

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

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2010

OR

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

For the transition period from _____ to _____.

Commission File Number: 000-32743

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 No.)

7195 Oakport Street
Oakland, California 94621
(Address of principal executive office)

Registrant's telephone number, including area code: (510) 777-7000

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, \$0.001 Par Value
(Title of class)

The Nasdaq Stock Market LLC
(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 filed 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definitions of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a 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 March 1, 2011, there were 30,610,000 shares outstanding of the registrant's common stock, \$0.001 par value. As of June 30, 2010 (the last business day of the registrant's most recently completed second fiscal quarter), the aggregate market value of common stock held by non-affiliates of the registrant was approximately \$36,268,625.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2011 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K where indicated.

TABLE OF CONTENTS

	<u>Page</u>
PART I	
Item 1. Business	3
Item 1A. Risk Factors	13
Item 1B. Unresolved Staff Comments	25
Item 2. Properties	25
Item 3. Legal Proceedings	26
Item 4. Reserved	26
PART II	
Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	27
Item 6. Selected Financial Data	28
Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations	29
Item 7A. Quantitative and Qualitative Disclosures About Market Risk	43
Item 8. Financial Statements and Supplementary Data	45
Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	75
Item 9A. Controls and Procedures	75
Item 9B. Other Information	76
PART III	
Item 10. Directors, Executive Officers and Corporate Governance	77
Item 11. Executive Compensation	77
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	77
Item 13. Certain Relationships and Related Transactions, and Director Independence	77
Item 14. Principal Accountant Fees and Services	77
PART IV	
Item 15. Exhibits, Financial Statement Schedules	78
Signatures	79
Exhibits	80

Forward-looking Statements

This Annual Report on Form 10-K, 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; our ability to repay our existing indebtedness prior to the applicable maturity date; 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, including those identified under the heading “Risk Factors” in Item 1A, elsewhere in this report and our other filings with the Securities and Exchange Commission (the SEC). 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 or to repay our existing indebtedness, 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. We undertake no obligation to revise or update any forward-looking statements for any reason.

PART I

ITEM 1. BUSINESS

Company Overview

We design, develop and manufacture communications network equipment for telecommunications, wireless and cable operators worldwide. We believe that these network service providers can increase their revenues and lower their operating costs by using our products to deliver high quality video and interactive entertainment and Internet Protocol (IP) enabled next generation voice services in addition to their existing voice and data service offerings, all on a platform that permits a seamless migration from legacy technologies to a converged packet-based architecture. Our mature Single Line Multi-Service (SLMS) architecture provides cost-efficiency and feature flexibility with support for voice over internet protocol (VoIP) and IP entertainment (IPTV). Within this versatile SLMS architecture, our products allow service providers to deliver all of these and other next generation converged packet services over their existing copper lines while providing support for fiber or Fiber to the home or business (FTTx) build-out. With our products and solutions, network service providers can seamlessly migrate from traditional circuit-based networks to packet-based networks and from copper-based access lines to fiber-based access lines without abandoning the investments they have made in their existing infrastructures.

In addition to our established product offerings, Zhone launched our flagship MXK IP Multi-service Terabit Access Concentrator (MXK) and multiple new Optical Line Terminal (OLT) and outdoor units in late 2009. Our MXK product is a converged multi-services access platform that can be configured as a Gigabit Passive Optical Network (GPON) or Active Ethernet OLT. The MXK GPON line module is ITU-T G.984 compliant, delivering

data throughputs of up to 2.5 Gbps downstream and 1.25 Gbps upstream. Each line card is designed for up to 64 passive splits per fiber. Active Ethernet delivers up to 100 Mbps point-to-point from a 20-port card. In 2010, we sold over 1000 MXK systems to new and existing customers globally.

Zhone's MXK product supports the next generation of high-performance business and residential FTTx services. Unlike most competing products, MXK has the ability to support both Passive Optical Network (PON) and Active Ethernet fiber technologies to the node, curb or premises. With our MXK product, service providers can offer digital or Ratio Frequency (RF) video, high-bandwidth Internet access, VoIP and cell relay services from a single OLT over IP. Additionally, our MXK product provides Zhone with industry leading density featuring an 8 port GPON Module enabling support for up to 9,216 GPON subscribers in a single MXK chassis.

The flexibility of our MXK product enables service providers to choose the best technology for both services and network architecture. Active Ethernet provides dedicated high symmetric bandwidth to the end customers and makes it an excellent technology for deployment of business services. GPON provides a cost-effective way to deliver high bandwidth to the residence for a robust triple play offering while enabling a host of high speed data and video options for the businesses. In addition to Active Ethernet and dense GPON support, the MXK provides a wide array of multi-service functionality supporting well defined access standards enabling the convergence of voice, data and entertainment over any access medium delivering high-performance all IP solutions designed for today's traffic mix.

Corporate Information

We were incorporated in Delaware under the name Zhone Technologies, Inc. in June 1999, and in November 2003, we consummated our merger with Tellium, Inc. Although Tellium acted as the legal acquirer, due to various factors, including the relative voting rights, board control and senior management composition of the combined company, Zhone was treated as the "acquirer" for accounting purposes. Following the merger, the combined company was renamed Zhone Technologies, Inc. and retained substantially all of Zhone's previous management and operating structure. The mailing address of our worldwide headquarters is 7195 Oakport Street, Oakland, California 94621, and our telephone number at that location is (510) 777-7000. Our website address is www.zhone.com. The information on our website does not constitute part of this report. Through a link on the Investor Relations section of our website, we make available the following filings as soon as reasonably practicable after they are electronically filed with or furnished to the SEC: our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. All such filings are available free of charge.

