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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

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**FORM 10-Q**

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(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended **June 30, 2009**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**000-32743**

(Commission File Number)

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**ZHONE TECHNOLOGIES, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**22-3509099**

(I.R.S. Employer  
Identification Number)

**7001 Oakport Street  
Oakland, California**

(Address of principal executive offices)

**94621**

(Zip code)

**(510) 777-7000**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of July 31, 2009, there were approximately 151,070,297 shares of the registrant's common stock outstanding.

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Balance Sheets**  
**(In thousands, except par value)**

	June 30, 2009 (Unaudited)	December 31, 2008
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 26,013	\$ 33,251
Short-term investments	828	2,992
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$5,485 as of June 30, 2009 and \$5,155 as of December 31, 2008	19,062	23,665
Inventories	33,569	40,706
Prepaid expenses and other current assets	2,203	2,654
Total current assets	81,675	103,268
Property and equipment, net	19,460	20,003
Restricted cash	58	123
Other assets	41	55
Total assets	<u>\$ 101,234</u>	<u>\$ 123,449</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 5,292	\$ 12,719
Line of credit	10,000	15,000
Current portion of long-term debt	399	380
Accrued and other liabilities	12,400	13,162
Total current liabilities	28,091	41,261
Long-term debt, less current portion	18,457	18,698
Other long-term liabilities	3,446	4,193
Total liabilities	49,994	64,152
Stockholders' equity:		
Common stock, \$0.001 par value. Authorized 900,000 shares; issued and outstanding 151,069 and 150,683 shares as of June 30, 2009 and December 31, 2008, respectively	151	151
Additional paid-in capital	1,065,577	1,064,493
Other comprehensive income	276	250
Accumulated deficit	(1,014,764)	(1,005,597)
Total stockholders' equity	51,240	59,297
Total liabilities and stockholders' equity	<u>\$ 101,234</u>	<u>\$ 123,449</u>

See accompanying notes to condensed consolidated financial statements.

**ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**Unaudited Condensed Consolidated Statements of Operations**  
(In thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2009	2008	2009	2008
Net revenue	\$ 30,346	\$ 40,069	\$ 54,449	\$ 83,102
Cost of revenue	19,290	28,453	35,580	57,680
Gross profit	<u>11,056</u>	<u>11,616</u>	<u>18,869</u>	<u>25,422</u>
Operating expenses:				
Research and product development	5,565	7,156	11,361	14,300
Sales and marketing	5,014	7,855	11,049	15,597
General and administrative	2,431	6,388	5,009	9,855
Gain on sale of assets	—	—	—	(455)
Gain on sale of intangible assets	—	(93)	—	(3,297)
Goodwill impairment	—	70,401	—	70,401
Total operating expenses	<u>13,010</u>	<u>91,707</u>	<u>27,419</u>	<u>106,401</u>
Operating loss	(1,954)	(80,091)	(8,550)	(80,979)
Interest expense	(330)	(391)	(677)	(843)
Interest income	11	201	38	517
Other income, net	56	40	83	156
Loss before income taxes	(2,217)	(80,241)	(9,106)	(81,149)
Income tax provision	47	93	61	126
Net loss	<u>\$ (2,264)</u>	<u>\$ (80,334)</u>	<u>\$ (9,167)</u>	<u>\$ (81,275)</u>
Basic and diluted net loss per share	\$ (0.02)	\$ (0.53)	\$ (0.06)	\$ (0.54)
Weighted average shares outstanding used to compute basic and diluted net loss per share	150,916	150,260	150,817	150,166

See accompanying notes to condensed consolidated financial statements.

**ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**Unaudited Condensed Consolidated Statements of Cash Flows**  
(In thousands)

	<b>Six Months Ended</b>	
	<b>June 30,</b>	
	<b>2009</b>	<b>2008</b>
Cash flows from operating activities:		
Net loss	\$ (9,167)	\$(81,275)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	960	1,135
Stock-based compensation	1,063	1,276
Accretion of premium/(discount) on investments	22	(122)
Provision for sales returns and doubtful accounts	1,198	1,667
Goodwill impairment	—	70,401
Gain on sale of assets	—	(455)
Gain on sale of intangible assets	—	(3,297)
Changes in operating assets and liabilities:		
Accounts receivable	3,405	1,345
Inventories	7,137	7,499
Prepaid expenses and other current assets	451	1,180
Other assets	14	14
Accounts payable	(7,427)	(3,751)
Accrued and other liabilities	(1,509)	1,257
Net cash used in operating activities	(3,853)	(3,126)
Cash flows from investing activities:		
Purchases of property and equipment	(417)	(844)
Purchases of short-term investments	(308)	(8,569)
Proceeds from sale and maturities of short-term investments	2,447	15,453
Proceeds from sale of assets	—	500
Proceeds from sale of intangible assets	—	3,297
Change in restricted cash	65	65
Net cash provided by investing activities	1,787	9,902
Cash flows from financing activities:		
Proceeds from issuance of common stock	21	247
Repayment of debt	(5,222)	(165)
Net cash provided by (used in) financing activities	(5,201)	82
Effect of exchange rate changes on cash	29	(179)
Net increase (decrease) in cash and cash equivalents	(7,238)	6,679
Cash and cash equivalents at beginning of period	33,251	37,804
Cash and cash equivalents at end of period	\$26,013	\$ 44,483

See accompanying notes to condensed consolidated financial statements.

## Notes to Condensed Consolidated Financial Statements

### (1) Organization and Summary of Significant Accounting Policies

#### (a) Description of Business

Zhone Technologies, Inc. (sometimes referred to, collectively with its subsidiaries, as “Zhone” or the “Company”) designs, develops and manufactures communications products for network service providers. The Company’s products allow network service providers to deliver video and interactive entertainment services in addition to their existing voice and data service offerings. The Company was incorporated under the laws of the state of Delaware in June 1999. The Company began operations in September 1999 and is headquartered in Oakland, California.

#### (b) Basis of Presentation

The condensed consolidated financial statements are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) that, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented. The Company has evaluated subsequent events through August 7, 2009, the date these unaudited condensed consolidated financial statements were filed with the Securities and Exchange Commission. The results of operations for the current interim period are not necessarily indicative of results to be expected for the current year or any other period. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Form 10-K for the year ended December 31, 2008.

#### (c) Risks and Uncertainties

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company’s continued losses reduced cash, cash equivalents and short-term investments in 2008 and the six months ended June 30, 2009. As of June 30, 2009, the Company had approximately \$26.8 million in cash, cash equivalents and short-term investments and \$10.0 million outstanding under its bank lending facility. Continued uncertainty in the credit markets may negatively impact the Company’s ability to access debt financing or to refinance existing indebtedness in the future on favorable terms, or at all. In order to meet liquidity needs and finance capital expenditures and working capital, the Company may be required to sell assets, or to borrow on potentially unfavorable terms. The Company may be unable to sell assets or access additional indebtedness to meet these needs. As a result, the Company may become unable to pay its ordinary expenses, including its debt service, on a timely basis. The Company’s current lack of liquidity could harm it by:

- increasing its vulnerability to adverse economic conditions in its industry or the economy in general;
- requiring substantial amounts of cash to be used for debt servicing, rather than other purposes, including operations;
- limiting its ability to plan for, or react to, changes in its business and industry; and
- influencing investor and customer perceptions about its financial stability and limiting its ability to obtain financing or acquire customers.

The global unfavorable economic and market conditions and the financial crisis could impact the Company’s business in a number of ways, including:

- Potential deferment of purchases and orders by customers;
- Customers’ inability to obtain financing to make purchases from the Company and/or maintain their business;
- Negative impact from increased financial pressures on third-party dealers, distributors and retailers; and
- Negative impact from increased financial pressures on key suppliers.

If the economic, market and geopolitical conditions in the United States and the rest of the world do not improve, or if they continue to deteriorate, the Company may experience material adverse impacts on its business, operating results and financial condition.

During 2008 and the six months ended June 30, 2009, the Company implemented several activities intended to reduce costs, improve operating efficiencies and change its operations to more closely align them with its key strategic focus, including the sale of legacy product lines and headcount reductions.

The Company expects that operating losses and negative cash flows from operations will continue. In order to meet the Company's liquidity needs and finance its capital expenditures and working capital needs for the business, the Company may need to raise additional capital through the issuance of debt or equity financing or the sale of assets. Continued uncertainty in credit markets may negatively impact the Company's ability to access debt financing or to refinance existing indebtedness in the future on favorable terms, or at all. If additional capital is raised through the issuance of debt securities or other debt financing, the terms of such debt may include covenants, restrictions and financial ratios that may restrict the Company's ability to operate its business. Likewise, any equity financing could result in additional dilution of the Company's stockholders. If the Company is unable to obtain additional capital or is required to obtain additional capital on terms that are not favorable, it may be required to reduce the scope of its planned product development and sales and marketing efforts beyond the reductions it has previously taken. Based on the Company's current plans and business conditions, it believes that its existing cash, cash equivalents and short-term investments and available credit facilities will be sufficient to satisfy its anticipated cash requirements for the foreseeable future.

**(d) Use of Estimates**

The preparation of the condensed consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ materially from those estimates.

**(e) Fair Value of Financial Instruments**

The carrying amounts of the Company's consolidated financial instruments which include cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their fair values as of June 30, 2009 and December 31, 2008 due to the relatively short maturities of these instruments. The carrying value of the Company's debt obligations at June 30, 2009 and December 31, 2008 approximate their fair value.

**(f) Concentration of Risk**

The Company's customers include competitive and incumbent local exchange carriers, competitive access providers, Internet service providers, wireless carriers and resellers serving these markets. The Company performs ongoing credit evaluations of its customers and generally does not require collateral. Allowances are maintained for potential doubtful accounts. For the three and six months ended June 30, 2009, one customer accounted for 18% and 10% of net revenue, respectively. For the six months ended June 30, 2008, the same customer accounted for 16% of net revenue. As of June 30, 2009, one customer accounted for 29% of accounts receivable, and as of December 31, 2008, two customers accounted for 18% and 14% of accounts receivable, respectively. As of June 30, 2009 and December 31, 2008, receivables from customers in territories outside of the United States of America represented 64% and 75%, respectively, of accounts receivable.

**(g) Presentation of Transactional-based Taxes**

The Company nets sales taxes against revenue in accordance with the provisions of Emerging Issues Task Force Issue No. 06-3 (EITF 06-3), *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)*.

