxable year ending within or with his taxable year. In addition, a unitholder who has a taxable year ending on a date other than December 31 and who disposes of all of his units following the close of our taxable year but before the close of his taxable year must include his share of our income, gain, loss and deduction in income for his taxable year, with the result that he will be required to include in income for his taxable year his share of more than twelve months of our income, gain, loss and deduction. Please read [Disposition of Common Units](#) [Allocations Between Transferors and Transferees](#).

Tax Basis, Depreciation and Amortization. The tax basis of our assets will be used for purposes of computing depreciation and cost recovery deductions and, ultimately, gain or loss on the disposition of these assets. The federal income tax burden associated with the difference between the fair market value of our assets and their tax basis immediately prior to an offering will be borne by our unitholders holding interests in us prior to any such offering. Please read [Tax Consequences of Unit Ownership](#) [Allocation of Income, Gain, Loss and Deduction](#).

To the extent allowable, we may elect to use the depreciation and cost recovery methods, including bonus depreciation to the extent available, that will result in the largest deductions being taken in the early years after assets subject to these allowances are placed in service. Please read [Disposition of Common Units](#) [Uniformity of Units](#). Property we subsequently acquire or construct may be depreciated using accelerated methods permitted by the Internal Revenue Code.

If we dispose of depreciable property by sale, foreclosure or otherwise, all or a portion of any gain, determined by reference to the amount of depreciation previously deducted and the nature of the property, may be subject to the recapture rules and taxed as ordinary income rather than capital gain. Similarly, a unitholder who has taken cost recovery or depreciation deductions with respect to property we own will likely be required to recapture some or all of those deductions as ordinary income upon a sale of his interest in us. Please read [Tax Consequences of Unit Ownership](#) [Allocation of Income, Gain, Loss and Deduction](#) and [Disposition of Common Units](#) [Recognition of Gain or Loss](#).

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The costs we incur in selling our units (called syndication expenses) must be capitalized and cannot be deducted currently, ratably or upon our termination. There are uncertainties regarding the classification of costs as organization expenses, which may be amortized by us, and as syndication expenses, which may not be amortized by us. The underwriting discounts and commissions we incur will be treated as syndication expenses.

Valuation and Tax Basis of Our Properties. The federal income tax consequences of the ownership and disposition of units will depend in part on our estimates of the relative fair market values, and the initial tax bases, of our assets. Although we may from time to time consult with professional appraisers regarding valuation matters, we will make many of the relative fair market value estimates ourselves. These estimates and determinations of basis are subject to challenge and will not be binding on the IRS or the courts. If the estimates of fair market value or basis are later found to be incorrect, the character and amount of items of income, gain, loss or deductions previously reported by unitholders might change, and unitholders might be required to adjust their tax liability for prior years and incur interest and penalties with respect to those adjustments.

Disposition of Common Units

Recognition of Gain or Loss. Gain or loss will be recognized on a sale of units equal to the difference between the amount realized and the unitholder's tax basis for the units sold. A unitholder's amount realized will be measured by the sum of the cash or the fair market value of other property received by him plus his share of our nonrecourse liabilities. Because the amount realized includes a unitholder's share of our nonrecourse liabilities, the gain recognized on the sale of units could result in a tax liability in excess of any cash received from the sale.

Prior distributions from us that in the aggregate were in excess of cumulative net taxable income for a common unit and, therefore, decreased a unitholder's tax basis in that common unit will, in effect, become taxable income if the common unit is sold at a price greater than the unitholder's tax basis in that common unit, even if the price received is less than his original cost.