Industry Background

Over the past decade, the communications network industry has experienced rapid expansion as the internet and the proliferation of bandwidth intensive applications and services have led to an increased demand for high bandwidth communications networks. The broad adoption of new technologies such as smartphones, MP3 players, digital cameras and high definition televisions allow music, pictures, user-generated content (as found on the many video-sharing sites) and high definition video to be a growing part of consumers' regular exchange of information. In 2010, the advent of social communications and social networking has continued to place demands on existing copper based access infrastructure and new consumer demands are challenging even the newest and most advanced infrastructures. All of these new technologies share a common dependency on high bandwidth communication networks and sophisticated traffic management tools. However, network service providers have struggled to meet the increased demand for high speed broadband access due to the constraints of the existing communications network infrastructure. This infrastructure consists of two interconnected networks:

- the "core" network, which interconnects service providers with each other; and
- the "access" network, which connects end-users to a service provider's closest facility.

To address the increased demand for higher transmission speeds via greater bandwidth, service providers have expended significant capital over the past decade to upgrade the core network by replacing much of their copper infrastructure with high-speed optical infrastructure. While the use of fiber optic equipment in the core network has relieved the bandwidth capacity constraints in the core network between service providers, the access network continues to be a “bottleneck” that severely limits the transmission speed between service providers and end-users. As a result, communications in the core network can travel at up to 10 gigabits per second, while in stark contrast, many communications over the access network throughout the world still occur at a mere 56 kilobits per second, a speed that is 175,000 times slower. At 56 kilobits per second, it may take several minutes to access even a modestly media laden website and several hours to download large files. Fiber access lines have the potential to remedy this disparity, but re-wiring every home or business with fiber optic cable is both cost prohibitive and extremely time consuming. Consequently, solving the access network bottleneck has typically required more efficient use of the existing copper wire infrastructure and support for the gradual migration from copper to fiber.

In an attempt to deliver high bandwidth services over existing copper wire in the access network, service providers began deploying digital subscriber line (DSL) technology over a decade ago. However, this early DSL technology has practical limitations. Copper is a distance sensitive medium in that the amount of bandwidth available over a copper wire is inversely proportional to the length of the copper wire. In other words, the greater the distance between the service provider’s equipment and the customer’s premises, the lower the bandwidth. Unfortunately, most DSL services available today are provided by first generation DSL access multiplexer (DSLAM) equipment. These large unwieldy devices require conditioned power and a climate controlled environment typically found only in a telephone company’s central office, which is often at great distance from the customer. While adequate for basic data services, these first generation DSLAMs were not designed to meet the needs of today’s high bandwidth applications. The modest bandwidth provided by existing DSLAM equipment is often incapable of delivering even a single channel of standard definition video, much less multiple channels of standard definition video or high definition video.

More recently, regulatory changes have introduced new competitors in the telecommunication services industry. Cable operators, with extensive networks designed originally to provide only video programming, have collaborated to adopt new packet technologies that leverage their hybrid fiber/coaxial cable infrastructure. Using more recent technologies, cable operators have begun to cost-effectively deliver new service bundles. The new service offerings provide not only enhanced features and capabilities, but also allow the cable operators to deliver these services over a common network. The resulting cost-efficiencies realized by cable operators are difficult for incumbent telephone companies to match. Even with the telephone companies’ legacy voice switches fully paid for, maintaining separate networks for their circuit-based voice and packet-based video and data networks is operationally non-competitive. Perhaps even more important than economic efficiencies, by integrating these services over a common packet infrastructure, cable operators will realize levels of integration between applications and new features that will be difficult to achieve from a multi-platform solution. Despite these benefits, coaxial cable has its own share of limitations. Unlike DSL, coaxial cable shares its bandwidth among all customers connected to it. Consequently, as new customers are added to coaxial cable networks, performance decreases. As a shared medium, large numbers of subscribers who simultaneously access the same segment of the coaxial cable network can potentially compromise performance and security. This represents a source of strategic advantage for telecom operators who employ technology designed to maximize their service capabilities on the point-to-point (i.e. not shared) architecture of their copper infrastructure. In addition, in recent years the introduction of 3G and 4G wireless technologies and improved satellite technologies have enabled wireless and satellite service providers to provide competitive broadband offerings as alternatives to traditional landline access. This increased competition has placed significant pressure on all network service providers. With significant service revenues at risk, these service providers have sought to upgrade and modernize their networks and broaden their service offerings to enable delivery of additional high bandwidth, high margin services, and to lower the cost of delivering these services.

The Zhone Solution

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 legacy networks. Our next-generation solutions are based upon our Single Line Multi-Service, or 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 using their existing infrastructures, as well as giving newer service providers the capability to deploy cost-effective, multi-service networks that can support voice, data and video.

Triple Play Services with Converged Voice, Data and Video – SLMS simplifies the access network by consolidating new and existing services onto a single line. This convergence of services and networks simplifies provisioning and operations, ensures quality of service and reliability, and reduces the time required to provide services. SLMS integrates access, transport, customer premises equipment, and management functions in a standards-based system that provides scalability, interoperability and functionality for voice, data and video services.

Packet Migration – SLMS is a flexible multi-service architecture that provides current services while simultaneously supporting migration to a pure packet network. This flexibility allows service providers to cost-effectively provide carrier class performance, and functionality for current and future services without interrupting existing services or abandoning existing subscribers. SLMS also protects the value of the investments made by residential and commercial subscribers in equipment, inside wiring and applications, thereby minimizing transition impact and subscriber attrition.

Fiber to the Home, Premise, Node, or Curb (FTTx) – We provide support for the full range of fiber-based access network architectures that are seeing increased use by carriers. In many markets worldwide, both business and residential demand for bandwidth is growing to the point where the deployment of fiber in the access network is increasingly desirable. Where copper loops are plentiful and where civil restrictions make fiber deployment all the way to the customer premises prohibitively expensive, if not impossible, many operators are choosing to deploy fiber from central offices to neighborhoods and then using VDSL2 over copper to deliver broadband connectivity over the last hundred meters or so. In other circumstances operators choose to deploy passive optical networks (PON) all the way to the customer premises, where a single fiber's bandwidth is shared through splitters with up to 64 subscribers. Some circumstances demand so-called "home run" fiber networks (with dedicated fiber resources linking every customer directly to the central office) to maximize bandwidth or service segmentation. By supporting all these architectures within a common SLMS-based platform, we provide carriers maximum flexibility to build the network that best suits their needs.