**(h) Recent Accounting Pronouncements**

In May 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 165, *Subsequent Events* (SFAS 165). SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS 165 is effective for interim and annual periods ending after June 15, 2009. The Company adopted SFAS 165 in the second quarter of fiscal 2009. See Note 1(b) "Basis of Presentation" for more information.

In April 2009, the FASB issued FASB Staff Position FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other – Than-Temporary Impairments* (FSP FAS 115-2 and FAS 124-2). FSP FAS 115-2 and FAS 124-2 amends the other-than-temporary guidance in U.S. GAAP for debt securities to modify the requirement for recognizing other-than-temporary impairments, changes the existing impairment model, and modifies the presentation and frequency of related disclosures. FSP FAS 115-2 and FAS 124-2 are effective for interim and annual periods ending after June 15, 2009. The Company adopted FSP FAS 115-2 and FAS 124-2 in the second quarter of fiscal 2009. The adoption of the FSP did not have any impact on the Company’s condensed consolidated financial statements.

In April 2009, the FASB issued FASB staff Position FAS 107-1 and Accounting Principles Board (APB) Opinion No. 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1 expand the fair value disclosures currently required on an annual basis for financial instruments to interim reporting periods. FSP FAS 107-1 and APB 28-1 also requires entities to disclose the methods and significant

assumptions used to estimate the value of financial instruments on an interim basis and describe changes in methods and significant assumptions, if any, during the period. FSP FAS 107-1 and APB 28-1 are effective for interim reporting periods ending after June 15, 2009. The Company adopted FSP FAS 107-1 and APB 28-1 in the second quarter of fiscal 2009. The adoption of FSP FAS 107-1 and APB 28-1 did not have a material effect on the Company's condensed consolidated financial statements for the three and six months ended June 30, 2009. See Note 2 "Cash and Cash Equivalents and Short-Term Investments" and Note 3 "Fair Value Measurement" for information on the fair value of financial instruments.

In April 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. This FSP provides additional guidance for estimating fair value in accordance with Statement of Financial Accounting Standards ("SFAS") No. 157, *Fair Value Measurements* ("SFAS 157"), when the volume and level of activity for the asset or liability have significantly decreased. It also includes guidance on identifying circumstances that indicate a transaction is not orderly. The adoption of FAS 157-4 did not have a material effect on the Company's condensed consolidated financial statements for the three and six months ended June 30, 2009.

(2) **Cash and Cash Equivalents and Short-term Investments**

Cash, cash equivalents, and short-term investments as of June 30, 2009 and December 31, 2008 consisted of the following (in thousands):

	<u>June 30, 2009</u>	<u>December 31, 2008</u>
<b>Cash and Cash Equivalents:</b>		
Cash	\$14,930	\$ 26,607
Money Market Funds	11,083	6,644
	<u>\$26,013</u>	<u>\$ 33,251</u>
<b>Short-term investments:</b>		
Commercial Paper	\$ —	\$ 898
Corporate Securities	828	2,094
	<u>\$ 828</u>	<u>\$ 2,992</u>

Cash, cash equivalents, and short-term investments consisted of the following as of June 30, 2009 (in thousands):

	<u>Cost</u>	<u>Unrealized Gain</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>
<b>Cash and Cash Equivalents:</b>				
Cash	\$14,930	\$ —	\$ —	\$ 14,930
Money Market Funds	11,083	—	—	11,083
	<u>\$26,013</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 26,013</u>
<b>Short-term investments:</b>				
Corporate Securities	\$ 826	\$ 2	\$ —	\$ 828
	<u>\$ 826</u>	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ 828</u>

Cash, cash equivalents, and short-term investments consisted of the following as of December 31, 2008 (in thousands):

	Cost	Unrealized Gain	Unrealized Loss	Fair Value
<b>Cash and Cash Equivalents:</b>				
Cash	\$26,607	\$ —	\$ —	\$ 26,607
Money Market Funds	6,644	—	—	6,644
	<u>\$33,251</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 33,251</u>
<b>Short-term investments:</b>				
Commercial Paper	\$ 896	\$ 2	\$ —	\$ 898
Corporate Securities	2,091	5	(2)	2,094
	<u>\$ 2,987</u>	<u>\$ 7</u>	<u>\$ (2)</u>	<u>\$ 2,992</u>

### (3) Fair Value Measurement

The Company adopted SFAS 157 for financial assets and liabilities during the first fiscal quarter of 2008. SFAS 157 requires enhanced disclosures about assets and liabilities measured at fair value.

The Company utilizes the market approach to measure fair value of its financial assets and liabilities. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

SFAS 157 includes a fair value hierarchy that is intended to increase consistency and comparability in fair value measurements and related disclosures. The fair value hierarchy is based on inputs to valuation techniques that are used to measure fair value that are either observable or unobservable. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon their own market assumptions. The fair value hierarchy consists of the following three levels:

- Level 1 - Inputs are quoted prices in active markets for identical assets or liabilities.
- Level 2 - Inputs are quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable and market-corroborated inputs which are derived principally from or corroborated by observable market data.
- Level 3 - Inputs are derived from valuation techniques in which one or more significant inputs or value drivers are unobservable.

The following table represents the Company's financial assets and liabilities at fair value on a recurring basis as of June 30, 2009 and the basis for that measurement:

	<b>Fair Value Measurements at Reporting Date Using (In Thousands)</b>			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds (1)	\$ 11,083	\$ 11,083	\$ —	\$ —
Corporate securities (2)	828	—	828	—
<b>Total</b>	<u>\$ 11,911</u>	<u>\$ 11,083</u>	<u>\$ 828</u>	<u>\$ —</u>

- (1) Included in cash and cash equivalents on the Company's condensed consolidated balance sheet.
- (2) Included in short-term investments on the Company's condensed consolidated balance sheet.

Effective January 1, 2009, the Company adopted SFAS 157 for all non-financial assets and liabilities that are measured at fair value on a non-recurring basis, such as goodwill and identifiable intangible assets. The adoption of SFAS 157 for non-financial assets and liabilities did not materially impact the Company's consolidated financial statements for the six months ended June 30, 2009 and the Company does not expect the adoption to have a material impact on the amounts reported in its consolidated financial statements in future periods.

#### (4) Operating Lease Liabilities

As a result of the acquisition of Paradyne Networks, Inc. (“Paradyne”) in September 2005, the Company assumed a lease commitment for facilities in Largo, Florida. In accordance with Emerging Issues Task Force Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination* (EITF 95-3), the Company accrued a liability for the excess portion of these facilities. The term of the lease expires in June 2012 and had an estimated remaining obligation of approximately \$13.0 million as of June 30, 2009, of which \$4.9 million was accrued for excess facilities, net of estimated sublease income. The computation of the estimated liability includes a number of assumptions and subjective variables. These variables include the level and timing of future sublease income, amount of contractual variable costs, future market rental rates, discount rate, and other estimated expenses. If circumstances change, and the Company employs different assumptions in future periods, the lease liability may differ significantly from what the Company has recorded in the current period and could materially affect its net loss and net loss per share. During the second quarter of 2008, the Company significantly reduced its assumptions regarding estimated future sublease income primarily as a result of the deteriorating real estate market. Accordingly, during the second quarter of 2008, the Company increased its excess lease liability balance by \$3.3 million, with a corresponding charge to general and administrative expenses. During the first and second quarters of 2009, the Company reduced its assumptions regarding the future sublease income due to the continued deterioration in the real estate market. The Company increased its excess lease liability balance by \$0.1 million and \$0.2 million in the first and second quarters of 2009, respectively, with a corresponding charge to general and administrative expenses. A summary of current period activity related to excess lease liabilities accrued is as follows (in thousands):

Balance at December 31, 2008	\$5,597
Cash payments, net	(440)
Lease adjustment	54
Balance at March 31, 2009	\$5,211
Cash payments, net	(454)
Lease adjustment	173
Balance at June 30, 2009	<u>\$4,930</u>

A summary of the excess lease liabilities at their net present value as of June 30, 2009 is as follows (in thousands):

Future lease payments for excess space	\$ 7,083
Less: contractual sublease income	(1,803)
Less: estimated sublease income	(376)
Other sublease expenses	26
Balance at June 30, 2009	<u>\$ 4,930</u>

The current portion of the excess lease liability as of June 30, 2009 of \$1.8 million is classified in “Accrued and other liabilities” and the long-term portion of \$3.1 million is classified in “Other long-term liabilities” in the accompanying condensed consolidated balance sheet.

#### (5) Inventories

Inventories as of June 30, 2009 and December 31, 2008 were as follows (in thousands):

	June 30, 2009	December 31, 2008
Inventories:		
Raw materials	\$21,475	\$ 26,720
Work in process	3,301	5,160
Finished goods	8,793	8,826
	<u>\$33,569</u>	<u>\$ 40,706</u>

#### *Sale of Legacy Inventory and Other Assets*

In January 2008, the Company sold its GigaMux legacy product line to a third party. The sale of the GigaMux legacy product line was not treated as a discontinued operation since it did not represent a component of the Company that had operations and cash flows that were clearly distinguishable, operationally and for financial reporting purposes, from the rest of the entity. The Company allocated the proceeds received to receivables, inventory, fixed assets and intangible assets based on the relative fair

value of the assets sold. The Company recognized a gain of \$1.3 million on the sale of the inventory related to this product line in the first quarter of 2008 that was recorded in cost of revenue. The Company also recognized a gain of \$0.5 million and \$3.2 million on the sale of fixed assets and intangible assets, respectively, in the first quarter of 2008 that was recorded as a component of operating expenses. The Company is entitled to additional contingent consideration for the sale of the GigaMux legacy product line upon the buyer's usage of inventory and/or attainment of certain performance targets through December 2010. Additional contingent consideration, if any, will be recorded upon receipt of cash as an additional gain in cost of revenue. During 2008, the Company received contingent consideration of \$1.1 million related to the buyer's usage of inventory related to the GigaMux legacy product line. For the six months ended June 30, 2009, the Company received additional contingent consideration of \$0.2 million related to the buyer's usage of inventory related to the GigaMux legacy product line.

In December 2007, the Company sold inventory and certain assets related to its Access Node legacy product line to a third party. The sale of the Access Node product line was not treated as a discontinued operation since it did not represent a component of the Company that had operations and cash flows that were clearly distinguishable, operationally and for financial reporting purposes, from the rest of the entity. Upon sale of the Access Node inventory, the Company recognized a gain of \$1.7 million in 2007 that was recorded in cost of revenue. In 2008, the Company recognized an additional gain of \$0.2 million that was recorded in cost of revenue. For the six months ended June 30, 2009, the Company recognized an additional gain of \$0.2 million that was recorded in cost of revenue. The Company will continue to record additional gains in the future contingent upon attainment of certain earnout provisions.