Except as noted below, gain or loss recognized by a unitholder, other than a dealer in units, on the sale or exchange of a unit will generally be taxable as capital gain or loss. Capital gain recognized by an individual on the sale of units held for more than twelve months will generally be taxed at the U.S. federal income tax rate applicable to long-term capital gains. However, a portion of this gain or loss, which will likely be substantial, will be separately computed and taxed as ordinary income or loss under Section 751 of the Internal Revenue Code to the extent attributable to assets giving rise to depreciation recapture or other unrealized receivables or to inventory items we own. The term unrealized receivables includes potential recapture items, including depreciation recapture. Ordinary income attributable to unrealized receivables, inventory items and depreciation recapture may exceed net taxable gain realized upon the sale of a unit and may be recognized even if there is a net taxable loss realized on the sale of a unit. Thus, a unitholder may recognize both ordinary income and a capital loss upon a sale of units. Capital losses may offset capital gains and no more than \$3,000 of ordinary income, in the case of individuals, and may only be used to offset capital gains in the case of corporations. Both ordinary income and capital gain recognized on a sale of units may be subject to the NIIT in certain circumstances. Please read Tax Consequences of Unit Ownership Tax Rates.

The IRS has ruled that a partner who acquires interests in a partnership in separate transactions must combine those interests and maintain a single adjusted tax basis for all those interests. Upon a sale or other disposition of less than all of those interests, a portion of that tax basis must be allocated to the interests sold using an equitable apportionment method, which generally means that the tax basis allocated to the interest sold equals an amount that bears the same relation to the partner's tax basis in his entire interest in the partnership as the value of the interest sold bears to the value of the partner's entire interest in the partnership. Treasury Regulations under Section 1223 of the Internal Revenue Code allow a selling unitholder who can identify common units transferred with an ascertainable holding

period to elect to use the actual holding period of the common units transferred. Thus, according to the ruling discussed above, a common unitholder will be

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unable to select high or low basis common units to sell as would be the case with corporate stock, but, according to the Treasury Regulations, he may designate specific common units sold for purposes of determining the holding period of units transferred. A unitholder electing to use the actual holding period of common units transferred must consistently use that identification method for all subsequent sales or exchanges of common units. A unitholder considering the purchase of additional units or a sale of common units purchased in separate transactions is urged to consult his tax advisor as to the possible consequences of this ruling and application of the Treasury Regulations.

Specific provisions of the Internal Revenue Code affect the taxation of some financial products and securities, including partnership interests, by treating a taxpayer as having sold an appreciated partnership interest, one in which gain would be recognized if it were sold, assigned or terminated at its fair market value, if the taxpayer or related persons enter(s) into:

(a) a short sale;

(b) an offsetting notional principal contract; or

(c) a futures or forward contract;

in each case, with respect to the partnership interest or substantially identical property.

Moreover, if a taxpayer has previously entered into a short sale, an offsetting notional principal contract or a futures or forward contract with respect to the partnership interest, the taxpayer will be treated as having sold that position if the taxpayer or a related person then acquires the partnership interest or substantially identical property. The Secretary of the Treasury is also authorized to issue regulations that treat a taxpayer that enters into transactions or positions that have substantially the same effect as the preceding transactions as having constructively sold the financial position.

Allocations Between Transferors and Transferees. In general, our taxable income and losses will be determined annually, will be prorated on a monthly basis and will be subsequently apportioned among the unitholders in proportion to the number of units owned by each of them as of the opening of the applicable exchange on the first business day of the month, which we refer to in this prospectus as the Allocation Date. However, gain or loss realized on a sale or other disposition of our assets other than in the ordinary course of business will be allocated among the unitholders on the Allocation Date in the month in which that gain or loss is recognized. As a result, a unitholder transferring units may be allocated income, gain, loss and deduction realized after the date of transfer.

Although simplifying conventions are contemplated by the Internal Revenue Code and most publicly traded partnerships use similar simplifying conventions, the use of this method may not be permitted under existing Treasury Regulations as there is no direct or indirect controlling authority on this issue. The Department of the Treasury and the IRS have issued proposed Treasury Regulations that provide a safe harbor pursuant to which a publicly traded partnership may use a similar monthly simplifying convention to allocate tax items among transferor and transferee unitholders, alt