Ethernet Service Delivery – We offer a complete array of equipment that allows carriers to deliver ethernet services over copper or fiber. For business subscribers, our ethernet over copper product family allows carriers to quickly deliver ethernet services over existing copper SHDSL or T1/E1 circuits. Multiple circuits can be bonded to provide over 70 Megabits per second, enough to deliver ample ethernet bandwidth to satisfy business subscribers' growing service requirements. This copper-based solution provides a compelling alternative to burying fiber and dedicating valuable fiber strands to long-haul ethernet services to small and medium enterprises.

The Zhone Strategy

Our strategy has been to combine internal development with acquisitions of established access equipment vendors to achieve the critical mass required of telecommunications equipment providers. We expect that our future growth will focus primarily on organic growth in emerging technology markets. Going forward, the key elements of our strategy include:

- *Expand Our Infrastructure to Meet Service Provider Needs.* Network service providers require extensive support and integration with manufacturers to deliver reliable, innovative and cost-effective services. By combining advanced, computer-aided design, test and manufacturing systems with experienced, customer-focused management and technical staff, we believe that we have established the critical mass required to fully support global service provider requirements. We continue to expand our infrastructure through ongoing development and strategic relationships, continuously improving quality, reducing costs and accelerating delivery of advanced solutions.
- *Continue the Development and Enhancement of Our SLMS Products.* Our SLMS architecture is the cornerstone of our product development strategy. The design criteria for SLMS products include carrier-class reliability, multi-protocol and multi-service support, and ease of provisioning. We intend to continue to introduce SLMS products that offer the configurations and feature sets that our customers require. In addition, we have introduced products that adhere to the standards, protocols and interfaces dictated by international standards bodies and service providers. In 2009, we introduced our MXK product, a new flagship SLMS product that provides a converged multi-services access platform. To facilitate the rapid development of our existing and new SLMS architecture and products, we have established engineering teams responsible for each critical aspect of the architecture and products. We intend to continue to leverage our expertise in voice, data and video technologies to enhance our SLMS architecture, supporting new services, protocols and technologies as they emerge. To further this objective, we intend to continue investing in research and development efforts to extend the SLMS architecture and introduce new SLMS products.
- *Deliver Full Customer Solutions.* In addition to delivering hardware and software product solutions, we provide customers with pre-sales and post-sales support, education and professional services to enable our customers to more efficiently deploy and manage their networks. We provide customers with application notes, business planning information, web-based and phone-based troubleshooting assistance and installation guides. Our support programs provide a comprehensive portfolio of support tools and resources that enable our customers to effectively sell to, support and expand their subscriber base using our products and solutions.

Product Portfolio

Our products provide the framework around which we are designing and developing high speed communications software and equipment for the access network. All of the products listed below are currently available and being shipped to customers. Our products span two distinct categories:

SLMS Products

Our SLMS products address three areas of customer requirements. Our Broadband Aggregation and Service products aggregate, concentrate and optimize communications traffic from copper and fiber networks. These products are deployed in central offices, remote offices, points of presence, curbsides, data and co-location centers, and large enterprises. Our Customer Premise Equipment, or CPE, products offer a cost-effective solution for combining analog voice and data services to the subscriber's premises over a single platform. The Zhone Management System, or ZMS, product provides optional software tools to help manage aggregation and customer premises network hardware. These products deliver voice, data and video interface connectivity for broadcast and subscription television, internet routers and traditional telephony equipment.

Our SLMS products include:

<u>Category</u>	<u>Product</u>	<u>Function</u>
Broadband Aggregation and Service	MXK	Multi-Service Terabit Access Concentrator
	MALC	Multi-Access Line Concentrator
	MX	Scalable 1U SLMS VDSL2/Ethernet
	MALC-OLT	FTTx Optical Line Terminal
	4000 /8000 /12000	DSLAMs
Customer Premise Equipment (CPE)	EtherXtend	Ethernet Over Copper
	16xx, 17xx, 6xxx	Wireline/Wireless DSL Modems
	zNID	Optical Network Terminals
Network and Subscriber Management . . .	ZMS	Zhone Management System

Legacy, Service and Other Products

Our legacy products support a variety of voice and data services, and are broadly deployed by service providers worldwide. Our main legacy product during 2010 and 2009 was our IMACS product which functions as a multi-access multiplexer.

Global Service & Support

In addition to our product offerings, we provide a broad range of service offerings through our Global Service & Support organization. We supplement our standard and extended product warranties with programs that offer technical support, product repair, education services and enhanced support services. These services enable our customers to protect their network investments, manage their networks more efficiently and minimize downtime for mission-critical systems. Technical support services are designed to help ensure that our products operate efficiently, remain highly available, and benefit from recent software releases. Through our education services program, we offer in-depth training courses covering network design, installation, configuration, operation, trouble-shooting and maintenance. Our enhanced services offering is a comprehensive program that provides network engineering, configuration, integration, project management and other consultative support to maximize the results of our customers during the design, deployment and operational phases. As part of our commitment to ensure around-the-clock support, we maintain a technical assistance center and a staff of qualified network support engineers to provide customers with 24-hour service, seven days a week.