## (6) Property and Equipment, net

Property and equipment, net, as of June 30, 2009 and December 31, 2008 were as follows (in thousands):

	June 30, 2009	December 31, 2008
Property and equipment:		
Land	\$ 4,821	\$ 4,821
Buildings	14,007	14,007
Machinery and equipment	8,927	8,682
Computers and acquired software	3,727	3,536
Furniture and fixtures	498	513
Leasehold improvements	377	381
	<u>32,357</u>	<u>31,940</u>
Less accumulated depreciation and amortization	<u>(12,897)</u>	<u>(11,937)</u>
	<u>\$ 19,460</u>	<u>\$ 20,003</u>

Depreciation and amortization expense associated with property and equipment amounted to \$1.0 million and \$1.1 million for the six months ended June 30, 2009 and 2008, respectively.

## (7) Stock-Based Compensation

As of June 30, 2009, the Company had two types of stock-based compensation plans: a stock option plan and an employee stock purchase plan. The compensation cost that has been charged as an expense in the statement of operations for those plans was \$1.1 million and \$1.3 million for the six months ended June 30, 2009 and 2008, respectively.

The following table summarizes stock-based compensation expense for the three and six months ended June 30, 2009 and 2008 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Stock-based compensation	\$ 488	\$ 535	\$ 998	\$ 1,121
Compensation expense relating to non-employees	47	64	53	68
Compensation expense relating to Employee Stock Purchase Plan	8	41	12	87
Stock-based compensation expense	<u>\$ 543</u>	<u>\$ 640</u>	<u>\$ 1,063</u>	<u>\$ 1,276</u>

### Stock Options

The Company's stock-based compensation plans are designed to attract, motivate, retain and reward talented employees, directors and consultants and align stockholder and employee interests. The Company has two active stock option plans: the Amended and Restated Special 2001 Stock Incentive Plan and the Amended and Restated 2001 Stock Incentive Plan. Stock options are primarily issued from the Amended and Restated 2001 Stock Incentive Plan. This plan provides for the grant of



incentive stock options, non-statutory stock options, restricted stock awards and other stock-based awards to officers, employees, directors and consultants of the Company. As of June 30, 2009, 8.6 million shares were available for grant under these plans.

The assumptions used to value option grants for the three and six months ended June 30, 2009 and 2008 are as follows:

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Expected term	4.7 years	4.7 years	4.7 years	4.7 years
Volatility	88%	61%	88%	61%
Risk free interest rate	2.74%	3.52%	2.66%	3.49%

The following table sets forth the summary of option activity under the stock option plans for the six months ended June 30, 2009 (in thousands, except per share data):

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding as of December 31, 2008	26,500	\$ 2.29	5.00	\$ —
Granted	25	\$ 0.13		
Canceled/Forfeited	(495)	\$ 0.36		
Outstanding as of March 31, 2009	26,030	\$ 2.33	4.77	\$ 1,289
Granted	225	\$ 0.28		
Canceled/Forfeited	(88)	\$ 0.15		
Exercised	(23)	\$ 0.12		
Outstanding as of June 30, 2009	26,144	\$ 2.32	4.56	\$ 3,147
Vested and expected to vest at June 30, 2009	24,989	\$ 2.51	4.36	\$ —
Vested and exercisable at June 30, 2009	11,477	\$ 5.11	2.26	\$ 484

The aggregate intrinsic value represents the total pretax intrinsic value, based on the Company's closing stock price of \$0.32 as of June 30, 2009, which would have been received from the option holders had all option holders exercised their options as of that date.

The weighted average grant date fair value of options granted during the three and six months ended June 30, 2009 was \$0.19 per share and \$0.18 per share, respectively. The weighted average grant date fair value of options granted during the three and six months ended June 30, 2008 was \$0.51 per share and \$0.52 per share, respectively. The intrinsic value of options exercised during the period and the proceeds received were insignificant for the three and six months ended June 30, 2009 and June 30, 2008.

As of June 30, 2009, there was \$3.4 million of unrecognized compensation expense, adjusted for estimated forfeitures related to unvested stock-based payments, which are expected to be recognized over a weighted average period of 1.7 years.

In November 2008, the Company completed an offer (the "Exchange Offer") to exchange certain stock options issued to eligible employees, officers and directors of Zhone under Zhone's equity incentive compensation plans. Stock options previously granted that had an exercise price per share of equal to or greater than \$0.35 per share were eligible to be exchanged on a one-for-one basis for new stock options with an exercise price equal to the last reported sale price of Zhone common stock on The Nasdaq Global Market on the date of grant. Options for an aggregate of 14.5 million shares of common stock were exchanged on November 17, 2008. The new stock options issued pursuant to the Exchange Offer have an exercise price of \$0.10, will vest over a four-year period with no credit for past vesting and have a seven-year term. The Exchange Offer will result in incremental stock-based compensation of approximately \$0.7 million to be recognized over the four-year vesting period. The remaining unrecognized compensation expense of the original grant will be amortized over the original requisite service period.

## (8) Net Loss Per Share

The following tables set forth potentially dilutive securities that have been excluded from the diluted net loss per share calculation because their effect would be antidilutive for the periods indicated (in thousands, except per share data):

	Three Months Ended June 30, 2009	Weighted Average Exercise Price	Six Months Ended June 30, 2009	Weighted Average Exercise Price
Warrants	36	\$ 23.31	36	\$ 23.31
Outstanding stock options and unvested restricted shares	26,247	\$ 2.32	26,247	\$ 2.32
	<u>26,283</u>		<u>26,283</u>	

	Three Months Ended June 30, 2008	Weighted Average Exercise Price	Six Months Ended June 30, 2008	Weighted Average Exercise Price
Warrants	2,182	\$ 4.20	2,182	\$ 4.20
Outstanding stock options and unvested restricted shares	24,597	\$ 4.21	24,597	\$ 4.21
	<u>26,779</u>		<u>26,779</u>	

## (9) Comprehensive Loss

The components of comprehensive loss, net of tax, for the three and six months ended June 30, 2009 and 2008 were as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net loss	\$(2,264)	\$(80,334)	\$(9,167)	\$(81,275)
Other comprehensive loss:				
Change in unrealized gain/(loss) on investments	1	(13)	(3)	(14)
Foreign currency translation adjustments	13	2	29	(179)
Total comprehensive loss	<u>\$(2,250)</u>	<u>\$(80,345)</u>	<u>\$(9,141)</u>	<u>\$(81,468)</u>

## (10) Debt

### *Secured Real Estate Loan*

In December 2005, the Company entered into an amendment to an existing loan with a financial institution relating to the financing of its Oakland, California campus (the "Amended Loan"). As of June 30, 2009, the Company had \$18.9 million of debt outstanding under this secured real estate loan facility which matures in April 2011. The interest rate on this debt was 6.5% as of June 30, 2009. The Company's obligations under the Amended Loan remain secured by a security interest in the Company's campus. As of June 30, 2009 and December 31, 2008, the debt was collateralized by land and buildings with a net book value of \$15.8 million and \$16.1 million, respectively.

Long-term debt consisted of the following as of June 30, 2009 and December 31, 2008 (in thousands):

	June 30, 2009	December 31, 2008
Secured real estate loan due April 2011	\$18,856	\$ 19,078
Less current portion of long-term debt	(399)	(380)
	<u>\$18,457</u>	<u>\$ 18,698</u>

Aggregate debt maturities as of June 30, 2009 were \$0.2 million for the remainder of 2009, \$0.4 million in 2010, and \$18.3 million in 2011.

### *Credit Facility*

In March 2009, the Company entered into a secured revolving credit arrangement ("SVB Facility") with Silicon Valley Bank ("SVB") to provide liquidity and working capital through March 15, 2010. The SVB Facility replaced the prior SVB facilities.

Under the SVB Facility, the Company has the option of borrowing funds at agreed upon interest rates as long as the aggregate amount outstanding does not exceed \$20.0 million. The amount that the Company is able to borrow under the SVB Facility will

vary based on the eligible accounts receivable, as defined in the agreement. In addition, under the SVB Facility, the Company is able to utilize up to \$7.0 million of the facility as security for letters of credit.

Under the SVB Facility, \$10.0 million was outstanding at June 30, 2009. An additional \$4.3 million was committed as security for various letters of credit as of June 30, 2009. The amounts borrowed under the SVB Facility bear interest, payable monthly, at a floating rate that is SVB's prime rate plus 2.5%. The minimum interest rate is 6.5%. The interest rate was 6.5% at June 30, 2009.

The Company's obligations under the SVB Facility are secured by substantially all of its personal property assets and those of its subsidiaries, including their intellectual property. The SVB Facility contains certain financial covenants, and customary affirmative covenants and negative covenants. If the Company does not comply with the various covenants and other requirements under the SVB Facility, SVB is entitled to, among other things, require the immediate repayment of all outstanding amounts and sell the Company's assets to satisfy the obligations under the SVB Facility. As of June 30, 2009, the Company was in compliance with these covenants.

## (11) Commitments and Contingencies

### *Leases*

The Company has entered into operating leases for certain office space and equipment, some of which contain renewal options. Estimated future lease payments under all non-cancelable operating leases with terms in excess of one year, including taxes and service fees, are as follows (in thousands):

	<u>Operating Leases</u>
Year ending December 31:	
2009 (remainder of the year)	\$ 2,469
2010	4,581
2011	4,479
2012	2,278
2013	—
Total minimum lease payments	<u>\$ 13,807</u>

The total minimum lease payments shown above include projected payments and obligations for leases that the Company is no longer utilizing, some of which relate to excess facilities obtained through acquisitions. At June 30, 2009, the Company had estimated commitments of \$13.0 million related to facilities assumed as a result of the Paradyne acquisition, of which \$4.9 million was accrued for excess facilities, which is net of estimated sublease income. For operating leases that include contractual commitments for operating expenses and maintenance, estimates of such amounts are included based on current rates.

### *Warranties*

The Company accrues for warranty costs based on historical trends for the expected material and labor costs to provide warranty services. Warranty periods are generally one year from the date of shipment. The following table reconciles changes in the Company's accrued warranties and related costs for the six months ended June 30, 2009 and 2008 (in thousands):

	<u>Six Months Ended</u> <u>June 30,</u>	
	<u>2009</u>	<u>2008</u>
Beginning balance	\$ 1,979	\$ 2,487
Charged to cost of revenue	649	820
Claims and settlements	(1,066)	(1,203)
Ending balance	<u>\$ 1,562</u>	<u>\$ 2,104</u>

### *Other Commitments*

Certain pre-acquisition contingencies from the acquisition of Tellium, Inc. in 2003 continue to exist for which the Company has reserved an estimated amount that it believes is sufficient to cover the probable loss from these matters.

The Company is currently under audit examination by several state taxing authorities for non income based taxes. The Company has reserved an estimated amount which the Company believes is sufficient to cover probable claims.

### *Royalties*

The Company has certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a dollar amount per unit shipped or a percentage of the underlying revenue and is recorded in cost of revenue.

## **Legal Proceedings**

### ***Paradyne Matters***

As a result of the acquisition of Paradyne, the Company became involved in various legal proceedings, claims and litigation, including those identified below, relating to the operations of Paradyne prior to the acquisition of Paradyne.

A purported stockholder class action complaint was filed in December 2001 in the United States District Court in the Southern District of New York against Paradyne, Paradyne's then-current directors and executive officers, and each of the underwriters (the "Underwriter Defendants") who participated in Paradyne's initial public offering and follow-on offering (collectively, the "Paradyne Offerings"). The complaint alleges that, in connection with the Paradyne Offerings, the Underwriter Defendants charged excessive commissions, inflated transaction fees not disclosed in the applicable registration statements and allocated shares of the Paradyne Offerings to favored customers in exchange for purported promises by such customers to purchase additional shares in the aftermarket, thereby allegedly inflating the market price for the Paradyne Offerings. The complaint seeks damages in an unspecified amount for the purported class for the losses suffered during the class period. This action has been consolidated with hundreds of other securities class actions commenced against more than 300 companies (collectively, the "Issuer Defendants") and approximately 40 investment banks in which the plaintiffs make substantially similar allegations as those made against Paradyne with respect to the initial public offerings and/or follow-on offerings at issue in those other cases. All of these actions have been consolidated before Judge Shira Scheindlin under the caption *In re: Initial Public Offering Securities Litigation* (the "IPO Actions").

In 2003, the Issuer Defendants participated in a global settlement among the plaintiffs and the insurance companies that provided directors' and officers' insurance coverage to the Issuer Defendants (the "Issuer Settlement"). The Issuer Settlement agreements provided for the Issuer Defendants (including Paradyne) to be fully released and dismissed from the IPO Actions. Under the terms of the Issuer Settlement agreements, Paradyne would not have been required to make any cash payment to the plaintiffs. Although the District Court preliminarily approved the Issuer Settlement, the preliminary approval remained subject to a future final settlement order, after notice of settlement had been provided to class members and they had been afforded the opportunity to oppose or opt out of the settlement. However, before the District Court could conduct its final settlement hearing, on December 5, 2006, the United States Court of Appeals for the Second Circuit (the "Second Circuit") reversed an October 13, 2004 order of the District Court in which Judge Scheindlin had granted class certification for six "test cases" in the IPO Actions. On April 4, 2007, the Second Circuit denied the plaintiffs' petition for rehearing of the December 5, 2006 ruling. The District Court has since made clear that the Issuer Settlement cannot be approved — in its current form — as a class action settlement in light of the Second Circuit's December 5, 2006 ruling and has declined to schedule a final approval hearing with respect to the Issuer Settlement for that reason.

In March 2009, counsel for the plaintiffs, for the Issuer Defendants and for the insurance companies that provided directors' and officers' insurance to the Issuer Defendants restructured the Issuer Settlement and submitted the restructured Issuer Settlement to the District Court for approval.

In July 2009, the District Court preliminarily approved the restructured Issuer Settlement submitted in March 2009. The District Court has set September 10, 2009 as the final approval hearing for the restructured Issuer Settlement. The restructured Issuer Settlement agreement provides for the Issuer Defendants (including Paradyne) to be fully released and dismissed from the IPO Actions. Under the terms of the restructured Issuer Settlement agreement, Paradyne will not be required to make any cash payments to the plaintiffs. There can be no assurance that the restructured Issuer Settlement will meet the conditions for final approval by the District Court.

### ***Other Matters***

The Company is subject to other legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect on its consolidated financial position or results of operations. However, litigation is subject to inherent uncertainties, and unfavorable rulings could occur. If an unfavorable ruling were to occur, there exists the possibility of a material adverse impact on the results of operations of the period in which the ruling occurs, or future periods.

## **(12) Enterprise-Wide Information**

The Company designs, develops and manufactures communications products for network service providers. The Company derives substantially all of its revenues from the sales of the Zhone product family. The Company's chief operating decision maker is the Company's Chief Executive Officer. The Chief Executive Officer reviews financial information presented on a consolidated basis accompanied by disaggregated information about revenues by geographic region for purposes of making operating decisions and assessing financial performance. The Company has determined that it has operated within one discrete reportable business segment since inception. The following summarizes required disclosures about geographic concentrations.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2009	2008	2009	2008
	(in thousands)		(in thousands)	
<b>Revenue by Geography:</b>				
United States	\$13,386	\$16,776	\$26,339	\$33,142
Canada	1,247	1,314	3,030	2,385
Total North America	14,633	18,090	29,369	35,527
Latin America	4,069	6,598	7,422	16,840
Europe, Middle East, Africa	11,136	14,577	16,562	28,434
Asia Pacific	508	804	1,096	2,301
Total International	15,713	21,979	25,080	47,575
	<u>\$30,346</u>	<u>\$40,069</u>	<u>\$54,449</u>	<u>\$83,102</u>

### (13) Income Taxes

In accordance with the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), the total amount of unrecognized tax benefits, including interest and penalties, at June 30, 2009 was not material. The amount of tax benefits that would impact the effective rate, if recognized, is not expected to be material. There were no significant changes to unrecognized tax benefits at the date of adoption or at the quarter ended June 30, 2009. The Company does not anticipate any significant changes with respect to unrecognized tax benefits within the next 12 months.

Interest and penalties, to the extent accrued on unrecognized tax benefits in the future, will be included in income tax expense.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The open tax years for the major jurisdictions are as follows:

- Federal 2005 – 2008
- California and Canada 2004 – 2008
- Brazil 2001 – 2008
- Germany and United Kingdom 2005 – 2008

However, due to the fact the Company had net operating losses and credits carried forward in most jurisdictions, certain items attributable to technically closed years are still subject to adjustment by the relevant taxing authority through an adjustment to tax attributes carried forward to open years.

In addition, to the extent the Company is deemed to have a sufficient connection to a particular taxing jurisdiction to enable that jurisdiction to tax the Company but the Company has not filed an income tax return in that jurisdiction for the year(s) at issue, the jurisdiction would typically be able to assert a tax liability for such years without limitation on the number of years it may examine.

The Company is not currently under examination for income taxes in any material jurisdiction.

### (14) Subsequent Events

On July 13, 2009, the Company received a letter from the Nasdaq Stock Market indicating that the temporary suspension of the minimum bid price rule will continue through September 25, 2009.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### *Forward-Looking Statements*

This report, including "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 and the Securities Exchange Act of 1934. These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. We use words such as "anticipate," "believe," "continue," "could," "estimate," "expect," "goal," "intend," "may," "plan," "project," "seek," "should," "target," "will," "would," variations of such words, and similar expressions to identify forward-looking statements. In addition, statements that refer to projections of earnings, revenue, costs or other financial items; anticipated growth and trends in our business or key markets; future growth and revenues from our Single Line Multi-Service, or SLMS, products; future economic conditions and performance; anticipated performance of products or services; plans, objectives and strategies for future operations; and other characterizations of future events or circumstances, are forward-looking statements.

Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Factors that might cause such a difference include, but are not limited to, the ability to generate sufficient revenue to achieve or sustain profitability, the ability to raise additional capital to fund existing and future operations, defects or other performance problems in our products, the economic slowdown in the telecommunications industry that has restricted the ability of our customers to purchase our products, commercial acceptance of our SLMS products, intense competition in the communications equipment market from large equipment companies as well as private companies with products that address the same networks needs as our products, higher than anticipated expenses that we may incur, and other factors identified elsewhere in this report and in our most recent reports on Forms 10-K, 10-Q and 8-K. We undertake no obligation to revise or update any forward-looking statements for any reason.

## OVERVIEW

We believe that we are the first company dedicated solely to developing the full spectrum of next-generation access network solutions to cost-effectively deliver high bandwidth services while simultaneously preserving the investment in today's networks. Our next-generation solutions are based upon our SLMS architecture. From its inception, this SLMS architecture was specifically designed for the delivery of multiple classes of subscriber services (such as voice, data and video distribution), rather than being based on a particular protocol or media. In other words, our SLMS products are built to support the migration from legacy circuit to packet technologies and from copper to fiber technologies. This flexibility and versatility allows our products to adapt to future technologies while allowing service providers to focus on the delivery of additional high bandwidth services. Because this SLMS architecture is designed to interoperate with existing legacy equipment, service providers can leverage their existing networks to deliver a combination of voice, data and video services today, while they migrate, either simultaneously or at a future date, from legacy equipment to next-generation equipment with minimal interruption. We believe that our SLMS solution provides an evolutionary path for service providers from their existing infrastructures, as well as gives newer service providers the capability to deploy cost-effective, multi-service networks that can support voice, data and video.

Our global customer base includes regional, national and international telecommunications carriers. To date, our products are deployed by over 700 network service providers on six continents worldwide. We believe that we have assembled the employee base, technological breadth and market presence to provide a simple yet comprehensive set of next-generation solutions to the bandwidth bottleneck in the access network and the other problems encountered by network service providers when delivering communications services to subscribers.

Since inception, we have incurred significant operating losses and had an accumulated deficit of \$1,014.8 million as of June 30, 2009.

Going forward, our key financial objectives include the following:

- Increasing revenue while continuing to carefully control costs;
- Continued investments in strategic research and product development activities that will provide the maximum potential return on investment; and
- Minimizing consumption of our cash and short-term investments.

Recent global market and economic conditions have been unprecedented and challenging, with tighter credit conditions and recession in most major economies continuing in 2009. Continued concerns about the systemic impact of potential long-term and widespread recession, energy costs, geopolitical issues, the availability and cost of credit, and the global housing and mortgage markets have contributed to increased market volatility and diminished expectations for western and emerging economies. In the second half of 2008, federal government interventions in the U.S. financial system led to increased market uncertainty and instability in both U.S. and international capital and credit markets. These conditions, combined with volatile oil prices, declining business and consumer confidence and increased unemployment, have contributed to volatility of unprecedented levels. These global unfavorable economic and market conditions and the financial crisis may result in an adverse effect on our financial condition and results of operations.