Technology

We believe that our future success is built upon our investment in the development of advanced technologies. SLMS is based on a number of technologies that provide sustainable advantages, including the following:

- *Services-Centric Architecture.* SLMS has been designed from inception for the delivery of multiple classes of subscriber services (such as voice, data or video distribution), rather than being based on a particular protocol or media. Our SLMS products are built to interoperate in networks supporting packet, cell and circuit technologies. This independence between services and the underlying transportation is designed to position our products to be able to adapt to future transportation technologies within established architectures and to allow our customers to focus on service delivery.
- *Common Code Base.* Our SLMS products share a common base of software code, which is designed to accelerate development, improve software quality, enable rapid deployment, and minimize training and operations costs, in conjunction with network management software.
- *Network Management and Operations.* Our ZMS product provides management capabilities that enable rapid, cost-effective, and secure control of the network; standards-based interfaces for seamless

integration with supporting systems; hierarchical service and subscriber profiles to allow rapid service definition and provisioning, and to enable wholesaling of services; automated and intelligent CPE provisioning to provide the best end-user experience and accelerate service turn-up; load-balancing for scalability; and full security features to ensure reliability and controlled access to systems and data.

- *Test Methodologies.* Our SLMS architecture provides for interoperability with a variety of products that reside in networks in which we will deploy our products. To ensure interoperability, we have built a testing facility to conduct extensive multi-vendor trials and to ensure full performance under valid network conditions. Testing has included participation with partners' certification and accreditation programs for a wide range of interoperable products, including soft switches, SAN equipment and management software. The successful completion of these processes is required by our largest customers to ensure interoperability with their existing software and systems.
- *Acquired Technologies.* Since our inception, we have completed twelve acquisitions pursuant to which we acquired products, technology and additional technical expertise.

Customers

We sell our products and services to network service providers that offer voice, data and video services to businesses, governments, utilities and residential consumers. Our global customer base includes regional, national and international telecommunications carriers. To date, our products are deployed by over 750 network service providers on six continents worldwide. Emirates Telecommunications Corporation (Etisalat) accounted for 24% of net revenue in 2010 and 19% of net revenue in 2009. No other customer accounted for 10% or more of net revenue during either period.

Research and Development

The industry in which we compete is subject to rapid technological developments, evolving industry standards, changes in customer requirements, and continuing developments in communications service offerings. Our continuing ability to adapt to these changes, and to develop new and enhanced products, is a significant factor in maintaining or improving our competitive position and our prospects for growth. Therefore, we continue to make significant investments in product development.

We conduct the majority of our research and product development activities at our headquarters in Oakland, California. In Oakland, we have built an extensive communications laboratory with hundreds of access infrastructure products from multiple vendors that serve as an interoperability and test facility. This facility allows us to emulate a communications network with serving capacity equivalent to that supporting a city of 350,000 residents. We also have focused engineering staff and activities at additional development centers located in Alpharetta, Georgia; Largo, Florida; Westlake Village, California; and Portsmouth, New Hampshire.

Our product development activities focus on products to support both existing and emerging technologies in the segments of the communications industry that we consider viable revenue opportunities. We are actively engaged in continuing to refine our SLMS architecture, introducing new products under our SLMS architecture, and creating additional interfaces and protocols for both domestic and international markets.

We continue our commitment to invest in leading edge technology research and development. Our research and product development expenditures were \$21.2 million, \$22.1 million, and \$27.1 million, in 2010, 2009 and 2008, respectively. All of our expenditures for research and product development costs, as well as stock-based compensation expense relating to research and product development, have been expensed as incurred. These amounts include stock-based compensation of \$0.4 million, \$0.4 million, and \$0.5 million for 2010, 2009, and 2008, respectively. We plan to continue to support the development of new products and features, while seeking to carefully manage associated costs through expense controls.

Intellectual Property

We seek to establish and maintain our proprietary rights in our technology and products through the use of patents, copyrights, trademarks and trade secret laws. We also seek to maintain our trade secrets and confidential information by nondisclosure policies and through the use of appropriate confidentiality agreements. We have obtained a number of patents and trademarks in the United States and in other countries. There can be no assurance, however, that these rights can be successfully enforced against competitive products in every jurisdiction. Although we believe the protection afforded by our patents, copyrights, trademarks and trade secrets has value, the rapidly changing technology in the networking industry and uncertainties in the legal process make our future success dependent primarily on the innovative skills, technological expertise, and management abilities of our employees rather than on the protection afforded by patent, copyright, trademark, and trade secret laws. In addition, we sold certain of our non-strategic patents for \$1.1 million in 2008.

Many of our products are designed to include software or other intellectual property licensed from third parties. While it may be necessary in the future to seek or renew licenses relating to various aspects of our products, we believe, based upon past experience and standard industry practice, that such licenses generally could be obtained on commercially reasonable terms. Nonetheless, there can be no assurance that the necessary licenses would be available on acceptable terms, if at all. Our inability to obtain certain licenses or other rights or to obtain such licenses or rights on favorable terms, or the need to engage in litigation regarding these matters, could have a material adverse effect on our business, operating results and financial condition.

The communications industry is characterized by rapidly changing technology, a large number of patents, and frequent claims and related litigation regarding patent and other intellectual property rights. We cannot assure you that our patents and other proprietary rights will not be challenged, invalidated or circumvented, that others will not assert intellectual property rights to technologies that are relevant to us, or that our rights will give us a competitive advantage. In addition, the laws of some foreign countries may not protect our proprietary rights to the same extent as the laws of the United States.

Sales and Marketing

We have a sales presence in various domestic and foreign locations, and we sell our products and services both directly and indirectly through channel partners with support from our sales force. Channel partners include distributors, resellers, system integrators and service providers. These partners sell directly to end customers and often provide system installation, technical support, professional services and support services in addition to the network equipment sale. Our sales efforts are generally organized according to geographical regions:

- *U.S. Sales.* Our U.S. Sales organization establishes and maintains direct relationships with domestic customers, which include communication service providers, cable operators, independent operating companies, or IOCs, as well as competitive carriers, developers and utilities. In addition, this organization is responsible for managing our distribution and original equipment manufacturer, or OEM, partnerships.
- *International Sales.* Our International Sales organization targets foreign based service providers and is staffed with individuals with specific experience dealing with service providers in their designated international territories.

Our marketing team works closely with our sales, research and product development organizations, and our customers by providing communications that keep the market current on our products and features. Marketing also identifies and sizes new target markets for our products, creates awareness of our company and products, generates contacts and leads within these targeted markets and performs outbound education and public relations.

Backlog

Our backlog consists of purchase orders for products and services that we expect to ship or perform within the next year. At December 31, 2010, our backlog was \$4.4 million, as compared to \$21.6 million at December 31, 2009. We consider backlog to be an indicator, but not the sole predictor, of future sales because our customers may cancel or defer orders without penalty.

Competition

We compete in the communications equipment market, providing products and services for the delivery of voice, data and video services. This market is characterized by rapid change, converging technologies and a migration to solutions that offer superior advantages. These market factors represent both an opportunity and a competitive threat to us. We compete with numerous vendors, including Alcatel-Lucent, Calix, Huawei, and ZTE, among others. In addition, a number of companies have introduced products that address the same network needs that our products address, both domestically and abroad. The overall number of our competitors may increase, and the identity and composition of competitors may change. As we continue to expand our sales globally, we may see new competition in different geographic regions. Barriers to entry are relatively low, and new ventures to create products that do or could compete with our products are regularly formed. Many of our competitors have greater financial, technical, sales and marketing resources than we do.

The principal competitive factors in the markets in which we presently compete and may compete in the future include:

- product performance;
- interoperability with existing products;
- scalability and upgradeability;
- conformance to standards;
- breadth of services;
- reliability;
- ease of installation and use;
- geographic footprints for products;
- ability to provide customer financing;
- price;
- technical support and customer service; and
- brand recognition.

While we believe that we compete successfully with respect to each of these factors, we expect to face intense competition in our market. In addition, the inherent nature of communications networking requires interoperability. As such, we must cooperate and at the same time compete with many companies.

Manufacturing

We manufacture our products using a strategic combination of procurement from qualified suppliers, in-house manufacturing at our facility in Florida, and the use of original design manufacturers (ODM) located in the Far East. Since our acquisition of Paradyne Networks, Inc., or Paradyne, in September 2005, we have been manufacturing a significant majority of our more complex products at our manufacturing facility in Florida.

Our parts and components are procured from a variety of qualified suppliers in the U.S., Far East, Mexico, and other countries around the world per our Approved Supplier List and detailed engineering specifications. Some completed products are procured to our specifications and shipped directly to our customers. We also acquire completed products from certain suppliers and configure and ship from our facility. Some of these purchases are significant. We purchase both standard off-the-shelf parts and components, which are generally available from more than one supplier, and single-source parts and components. We have generally been able to obtain adequate supplies to meet customer demand in a timely manner from our current vendors, or, when necessary, from alternate vendors. We believe that alternate vendors can be identified if current vendors are unable to fulfill our needs, or design changes can be made to employ alternate parts.

We design, specify, and monitor all of the tests that are required to meet our internal and external quality standards. Our manufacturing and test engineers work closely with our design engineers to ensure manufacturability and testability of our products, and to ensure that manufacturing and testing processes evolve as our technologies evolve. Our manufacturing engineers specify, build, or procure our test stations, establish quality standards and protocols, and develop comprehensive test procedures and processes to assure the reliability and quality of our products. These processes and tests are reviewed by our design engineers to ensure they meet the intent of the design. Products that are procured complete or partially complete are inspected, tested, and audited for quality control.

Our manufacturing quality system is ISO-9001 and is certified to ISO-9001 by our external registrar. ISO-9001 ensures our processes are documented, followed, and continuously improved. Internal audits are conducted on a regular schedule by our quality assurance personnel, and external audits are conducted by our external registrar every six months. Our quality system is based upon our model for quality assurance in design, development, production, installation, and service to ensure our products meet rigorous quality standards.

We believe that we have sufficient production capacity to meet current and future demand for our product offerings through a combination of existing and added capacity, additional employees, or the outsourcing of products or components.

Compliance with Regulatory and Industry Standards

Our products must comply with a significant number of voice and data regulations and standards which vary between the U.S. and international markets, and which vary between specific international markets. Standards for new services continue to evolve, and we may need to modify our products or develop new versions to meet these standards. Standards setting and compliance verification in the U.S. are determined by the Federal Communications Commission, or FCC, Underwriters Laboratories, Quality Management Institute, Telcordia Technologies, Inc., and other communications companies. In international markets, our products must comply with standards issued by the European Telecommunications Standards Institute, or ETSI, and implemented and enforced by the telecommunications regulatory authorities of each nation.

Environmental Matters

Our operations and manufacturing processes are subject to federal, state, local and foreign environmental protection laws and regulations. These laws and regulations relate to the use, handling, storage, discharge and disposal of certain hazardous materials and wastes, the pre-treatment and discharge of process waste waters and the control of process air pollutants.

We believe that our operations and manufacturing processes currently comply in all material respects with applicable environmental protection laws and regulations. If we fail to comply with any present and future regulations, we could be subject to future liabilities, the suspension of production or a prohibition on the sale of our products. In addition, such regulations could require us to incur other significant expenses to comply with environmental regulations, including expenses associated with the redesign of any non-compliant product. From

time to time new regulations are enacted, and it is difficult to anticipate how such regulations will be implemented and enforced. For example, in 2003 the European Union enacted the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment Directive (RoHS) and the Waste Electrical and Electronic Equipment Directive (WEEE), for implementation in European Union member states. We are aware of similar legislation that is currently in force or is being considered in the United States, as well as other countries. Our failure to comply with any of such regulatory requirements or contractual obligations could result in our being liable for costs, fines, penalties and third-party claims, and could jeopardize our ability to conduct business in countries in the jurisdictions where these regulations apply.