## Sale of Legacy Inventory and Other Assets

In January 2008, we sold our GigaMux legacy product line to a third party. The sale of the GigaMux legacy product line was not treated as a discontinued operation since it did not represent a component of the company that had operations and cash flows that were clearly distinguishable, operationally and for financial reporting purposes, from the rest of the entity. We allocated the proceeds received to receivables, inventory, fixed assets and intangible assets based on the relative fair value of the assets sold. We recognized a gain of \$1.3 million on the sale of the inventory related to this product line in the first quarter of 2008 that was recorded in cost of revenue. We also recognized a gain of \$0.5 million and \$3.2 million on the sale of fixed assets and intangible assets, respectively, in the first quarter of 2008 that was recorded as a component of operating expenses. We are entitled to additional contingent consideration for the sale of the GigaMux legacy product line upon the buyer's usage of inventory and/or attainment of certain performance targets through December 2010. Additional contingent consideration, if any, will be recorded upon receipt of cash as an additional gain in cost of revenue. During 2008, we received contingent consideration of \$1.1 million

related to the buyer's usage of inventory related to the GigaMux legacy product line. For the six months ended June 30, 2009, we received additional contingent consideration of \$0.2 million related to the buyer's usage of inventory related to the GigaMux legacy product line.

In December 2007, we sold inventory and certain assets related to our Access Node legacy product line to a third party. The sale of the Access Node product line was not treated as a discontinued operation since it did not represent a component of our company that had operations and cash flows that were clearly distinguishable, operationally and for financial reporting purposes, from the rest of the entity. Upon sale of the Access Node inventory, we recognized a gain of \$1.7 million in 2007 that was recorded in cost of revenue. In 2008, we recognized an additional gain of \$0.2 million that was recorded in cost of revenue. For the six months ended June 30, 2009, we recognized an additional gain of \$0.2 million that was recorded in cost of revenue. We will continue to record additional gains in the future contingent upon attainment of certain earnout provisions.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Management's discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. The policies discussed below are considered by management to be critical because changes in such estimates can materially affect the amount of our reported net income or loss. For all of these policies, management cautions that actual results may differ materially from these estimates under different assumptions or conditions.

### **Revenue Recognition**

We recognize revenue when the earnings process is complete. We recognize product revenue upon shipment of product under contractual terms which transfer title to customers upon shipment, under normal credit terms, net of estimated sales returns and allowances at the time of shipment. Revenue is deferred if there are significant post-delivery obligations, if collection is not considered reasonably assured at the time of sale, or if the fees are not fixed or determinable. When significant post-delivery obligations exist, revenue is deferred until such obligations are fulfilled. Our arrangements generally do not have any significant post-delivery obligations. If our arrangements include customer acceptance provisions, revenue is recognized upon obtaining the signed acceptance certificate from the customer, unless we can objectively demonstrate that the delivered products or services meet all the acceptance criteria specified in the arrangement prior to obtaining the signed acceptance. In those instances where revenue is recognized prior to obtaining the signed acceptance certificate, we use successful completion of customer testing as the basis to objectively demonstrate that the delivered products or services meet all the acceptance criteria specified in the arrangement. We also consider our historical acceptance experience with the customer, as well as the payment terms specified in the arrangement, when revenue is recognized prior to obtaining the signed acceptance certificate. We offer products and services such as support, education and training, hardware upgrades and post-warranty support. For multiple element revenue arrangements, we establish the fair value of these products and services based primarily on sales prices when the products and services are sold separately. If fair value cannot be established for undelivered elements, all of the revenue under the arrangement is deferred until those elements have been delivered. When collectibility is not reasonably assured, revenue is recognized when cash is collected. Revenue from education services and support services is recognized over the contract term or as the service is performed. We make certain sales to product distributors. These customers are given certain privileges to return a portion of inventory. Return privileges generally allow distributors to return inventory based on a percent of purchases made within a specific period of time. We recognize revenue on sales to distributors that have contractual return rights when the products have been sold by the distributors, unless there is sufficient customer specific sales and sales returns history to support revenue recognition upon shipment. In those instances when revenue is recognized upon shipment to distributors, we use historical rates of return from the distributors to provide for estimated product returns in accordance with Statement of Financial Accounting Standards, or SFAS No. 48, *Revenue Recognition When Right of Return Exists*. We accrue for warranty costs, sales returns and other allowances at the time of shipment based on historical experience and expected future costs.

### **Allowances for Sales Returns and Doubtful Accounts**

We record an allowance for sales returns for estimated future product returns related to current period product revenue. The allowance for sales returns is recorded as a reduction of revenue and an allowance against our accounts receivable. We base our allowance for sales returns on periodic assessments of historical trends in product return rates and current approved returned products. If the actual future returns were to deviate from the historical data on which the reserve had been established, our future revenue could be adversely affected. We record an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make payments for amounts owed to us. The allowance for doubtful accounts is recorded as a charge to general and administrative expenses. We base our allowance on periodic assessments of our customers' liquidity and financial condition through analysis of information obtained from credit rating agencies, financial statement reviews, and historical collection trends. Additional allowances may be required in the future if the liquidity or financial condition of our customers deteriorates, resulting in impairment in their ability to make payments.

## Valuation of Long-Lived Assets, including Goodwill and Other Intangible Assets

Our long-lived assets have consisted primarily of goodwill, other acquisition-related intangible assets and property and equipment. We review goodwill for impairment in November of each year, or more frequently if events or circumstances indicate the carrying value of an asset may not be recoverable in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). Such events or circumstances include, but are not limited to, a significant decrease in the benefits realized from an acquired business, difficulty and delays in integrating an acquired business, a significant change in the operations of an acquired business, or significant negative economic trends, such as stock price movements. The provisions of SFAS 142 require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of each reporting unit to its carrying value. We have determined that we operate in a single segment with one operating unit. We estimate the fair value of our reporting unit based on a combination of the market, income and replacement cost approaches. In the application of the impairment testing, we are required to make estimates of future operating trends and resulting cash flows and judgments on discount rates and other variables. Actual future results and other assumed variables could differ from these estimates. If the fair value of the reporting unit exceeds the carrying value, goodwill is not impaired and we are not required to perform further testing. If the carrying value exceeds the fair value of the reporting unit, then we must perform the second step of the impairment test in order to determine the implied fair value of the reporting unit. An impairment loss is recognized to the extent that the carrying amount exceeds the implied fair value of the reporting unit.

In June 2008, we determined that indicators of impairment existed as a result of a significant decline in our market capitalization in the three months ended June 30, 2008 as well as subsequent to period end, which resulted in a goodwill impairment loss of \$70.4 million. At June 30, 2009 and December 31, 2008, we had no remaining goodwill.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we review long-lived assets, including intangible assets other than goodwill, for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on expected undiscounted cash flows attributable to that asset. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future net undiscounted cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

## Stock-Based Compensation

We estimate the fair value of stock-based payment awards on the date of grant using the Black Scholes pricing model, which is affected by our stock price as well as assumptions regarding a number of complex and subjective variables. These variables include our expected stock price volatility over the term of the awards, actual and projected employee option exercise behaviors, risk free interest rate and expected dividends. The expected stock price volatility is based on the weighted average of the historical volatility of our common stock over the most recent period commensurate with the estimated expected life of our stock options. We base our expected life assumption on our historical experience and on the terms and conditions of the stock awards we grant to employees. Risk free interest rates reflect the yield on zero-coupon U.S. Treasury securities. We do not anticipate paying any cash dividends in the foreseeable future and therefore use an expected dividend yield of zero.

If factors change, and we employ different assumptions for estimating stock-based compensation expense in future periods, or if we decide to use a different valuation model, the future periods may differ significantly from what we have recorded in the current period and could materially affect our operating income, net loss and net loss per share. We are also required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates.

Fair value stock-based compensation expense under SFAS 123R (revised 2004), *Share-Based Payment* (SFAS 123R), for the quarter ended June 30, 2009 includes compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro-forma provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. In conjunction with the provisions of SFAS 123R, we changed our method of attributing the value of stock-based compensation to expense from the accelerated method to the straight line method. Compensation expense for all employee share-based payment awards granted on or prior to December 31, 2005 will continue to be recognized using the accelerated method while compensation expense for all share-based payment awards granted subsequent to December 31, 2005 is recognized using the straight line method.

In addition, stock-based compensation expense was recorded for options issued to non-employees. These options are generally immediately exercisable and expire seven to ten years from the date of grant. We value non-employee options using the Black Scholes model. Non-employee options subject to vesting are valued as they become vested.

In November 2008, we completed an exchange offer, or the Exchange Offer, to exchange certain stock options issued to eligible employees, officers and directors of Zhone under Zhone's equity incentive compensation plans. The primary purpose of the Exchange Offer was to motivate, retain and reward talented employees and directors. Stock options previously granted that had an exercise price per share of equal to or greater than \$0.35 per share were eligible to be exchanged on a one-for-one basis for

new stock options with an exercise price equal to the last reported sale price of Zhone common stock on The Nasdaq Global

Market on the date of grant. Options for an aggregate of 14.5 million shares of common stock were exchanged on November 17, 2008. The new stock options issued pursuant to the Exchange Offer have an exercise price of \$0.10, will vest over a four-year period with no credit for past vesting and have a seven-year term. The Exchange Offer will result in incremental stock-based compensation of approximately \$0.7 million to be recognized over the four-year vesting period. The remaining unrecognized compensation expense of the original grant will be amortized over the original requisite service period.

## Inventories

Inventories are stated at the lower of cost or market, with cost being determined using the first-in, first-out (FIFO) method. In assessing the net realizable value of inventories, we are required to make judgments as to future demand requirements and compare these with the current or committed inventory levels. Once inventory has been written down to its estimated net realizable value, its carrying value cannot be increased due to subsequent changes in demand forecasts. To the extent that a severe decline in forecasted demand occurs, or we experience a higher incidence of inventory obsolescence due to rapidly changing technology and customer requirements, we may incur significant charges for excess inventory.