Employees

As of December 31, 2010, we employed 353 individuals worldwide. We consider the relationships with our employees to be positive. Competition for technical personnel in our industry is intense. We believe that our future success depends in part on our continued ability to hire, assimilate and retain qualified personnel. To date, we believe that we have been successful in recruiting qualified employees, but there is no assurance that we will continue to be successful in the future.

Executive Officers

Set forth below is information concerning our executive officers and their ages as of December 31, 2010.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Morteza Ejabat	60	Chief Executive Officer, President and Chairman of the Board of Directors
Kirk Misaka	52	Chief Financial Officer, Corporate Treasurer and Secretary

Morteza Ejabat is a co-founder of Zhone and has served as Chairman of the Board of Directors, President and Chief Executive Officer since June 1999. Prior to co-founding Zhone, from June 1995 to June 1999, Mr. Ejabat was President and Chief Executive Officer of Ascend Communications, Inc., a provider of telecommunications equipment which was acquired by Lucent Technologies, Inc. in June 1999. Previously, Mr. Ejabat held various senior management positions with Ascend from September 1990 to June 1995, most recently as Executive Vice President and Vice President, Operations. Mr. Ejabat holds a B.S. in Industrial Engineering and an M.S. in Systems Engineering from California State University at Northridge and an M.B.A. from Pepperdine University.

Kirk Misaka has served as Zhone’s Corporate Treasurer since November 2000 and as Chief Financial Officer and Secretary since July 2003. Prior to joining Zhone, Mr. Misaka was a Certified Public Accountant with KPMG LLP from 1980 to 2000, becoming a partner in 1989. Mr. Misaka earned a B.S. and an M.S. in Accounting from the University of Utah, and an M.S. in Tax from Golden Gate University.

ITEM 1A. RISK FACTORS

Set forth below and elsewhere in this report and in other documents we file with the SEC are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this report.

Our future operating results are difficult to predict and our stock price may continue to be volatile.

As a result of a variety of factors discussed in this report, our revenues for a particular quarter are difficult to predict. Our revenue and operating results may vary significantly from quarter to quarter due to a number of factors, many of which are outside of our control. The primary factors that may affect our results of operations include the following:

- commercial acceptance of our SLMS products;
- fluctuations in demand for network access products;
- the timing and size of orders from customers;
- the ability of our customers to finance their purchase of our products as well as their own operations;
- new product introductions, enhancements or announcements by our competitors;
- our ability to develop, introduce and ship new products and product enhancements that meet customer requirements in a timely manner;
- changes in our pricing policies or the pricing policies of our competitors;
- the ability of our company and our contract manufacturers to attain and maintain production volumes and quality levels for our products;
- our ability to obtain sufficient supplies of sole or limited source components;
- increases in the prices of the components we purchase, or quality problems associated with these components;
- unanticipated changes in regulatory requirements which may require us to redesign portions of our products;
- changes in accounting rules, such as recording expenses for employee stock option grants;
- integrating and operating any acquired businesses;
- our ability to achieve targeted cost reductions;
- how well we execute on our strategy and operating plans; and
- general economic conditions as well as those specific to the communications, internet and related industries.

Any of the foregoing factors, or any other factors discussed elsewhere herein, could have a material adverse effect on our business, results of operations, and financial condition that could adversely affect our stock price. In addition, public stock markets have experienced, and may in the future experience, extreme price and trading volume volatility, particularly in the technology sectors of the market. This volatility has significantly affected the market prices of securities of many technology companies for reasons frequently unrelated to or disproportionately impacted by the operating performance of these companies. These broad market fluctuations may adversely affect the market price of our common stock. In addition, if our average market capitalization falls below the carrying value of our assets for an extended period of time as it did in 2008 and 2009, this may indicate that the fair value of our net assets is below their carrying value, and may result in recording impairment charges.

We have incurred significant losses to date and expect that we may continue to incur losses in the foreseeable future. If we fail to generate sufficient revenue to achieve or sustain profitability, our stock price could decline.

We have incurred significant losses to date and expect that we may continue to incur losses in the foreseeable future. Our net losses for 2010 and 2009 were \$4.8 million and \$10.0 million, respectively, and we

had an accumulated deficit of \$1,020.4 million at December 31, 2010. We have significant fixed expenses and expect that we will continue to incur substantial manufacturing, research and product development, sales and marketing, customer support, administrative and other expenses in connection with the ongoing development of our business. In addition, we may be required to spend more on research and product development than originally budgeted to respond to industry trends. We may also incur significant new costs related to acquisitions and the integration of new technologies and other acquisitions that may occur in the future. We may not be able to adequately control costs and expenses or achieve or maintain adequate operating margins. As a result, our ability to achieve and sustain profitability will depend on our ability to generate and sustain substantially higher revenue while maintaining reasonable cost and expense levels. If we fail to generate sufficient revenue to achieve or sustain profitability, we will continue to incur substantial operating losses and our stock price could decline.

We have significant debt obligations, which could adversely affect our business, operating results and financial condition.

As of December 31, 2010, we had approximately \$10.0 million of total debt outstanding under our \$25.0 million revolving line of credit and letter of credit facility with Silicon Valley Bank, or SVB (the SVB Facility), of which all was current. Although we repaid this debt in full in January 2011, we expect to continue to make borrowings from time to time under the SVB Facility. In addition, as of December 31, 2010, \$6.4 million was committed as security for various letters of credit under the SVB Facility. Our debt obligations could materially and adversely affect us in a number of ways, including:

- limiting our ability to obtain additional financing in the future for working capital, capital expenditures, acquisitions or general corporate purposes;
- limiting our flexibility to plan for, or react to, changes in our business or market conditions;
- requiring us to use a significant portion of any future cash flow from operations to repay or service the debt, thereby reducing the amount of cash available for other purposes;
- making us more highly leveraged than some of our competitors, which may place us at a competitive disadvantage; and
- making us more vulnerable to the impact of adverse economic and industry conditions and increases in interest rates.

We cannot assure you that we will be able to generate sufficient cash flow in amounts sufficient to enable us to service our debt or to meet our working capital and capital expenditure requirements. If we are unable to generate sufficient cash flow from operations or to borrow sufficient funds to service our debt, due to borrowing base restrictions or otherwise, we may be required to sell assets, reduce capital expenditures or obtain additional financing. We cannot assure you that we will be able to engage in any of these actions on reasonable terms, if at all.

If we default under our SVB Facility because of a covenant breach or otherwise, all outstanding amounts thereunder could become immediately due and payable. Our failure to satisfy the financial covenant regarding minimum EBITDA for the compliance period ended December 31, 2010 constituted a default under the SVB Facility. In January 2011 we entered into an amendment with SVB in which SVB agreed to waive compliance with this covenant for the compliance periods ended December 31, 2010. We cannot give assurances that we will be able to obtain a waiver should a default occur in the future. Any acceleration of amounts due could have a material adverse effect on our liquidity and financial condition.

If we are unable to obtain additional capital to fund our existing and future operations, we may be required to reduce the scope of our planned product development, and marketing and sales efforts, which would harm our business, financial condition and results of operations.

The development and marketing of new products, and the expansion of our direct sales operations and associated support personnel requires a significant commitment of resources. We may continue to incur significant operating losses or expend significant amounts of capital if:

- the market for our products develops more slowly than anticipated;
- we fail to establish market share or generate revenue at anticipated levels;
- our capital expenditure forecasts change or prove inaccurate; or
- we fail to respond to unforeseen challenges or take advantage of unanticipated opportunities.

As a result, we may need to raise substantial additional capital. Additional capital, if required, may not be available on acceptable terms, or at all. For example, U.S. credit markets have in recent years experienced significant dislocations and liquidity disruptions which caused the spreads on prospective debt financings to widen considerably. These circumstances materially impacted liquidity in debt markets, making financing terms for borrowers less attractive and resulting in the general unavailability of some forms of debt financing. Uncertainty in credit or capital markets could 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. Weak and recessionary economic conditions in recent years have also adversely affected the trading prices of equity securities of many U.S. companies, including Zhone, which may make it more difficult or costly for us to raise capital through the issuance of common stock, preferred stock or other equity securities. If we elect to raise equity capital, this may be dilutive to existing stockholders and could reduce the trading price of our common stock. 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 that we have previously taken, which could have a material adverse effect on our business, financial condition and results of operations.

Our lack of liquid funds and other sources of financing may limit our ability to maintain our existing operations, grow our business and compete effectively.

Our continued losses reduced our cash, cash equivalents and short-term investments in 2009 and 2010. As of December 31, 2010, we had approximately \$21.2 million in cash, cash equivalents and short-term investments and \$10.0 million outstanding under our bank lending facility. In order to meet our liquidity needs and finance our capital expenditures and working capital needs for our business, we may be required to sell assets, or to borrow on potentially unfavorable terms. We may be unable to sell assets, or access additional indebtedness to meet these needs. As a result, we may become unable to pay our ordinary expenses, including our debt service, on a timely basis. Our current lack of liquidity could harm us by:

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

We cannot be certain that additional financing, if needed, will be available on acceptable terms or at all. If we cannot raise any necessary additional financing on acceptable terms, we may not be able to fund our business

expansion, take advantage of future opportunities, meet our existing debt obligations or respond to competitive pressures or unanticipated capital requirements, any of which could have a material adverse effect on our business, financial condition and results of operations. Further, if we issue additional equity or debt securities, stockholders may experience additional dilution or the new equity securities may have rights, preference or privileges senior to those of existing holders of our common stock.

We face a number of risks related to continued weak economic and market conditions.

Global market and economic conditions over the past three years have been unprecedented and challenging, with most major economies experiencing tighter credit conditions and an economic recession. Continued market turbulence and weak economic conditions, as well as concerns about energy costs, geopolitical issues, the availability and cost of credit, and the global housing and mortgage markets have contributed to continued market volatility and weak economic growth in most major economies. These conditions, combined with volatile oil prices, low business and consumer confidence and continued significant unemployment, have contributed to volatility of unprecedented levels. Continued weak economic and market conditions globally could impact our business in a number of ways, including:

Potential deferment of purchases and orders by customers: Uncertainty about current and future global economic conditions may cause consumers, businesses and governments to defer purchases in response to continued flat revenue budgets, tighter credit, decreased cash availability and weak consumer confidence. Accordingly, future demand for our products could differ materially from our current expectations.

Customers' inability to obtain financing to make purchases from Zhone and/or maintain their business: Some of our customers require substantial financing in order to finance their business operations, including capital expenditures on new equipment and equipment upgrades, and make purchases from Zhone. The potential inability of these customers to access the capital needed to finance purchases of our products and meet their payment obligations to us could adversely impact our financial condition and results of operations. If our customers become insolvent due to market and economic conditions or otherwise, it could have a material adverse impact on our business, financial condition and results of operations.

Negative impact from increased financial pressures on third-party dealers, distributors and retailers: We make sales in certain regions through third-party dealers, distributors and retailers. These third parties may be impacted, among other things, by the significant decrease in available credit in recent years. If credit pressures or other financial difficulties result in insolvency for these third parties and we are unable to successfully transition end customers to purchase our products from other third parties, or from us directly, it could adversely impact our financial condition and results of operations.