## Operating Lease Liabilities

As a result of our acquisition of Paradyne in September 2005, we assumed certain lease liabilities for facilities in Largo, Florida. In accordance with Emerging Issues Task Force Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination* (EITF 95-3), we accrued a liability for the excess portion of these facilities. The computation of the estimated liability includes a number of assumptions and subjective variables. These variables include the level and timing of future sublease income, amount of contractual variable costs, future market rental rates, discount rate, and other estimated expenses. If circumstances change, and we employ different assumptions in future periods, the lease liability may differ significantly from what we have recorded in the current period and could materially affect our net loss and net loss per share. During the second quarter of 2008, we increased the excess lease liability balance by \$3.3 million with a corresponding charge to general and administrative expenses. During the first and second quarters of 2009, we reduced our assumptions regarding the future sublease income due to the continued deterioration in the real estate market. We increased our excess lease liability balance by \$0.1 million and \$0.2 million in the first and second quarters of 2009, respectively, with a corresponding charge to general and administrative expenses.

## RESULTS OF OPERATIONS

We list in the table below the historical condensed consolidated statement of operations data as a percentage of net revenue for the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net revenue	100%	100%	100%	100%
Cost of revenue	64%	71%	65%	69%
Gross profit	36%	29%	35%	31%
Operating expenses:				
Research and product development	18%	18%	21%	17%
Sales and marketing	16%	20%	21%	19%
General and administrative	8%	16%	9%	12%
Gain on sale of assets	0%	0%	0%	(1)%
Gain on sales of intangible assets	0%	(1)%	0%	(4)%
Goodwill impairment	0%	176%	0%	85%
Total operating expenses	42%	229%	51%	128%
Operating loss	(6)%	(200)%	(16)%	(97)%
Interest expense	(1)%	(1)%	(1)%	(1)%
Interest income	0%	1%	0%	0%
Other income, net	0%	0%	0%	0%
Loss before income taxes	(7)%	(200)%	(17)%	(98)%
Income tax provision	0%	0%	0%	0%
Net loss	(7)%	(200)%	(17)%	(98)%

## Revenue

Information about our net revenue for products and services for the three and six months ended June 30, 2009 and 2008 is summarized below (in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2009	2008	Increase (Decrease)	% Change	2009	2008	Increase (Decrease)	% Change
Products	\$28.9	\$39.2	\$ (10.3)	(26)%	\$51.4	\$81.5	\$ (30.1)	(37)%
Services	1.4	0.9	0.5	56%	3.0	1.6	1.4	88%
<b>Total</b>	<b>\$30.3</b>	<b>\$40.1</b>	<b>\$ (9.8)</b>	<b>(24)%</b>	<b>\$54.4</b>	<b>\$83.1</b>	<b>\$ (28.7)</b>	<b>(35)%</b>

Information about our net revenue for North America and International markets for the three and six months ended June 30, 2009 and 2008 is summarized below (in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2009	2008	Increase (Decrease)	% change	2009	2008	Increase (Decrease)	% change
Revenue by geography:								
United States	\$13.4	\$16.8	\$ (3.4)	(20)%	\$26.3	\$33.1	\$ (6.8)	(21)%
Canada	1.2	1.3	(0.1)	(8)%	3.0	2.4	0.6	25%
Total North America	14.6	18.1	(3.5)	(19)%	29.3	35.5	(6.2)	(17)%
Latin America	4.0	6.6	(2.6)	(39)%	7.4	16.8	(9.4)	(56)%
Europe, Middle East, Africa	11.2	14.6	(3.4)	(23)%	16.6	28.5	(11.9)	(42)%
Asia Pacific	0.5	0.8	(0.3)	(38)%	1.1	2.3	(1.2)	(52)%
Total International	15.7	22.0	(6.3)	(29)%	25.1	47.6	(22.5)	(47)%
<b>Total</b>	<b>\$30.3</b>	<b>\$40.1</b>	<b>\$ (9.8)</b>	<b>(24)%</b>	<b>\$54.4</b>	<b>\$83.1</b>	<b>\$ (28.7)</b>	<b>(35)%</b>

For the three months ended June 30, 2009, net revenue decreased 24% or \$9.8 million to \$30.3 million from \$40.1 million for the same period last year. For the six months ended June 30, 2009, net revenue decreased 35% or \$28.7 million to \$54.4 million from \$83.1 million for the same period last year.

For the three months ended June 30, 2009, product revenue decreased 26% or \$10.3 million to \$28.9 million, compared to \$39.2 million for the same period last year. For the six months ended June 30, 2009, product revenue decreased 37% or \$30.1 million to \$51.4 million, compared to \$81.5 million for the same period last year.

The decreases in total revenue and product revenue were primarily due to the global economic recession and credit contraction which caused many of our customers to defer or reduce their network expansion.

For the three months ended June 30, 2009, service revenue increased by 56% or \$0.5 million to \$1.4 million, compared to \$0.9 million for the same period last year. For the six months ended June 30, 2009, service revenue increased by 88% or \$1.4 million to \$3.0 million, compared to \$1.6 million for the same period last year. The increase in service revenue was primarily due to increased maintenance revenue during the current year periods. Service revenue represents revenue from maintenance and other services associated with product shipments.

International revenue decreased 29% or \$6.3 million to \$15.7 million for the three months ended June 30, 2009 from \$22.0 million for the same period last year, and represented 52% of total revenue compared with 55% during the same period of 2008. For the six months ended June 30, 2009, international revenue decreased 47% or \$22.5 million to \$25.1 million from \$47.6 million for the same period last year, and represented 46% of total revenue compared with 57% during the same period of 2008. The decrease in international revenue was primarily due to the global economic recession and credit contraction which caused many of our customers to defer or reduce their network expansion.

For the three and six months ended June 30, 2009, one customer represented 18% and 10% of net revenue, respectively. We anticipate that our results of operations in any given period may depend to a large extent on sales to a small number of large accounts. As a result, our revenue for any quarter may be subject to significant volatility based upon changes in orders from one or a small number of key customers.

## Cost of Revenue and Gross Profit

Total cost of revenue, including stock-based compensation, decreased \$9.2 million or 32% to \$19.3 million for the three months ended June 30, 2009 compared to \$28.5 million for the three months ended June 30, 2008. Cost of revenue decreased \$22.1 million or 38% to \$35.6 million for the six months ended June 30, 2009 compared to \$57.7 million for the six months ended June 30, 2008. The decrease in cost of revenue was primarily due to an overall decline in revenue and product mix. Total cost of revenue was 64% and 71% of net revenue for the three months ended June 30, 2009 and 2008, respectively, and 65% and 69%

of net revenue for the six months ended June 30, 2009 and 2008, respectively. During the six months ended June 30, 2009, a

\$0.2 million gain related to the sale of the GigaMux legacy product line was recorded in the cost of revenue compared to a \$1.9 million gain for the six months ended June 30, 2008. The decrease in the gain recognized was offset by higher standard margins realized in the six months ended June 30, 2009 mainly due to headcount reductions and product mix.

We expect that in the future, our cost of revenue as a percentage of net revenue will vary depending on the mix and average selling prices of products sold. In addition, competitive and economic pressures could cause us to reduce our prices, adjust the carrying values of our inventory, or record inventory charges relating to discontinued products and excess or obsolete inventory.

### **Research and Product Development Expenses**

Research and product development expenses decreased 22% or \$1.6 million to \$5.6 million from \$7.2 million for the three months ended June 30, 2009 compared to the three months ended June 30, 2008, and decreased 20% or \$2.9 million to \$11.4 million from \$14.3 million for the six months ended June 30, 2009 compared to the six months ended June 30, 2008. The decrease was primarily due to restructuring efforts to streamline processes, which reduced personnel-related costs by \$1.7 million and prototype costs by \$0.9 million for the six months ended June 30, 2009. We intend to continue to invest in research and product development to attain our strategic product development objectives, while seeking to manage the associated costs through expense controls.

### **Sales and Marketing Expenses**

Sales and marketing expenses decreased 37% or \$2.9 million to \$5.0 million from \$7.9 million for the three months ended June 30, 2009 compared to the three months ended June 30, 2008, and decreased 29% or \$4.6 million to \$11.0 million from \$15.6 million for the six months ended June 30, 2009 compared to the six months ended June 30, 2008. The decrease was primarily attributable to reduced personnel-related costs of \$3.1 million from lower headcount as we realigned our resources to focus on emerging markets, lower travel expenses of \$0.8 million, and reduced demonstration and trade show expenses of \$0.9 million for the six months ended June 30, 2009. This was offset by the closure of our Italy office in the first quarter of 2009 which resulted in severance costs of \$0.6 million and exit costs of \$0.3 million.

### **General and Administrative Expenses**

General and administrative expenses decreased 63% or \$4.0 million to \$2.4 million from \$6.4 million for the three months ended June 30, 2009 compared to the three months ended June 30, 2008, and decreased 49% or \$4.9 million to \$5.0 million from \$9.9 million for the six months ended June 30, 2009 compared to the six months ended June 30, 2008. The decrease was primarily due to reduced personnel-related costs of \$0.5 million and bad debt expenses of \$0.5 million for the six months ended June 30, 2009. In addition, during the second quarter of 2008, we significantly reduced our assumptions regarding estimated future sublease income primarily as a result of the deteriorating real estate market. Accordingly, we increased the excess lease liability balance by \$3.3 million with a corresponding charge to general and administrative expenses.

### **Gain on Sale of Fixed Assets**

Gain on sale of fixed assets was \$0.5 million for the six months ended June 30, 2008. The gain for the six months ended June 30, 2008 was attributable to the sale of fixed assets associated with our sale of the GigaMux legacy product line in January 2008. There were no similar sales of fixed assets for the six months ended June 30, 2009.

### **Gain on Sale of Intangible Assets**

Gain on sale of intangible assets was \$3.3 million for the six months ended June 30, 2008. The gain for the six months ended June 30, 2008 was attributable to the sale of intangible assets associated with our sale of the GigaMux legacy product line in January 2008. There were no similar sales of intangible assets for the six months ended June 30, 2009.

### **Goodwill Impairment**

In June 2008, we reviewed goodwill for impairment due to the significant decrease in our market capitalization in the three months ended June 30, 2008 as well as subsequent to period end. We determined that indicators of impairment existed, resulting in a goodwill impairment loss of \$70.4 million during the second quarter of 2008. At June 30, 2009, we had no remaining goodwill.

### **Income Tax Provision**

During the six months ended June 30, 2009 and 2008, no material provision or benefit for income taxes was recorded, due to our recurring operating losses and the significant uncertainty regarding the realization of our net deferred tax assets, against which we have continued to record a full valuation allowance.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our operations are financed through a combination of our existing cash, cash equivalents and short-term investments, available credit facilities, and sales of equity and debt instruments, based on our operating requirements and market conditions.

At June 30, 2009, cash, cash equivalents and short-term investments were \$26.8 million as compared with \$36.2 million at December 31, 2008. This amount included cash and cash equivalents of \$26.0 million at June 30, 2009, as compared with \$33.3 million at December 31, 2008. The decrease in cash and cash equivalents was attributable to net cash used in operating and financing activities of \$3.9 million and \$5.2 million, respectively, offset by net cash provided by investing activities of \$1.8 million.

### ***Operating Activities***

Net cash used in operating activities for the six months ended June 30, 2009 consisted of a net loss of \$9.2 million, adjusted for non-cash charges totaling \$3.2 million and a decrease in operating assets totaling \$2.1 million. The most significant components of the changes in net operating assets were a decrease in accounts receivable of \$3.4 million and a decrease in inventories of \$7.1 million, offset by a decrease in accounts payable of \$7.4 million and other liabilities of \$1.5 million.

### ***Investing Activities***

Net cash provided by investing activities for the six months ended June 30, 2009 consisted primarily of proceeds from the sale and maturity of short-term investments of \$2.4 million, offset by purchases of short-term investments of \$0.3 million and equipment purchases of \$0.4 million.

### ***Financing Activities***

Net cash used in financing activities for the six months ended June 30, 2009 consisted primarily of repayment of debt of \$5.2 million primarily in connection with the replacement of our existing revolving line of credit and letter of credit facility with Silicon Valley Bank, or SVB, with a new revolving line of credit and letter of credit facility in March 2009.

### ***Cash Management***

Our primary source of liquidity comes from our cash and cash equivalents and short-term investments, which totaled \$26.8 million at June 30, 2009, and our \$20.0 million revolving line of credit and letter of credit facility with SVB. Our cash and cash equivalents are held in accounts managed by third party financial institutions and consist of invested cash and cash in our operating accounts. To date, we have experienced no loss of access to our cash or cash equivalents; however, there can be no assurance that access to our cash and cash equivalents will not be impacted by adverse conditions in the financial markets.

Our short-term investments are classified as available-for-sale and consist of securities that are readily convertible to cash, including certificates of deposits, commercial paper and government securities, with original maturities at the date of acquisition ranging from 90 days to one year. Our short-term investments are available for use in current operations or other activities. To date, we have experienced no significant realized losses or other-than-temporary impairment losses with respect to our short-term investments; however, there can be no assurance that our short-term investments will not be affected by future volatility and uncertainty in the financial markets. At current revenue levels, we anticipate that some portion of our existing cash and cash equivalents and short-term investments will continue to be consumed by operations.

In March 2009, we entered into a secured revolving credit facility, or the SVB Facility, with SVB to provide liquidity and working capital through March 15, 2010, which replaced our prior facilities with SVB. Under the SVB Facility, we have the option of borrowing funds at agreed upon interest rates as long as the aggregate amount outstanding does not exceed \$20.0 million. The amount that we are able to borrow under the SVB Facility will vary based on the eligible accounts receivable, as defined in the agreement. In addition, under the SVB Facility, we are able to utilize up to \$7.0 million of the facility as security for letters of credit.

Under the SVB Facility, \$10.0 million was outstanding at June 30, 2009, and an additional \$4.3 million committed as security for various letters of credit as of June 30, 2009. The amounts borrowed under the SVB Facility bear interest, payable monthly, at a floating rate that is SVB's prime rate plus 2.5%. The minimum interest rate is 6.5%. The interest rate was 6.5% at June 30, 2009.

Our obligations under the SVB Facility are secured by substantially all of our personal property assets and those of our subsidiaries, including our intellectual property. The SVB Facility contains certain financial covenants, and customary affirmative covenants and negative covenants. If we do not comply with the various covenants and other requirements under the SVB Facility, SVB is entitled to, among other things, require the immediate repayment of all outstanding amounts and sell our assets to satisfy the obligations under the SVB Facility. As of June 30, 2009, we were in compliance with these covenants. We make no assurances that we will be in compliance with these covenants in the future.

### ***Future Requirements and Funding Sources***

Our fixed commitments for cash expenditures consist primarily of payments under operating leases, inventory purchase commitments, and payments of principal and interest for debt obligations. As a result of the Paradyne acquisition in 2005, we assumed a lease commitment for facilities in Largo, Florida. The term of the lease expires in June 2012 and had an estimated

remaining obligation of approximately \$13.0 million as of June 30, 2009. We intend to continue to occupy only a portion of

these facilities and are evaluating our options to exit the excess portion of the lease. We have recorded a liability of \$4.9 million as of June 30, 2009, which we believe is adequate to cover costs incurred to exit the excess portion of these facilities, net of estimated sublease income.

As a result of the financial demands of major network deployments and the difficulty in accessing capital markets, network service providers continue to request financing assistance from their suppliers. From time to time, we may provide or commit to extend credit or credit support to our customers. This financing may include extending the terms for product payments to customers. Depending upon market conditions, we may seek to factor these arrangements to financial institutions and investors to reduce the amount of our financial commitments associated with such arrangements. Our ability to provide customer financing is limited and depends upon a number of factors, including our capital structure, the level of our available credit and our ability to factor commitments to third parties. Any extension of financing to our customers will limit the capital that we have available for other uses.

Our accounts receivable, while not considered a primary source of liquidity, represents a concentration of credit risk because a significant portion of the accounts receivable balance at any point in time typically consists of a relatively small number of customer account balances. As of June 30, 2009, one customer accounted for 29% of accounts receivable, and receivables from customers in territories outside of the United States of America represented 64% of accounts receivable. We do not currently have any material commitments for capital expenditures, or any other material commitments aside from operating leases for our facilities, and debt.

We expect that operating losses and negative cash flows from operations will continue. In order to meet our liquidity needs and finance our capital expenditures and working capital needs for our business, we may need to raise additional capital through the issuance of debt or equity financing or the sale of assets. Continued uncertainty in credit markets may negatively impact our ability to access debt financing or to refinance existing indebtedness in the future on favorable terms, or at all. If additional capital is raised through the issuance of debt securities or other debt financing, the terms of such debt may include covenants, restrictions and financial ratios that may restrict our ability to operate our business. Likewise, any equity financing could result in additional dilution of our stockholders. If we are unable to obtain additional capital or are required to obtain additional capital on terms that are not favorable to us, we may be required to reduce the scope of our planned product development and sales and marketing efforts beyond the reductions we have previously taken. Based on our current plans and business conditions, we believe that our existing cash, cash equivalents and short-term investments and available credit facilities will be sufficient to satisfy our anticipated cash requirements for the foreseeable future.

### Contractual Commitments and Off-Balance Sheet Arrangements

At June 30, 2009, our future contractual commitments by fiscal year were as follows (in thousands):

	Total	Payments due by period				
		2009	2010	2011	2012	2013
Operating leases	\$13,807	\$ 2,469	\$4,581	\$ 4,479	\$2,278	\$—
Purchase commitments	8,060	8,060	—	—	—	—
Line of credit	10,000	10,000	—	—	—	—
Long-term Debt	18,856	191	412	18,253	—	—
Total future contractual commitments	<u>\$50,723</u>	<u>\$20,720</u>	<u>\$4,993</u>	<u>\$22,732</u>	<u>\$2,278</u>	<u>\$—</u>

#### *Operating Leases*

The operating lease amounts shown above represent primarily off-balance sheet arrangements. For operating lease commitments, a liability is generally not recorded on our balance sheet unless the facility represents an excess facility for which an estimate of the facility exit costs has been recorded on our balance sheet, net of estimated sublease income. Payments made under operating leases will be treated as rent expense for the facilities currently being utilized. For operating leases that include contractual commitments for operating expenses and maintenance, estimates of such amounts are included based on current rates. Of the total \$13.8 million operating lease amount, \$4.9 million has been recorded as a liability on our balance sheet as of June 30, 2009.

#### *Purchase Commitments*

The purchase commitments shown above represent non-cancellable inventory purchase commitments as of June 30, 2009. The inventory purchase commitments typically allow for cancellation of orders 30 days in advance of the required inventory availability date as set by us at time of order.

### ***Line of Credit and Debt***

The long-term debt and line of credit obligations have been recorded as liabilities on our balance sheet. The long-term debt and line of credit obligation amounts shown above represent the scheduled principal repayments, but not the associated interest payments which may vary based on changes in market interest rates.

As of June 30, 2009, we had \$10.0 million outstanding under our line of credit and an additional \$4.3 million committed as security for various letters of credit, as discussed in Note 10 to the condensed consolidated financial statements. At June 30, 2009, the interest rate on our outstanding long-term debt and line of credit obligations was 6.5%.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

#### **Cash, Cash Equivalents and Short-Term Investments**

Cash, cash equivalents and short-term investments consisted of the following as of June 30, 2009 and December 31, 2008 (in thousands):

	<u>June 30, 2009</u>	<u>December 31, 2008</u>
Cash and cash equivalents	\$26,013	\$ 33,251
Short-term investments	828	2,992
	<u>\$26,841</u>	<u>\$ 36,243</u>

#### **Concentration of Credit Risk**

Financial instruments which potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, short-term investments and accounts receivable. Cash and cash equivalents and short-term investments consist principally of demand deposit and money market accounts, commercial paper and corporate debentures and bonds with credit ratings of AA or better. Cash and cash equivalents and short-term investments are principally held with various domestic financial institutions with high credit standing. As of June 30, 2009 and December 31, 2008, receivables from customers in international territories represented 64% and 75%, respectively, of accounts receivable.

#### **Interest Rate Risk**

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio and long-term debt. We do not use derivative financial instruments in our investment portfolio. We do not hold financial instruments for trading or speculative purposes. We manage our interest rate risk by maintaining an investment portfolio primarily consisting of debt instruments of high credit quality and relatively short average maturities. Under our investment policy, short-term investments have a maximum maturity of one year from the date of acquisition, and the average maturity of the portfolio cannot exceed six months. Due to the relatively short maturity of the portfolio, a 10% increase in market interest rates at June 30, 2009 would decrease the fair value of the portfolio by less than \$0.1 million.

As of June 30, 2009, our outstanding long-term debt balance was \$18.9 million. Interest on our long-term debt accrues on the unpaid principal balance at a variable interest rate (which adjusts every six months) equal to the sum of the LIBOR rate plus 3.0% per annum; provided that in no event will the variable interest rate (a) exceed 14.2488% per annum, (b) be less than 6.5% per annum, or (c) be adjusted by more than 1.0% at any adjustment date. Assuming the outstanding balance on our variable rate long-term debt remains constant over a year, a 2% increase in the interest rate would decrease pre-tax income and cash flow by approximately \$0.4 million.

#### **Foreign Currency Exchange Risk**

We transact business in various foreign countries. Substantially all of our assets are located in the United States. We have sales operations throughout Europe, Asia, the Middle East and Latin America. We are exposed to foreign currency exchange rate risk associated with foreign currency denominated assets and liabilities, primarily inter-company receivables and payables.

Accordingly, our operating results are exposed to changes in exchange rates between the U.S. dollar and those currencies. During 2009 and 2008, we did not hedge any of our foreign currency exposure.

We have performed sensitivity analyses as of June 30, 2009 using a modeling technique that measures the change in the fair values arising from a hypothetical 10% adverse movement in the levels of foreign currency exchange rates relative to the U.S. dollar, with all other variables held constant. The sensitivity analyses indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in a foreign exchange loss of \$0.6 million at June 30, 2009. This sensitivity analysis assumes a parallel adverse shift in foreign currency exchange rates, which do not always move in the same direction. Actual results may differ materially.

## **Item 4. Controls and Procedures**

### **Disclosure Controls and Procedures**

We conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. The controls evaluation was done under the supervision and with the participation of management, including our Chief Executive Officer and our Chief Financial Officer. Based upon this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted in this Part I, Item 4, as of the end of the period covered by this report, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in our reports under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified by the SEC, and that material information relating to Zhong and its consolidated subsidiaries is made known to management, including our Chief Executive Officer and Chief Financial Officer, particularly during the period when our periodic reports are being prepared.

### **Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### **Inherent Limitations on Effectiveness of Controls**

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

#### ***Paradyne Matters***

As a result of our acquisition of Paradyne, we became involved in various legal proceedings, claims and litigation, including those identified below, relating to the operations of Paradyne prior to our acquisition of Paradyne.

A purported stockholder class action complaint was filed in December 2001 in the United States District Court in the Southern District of New York against Paradyne, Paradyne's then-current directors and executive officers, and each of the underwriters (the "Underwriter Defendants") who participated in Paradyne's initial public offering and follow-on offering (collectively, the "Paradyne Offerings"). The complaint alleges that, in connection with the Paradyne Offerings, the Underwriter Defendants charged excessive commissions, inflated transaction fees not disclosed in the applicable registration statements and allocated shares of the Paradyne Offerings to favored customers in exchange for purported promises by such customers to purchase additional shares in the aftermarket, thereby allegedly inflating the market price for the Paradyne Offerings. The complaint seeks damages in an unspecified amount for the purported class for the losses suffered during the class period. This action has been consolidated with hundreds of other securities class actions commenced against more than 300 companies (collectively, the "Issuer Defendants") and approximately 40 investment banks in which the plaintiffs make substantially similar allegations as those made against Paradyne with respect to the initial public offerings and/or follow-on offerings at issue in those other cases. All of these actions have been consolidated before Judge Shira Scheindlin under the caption *In re: Initial Public Offering Securities Litigation* (the "IPO Actions").

In 2003, the Issuer Defendants participated in a global settlement among the plaintiffs and the insurance companies that provided directors' and officers' insurance coverage to the Issuer Defendants (the "Issuer Settlement"). The Issuer Settlement agreements provided for the Issuer Defendants (including Paradyne) to be fully released and dismissed from the IPO Actions. Under the terms of the Issuer Settlement agreements, Paradyne would not have been required to make any cash payment to the plaintiffs. Although the District Court preliminarily approved the Issuer Settlement, the preliminary approval remained subject to a future final settlement order, after notice of settlement had been provided to class members and they had been afforded the

opportunity to oppose or opt out of the settlement. However, before the District Court could conduct its final settlement hearing, on December 5, 2006, the United States Court of Appeals for the Second Circuit (the “Second Circuit”) reversed an October 13, 2004

order of the District Court in which Judge Scheindlin had granted class certification for six “test cases” in the IPO Actions. On April 4, 2007, the Second Circuit denied the plaintiffs’ petition for rehearing of the December 5, 2006 ruling. The District Court has since made clear that the Issuer Settlement cannot be approved — in its current form — as a class action settlement in light of the Second Circuit’s December 5, 2006 ruling and has declined to schedule a final approval hearing with respect to the Issuer Settlement for that reason.

In March 2009, counsel for the plaintiffs, for the Issuer Defendants and for the insurance companies that provided directors’ and officers’ insurance to the Issuer Defendants restructured the Issuer Settlement and submitted the restructured Issuer Settlement to the District Court for approval.

In July 2009, the District Court preliminarily approved the restructured Issuer Settlement submitted in March 2009. The District Court has set September 10, 2009 as the final approval hearing for the restructured Issuer Settlement. The restructured Issuer Settlement agreement provides for the Issuer Defendants (including Paradyne) to be fully released and dismissed from the IPO Actions. Under the terms of the restructured Issuer Settlement agreement, Paradyne will not be required to make any cash payments to the plaintiffs. There can be no assurance that the restructured Issuer Settlement will meet the conditions for final approval by the District Court.

### ***Other Matters***

We are subject to other legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, management does not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position or results of operations. However, litigation is subject to inherent uncertainties, and unfavorable rulings could occur. If an unfavorable ruling were to occur, there exists the possibility of a material adverse impact on the results of operations of the period in which the ruling occurs, or future periods.

## **Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2008, which could materially affect our business, financial condition or future results. There have been no material changes to the risk factors described in the “Risk Factors” section in our Annual Report on Form 10-K for the year ended December 31, 2008, other than the risk factor entitled “Our common stock may be delisted from the Nasdaq Global Market, which could negatively impact the price of our common stock and our ability to access the capital markets,” which has been updated to reflect the extension in the deadline by which we are required to regain compliance with Nasdaq’s minimum bid price rule. The risks described in our Annual Report on Form 10-K and set forth below are not the only risks facing our company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

### **Our common stock may be delisted from The Nasdaq Global Market, which could negatively impact the price of our common stock and our ability to access the capital markets.**

Our common stock is listed on The Nasdaq Global Market. On June 11, 2008, we received a letter from The Nasdaq Stock Market, or Nasdaq, indicating that, for the last 30 consecutive business days preceding the date of the letter, the bid price of our common stock had closed below the \$1.00 minimum per share bid price required for continued inclusion on The Nasdaq Global Market under Marketplace Rule 4450(a)(5). In accordance with Marketplace Rule 4450(e)(2), we were given 180 calendar days from the date of the Nasdaq letter, or until December 8, 2008, to regain compliance with the minimum bid price rule. Nasdaq has since extended the temporary suspension of the minimum bid price rule on several occasions, and on July 13, 2009, we received a letter from Nasdaq indicating that the suspension of the rule will continue through September 25, 2009. Our stock price has not closed above \$1.00 since the date of the receipt of the original letter from Nasdaq. To regain compliance, the closing bid price of our common stock must be at or above \$1.00 per share for a minimum of 10 consecutive business days. Nasdaq may, in its discretion, require us to maintain a bid price of at least \$1.00 per share for a period in excess of 10 consecutive business days, but generally no more than 20 consecutive business days, before determining that we have demonstrated an ability to maintain long-term compliance. If we do not regain compliance by the applicable compliance deadline, Nasdaq will provide written notification to us that our common stock will be delisted. At that time, we may appeal Nasdaq’s delisting determination to a Nasdaq Listing Qualifications Panel. Alternatively, we could apply to transfer our common stock to The Nasdaq Capital Market if we satisfy all of the requirements, other than the minimum bid price requirement, for initial listing on The Nasdaq Capital Market set forth in Marketplace Rule 4310(c). If we were to elect to apply for such transfer and if such application were approved, we would have an additional 180 days to regain compliance with the minimum bid price rule while listed on The Nasdaq Capital Market. In October 2008, Zhone’s stockholders approved an amendment to our restated certificate of incorporation to effect a reverse stock split at an exchange ratio ranging from one-for-five to one-for-ten, with the exchange ratio determined by Zhone. We are currently actively monitoring the bid price for our common stock, and will consider available options to resolve the deficiency and regain compliance with the Nasdaq minimum bid price requirement.



Delisting from The Nasdaq Global Market could have an adverse effect on our business and on the trading of our common stock. If a delisting of our common stock were to occur, our common stock would trade on the OTC Bulletin Board or on the “pink sheets” maintained by the National Quotation Bureau, Inc. Such alternatives are generally considered to be less efficient markets, and our stock price, as well as the liquidity of our common stock, may be adversely impacted as a result. Delisting from The Nasdaq Global Market could also have other negative results, including the potential loss of confidence by suppliers and employees, the loss of institutional investor interest and fewer business development opportunities.

**Item 4. Submission of Matters to a Vote of Security Holders**

At our 2009 annual meeting of stockholders held on May 14, 2009, the stockholders voted on the following two proposals and cast their votes as follows:

Proposal 1: To elect two members of the Board of Directors to serve for three year terms as Class II Directors.

<u>Nominee</u>	<u>For</u>	<u>Withheld</u>
James H. Greene Jr.	126,080,711	2,695,317
C. Richard Kramlich	126,065,993	2,710,035

Proposal 2: To ratify the appointment of KPMG LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2009.

<u>For</u>	<u>Against</u>	<u>Abstentions</u>	<u>Not Voted</u>
127,191,468	1,108,795	475,765	0

**Item 6. Exhibits**

The Exhibit Index on page 29 is incorporated herein by reference as the list of exhibits required as part of this report.



## EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)
32.1	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO  
RULE 13a-14(a)/15d-14(a)**

I, Morteza Ejabat, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Zhone Technologies, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 7, 2009

/s/ MORTEZA EJABAT

Morteza Ejabat

Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO  
RULE 13a-14(a)/15d-14(a)**

I, Kirk Misaka, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Zhone Technologies, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 7, 2009

/s/ KIRK MISAKA  
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Kirk Misaka  
Chief Financial Officer

**SECTION 1350 CERTIFICATION**

Pursuant to 18 U.S.C. Section 1350, Morteza Ejabat, Chief Executive Officer of Zhone Technologies, Inc. (the "Company"), and Kirk Misaka, Chief Financial Officer of the Company, each hereby certify that, to their knowledge:

1. The Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2009 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 7, 2009

/s/ MORTEZA EJABAT

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Morteza Ejabat

Chief Executive Officer

/s/ KIRK MISAKA

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Kirk Misaka

Chief Financial Officer