Negative impact from increased financial pressures on key suppliers: Our ability to meet customers' demands depends, in part, on our ability to obtain timely and adequate delivery of quality materials, parts and components from our suppliers. Certain of our components are available only from a single source or limited sources. If certain key suppliers were to become capacity constrained or insolvent, it could result in a reduction or interruption in supplies or a significant increase in the price of supplies and adversely impact our financial condition and results of operations. In addition, credit constraints of key suppliers could result in accelerated payment of accounts payable by Zhone, impacting our cash flow.

If weak economic, market and geopolitical conditions in the United States and the rest of the world continue or worsen, we may experience material adverse impacts on our business, operating results and financial condition.

If demand for our SLMS products does not develop, then our results of operations and financial condition will be adversely affected.

Our future revenue depends significantly on our ability to successfully develop, enhance and market our SLMS products to the network service provider market. Most network service providers have made substantial

investments in their current infrastructure, and they may elect to remain with their current architectures or to adopt new architectures, such as SLMS, in limited stages or over extended periods of time. A decision by a customer to purchase our SLMS products will involve a significant capital investment. We must convince our service provider customers that they will achieve substantial benefits by deploying our products for future upgrades or expansions. We do not know whether a viable market for our SLMS products will develop or be sustainable. If this market does not develop or develops more slowly than we expect, our business, financial condition and results of operations will be seriously harmed.

We depend upon the development of new products and enhancements to existing products, and if we fail to predict and respond to emerging technological trends and customers' changing needs, our operating results and market share may suffer.

The markets for our products are characterized by rapidly changing technology, evolving industry standards, changes in end-user requirements, frequent new product introductions and changes in communications offerings from network service provider customers. Our future success depends on our ability to anticipate or adapt to such changes and to offer, on a timely and cost-effective basis, products that meet changing customer demands and industry standards. We may not have sufficient resources to successfully and accurately anticipate customers' changing needs and technological trends, manage long development cycles or develop, introduce and market new products and enhancements. The process of developing new technology is complex and uncertain, and if we fail to develop new products or enhancements to existing products on a timely and cost-effective basis, or if our new products or enhancements fail to achieve market acceptance, our business, financial condition and results of operations would be materially adversely affected.

Because our products are complex and are deployed in complex environments, our products may have defects that we discover only after full deployment by our customers, which could seriously harm our business.

We produce highly complex products that incorporate leading-edge technology, including both hardware and software. Software typically contains defects or programming flaws that can unexpectedly interfere with expected operations. In addition, our products are complex and are designed to be deployed in large quantities across complex networks. Because of the nature of these products, they can only be fully tested when completely deployed in large networks with high amounts of traffic, and there is no assurance that our pre-shipment testing programs will be adequate to detect all defects. As a result, our customers may discover errors or defects in our hardware or software, or our products may not operate as expected, after they have been fully deployed by our customers. If we are unable to cure a product defect, we could experience damage to our reputation, reduced customer satisfaction, loss of existing customers and failure to attract new customers, failure to achieve market acceptance, reduced sales opportunities, loss of revenue and market share, increased service and warranty costs, diversion of development resources, legal actions by our customers, and increased insurance costs. Defects, integration issues or other performance problems in our products could also result in financial or other damages to our customers. Our customers could seek damages for related losses from us, which could seriously harm our business, financial condition and results of operations. A product liability claim brought against us, even if unsuccessful, would likely be time consuming and costly. The occurrence of any of these problems would seriously harm our business, financial condition and results of operations.

A shortage of adequate component supply or manufacturing capacity could increase our costs or cause a delay in our ability to fulfill orders, and our failure to estimate customer demand properly may result in excess or obsolete component inventories that could adversely affect our gross margins.

Occasionally, we may experience a supply shortage, or a delay in receiving, certain component parts as a result of strong demand for the component parts and/or capacity constraints or other problems experienced by suppliers. If shortages or delays persist, the price of these components may increase, or the components may not be available at all, and we may also encounter shortages if we do not accurately anticipate our needs. Conversely,

we may not be able to secure enough components at reasonable prices or of acceptable quality to build new products in a timely manner in the quantities or configurations needed. Accordingly, our revenue and gross margins could suffer until other sources can be developed. Our operating results would also be adversely affected if, anticipating greater demand than actually develops, we commit to the purchase of more components than we need. Furthermore, as a result of binding price or purchase commitments with suppliers, we may be obligated to purchase components at prices that are higher than those available in the current market. In the event that we become committed to purchase components at prices in excess of the current market price when the components are actually used, our gross margins could decrease. In the past we experienced component shortages that adversely affected our financial results and in the future may continue to experience component shortages.

We rely on contract manufacturers for a portion of our manufacturing requirements.

We rely on contract manufacturers to perform a portion of the manufacturing operations for our products. These contract manufacturers build product for other companies, including our competitors. In addition, we do not have contracts in place with some of these providers and may not be able to effectively manage those relationships. We cannot be certain that our contract manufacturers will be able to fill our orders in a timely manner. We face a number of risks associated with this dependence on contract manufacturers including reduced control over delivery schedules, the potential lack of adequate capacity during periods of excess demand, poor manufacturing yields and high costs, quality assurance, increases in prices, and the potential misappropriation of our intellectual property. We have experienced in the past, and may experience in the future, problems with our contract manufacturers, such as inferior quality, insufficient quantities and late delivery of products.

We depend on a limited source of suppliers for several key components. If we are unable to obtain these components on a timely basis, we will be unable to meet our customers' product delivery requirements, which would harm our business.

We currently purchase several key components from a limited number of suppliers. If any of our limited source of suppliers become insolvent, cease business or experience capacity constraints, work stoppages or any other reduction or disruption in output, they may be unable to meet our delivery schedules. Our suppliers may enter into exclusive arrangements with our competitors, be acquired by our competitors, stop selling their products or components to us at commercially reasonable prices, refuse to sell their products or components to us at any price or be unable to obtain or have difficulty obtaining components for their products from their suppliers. If we do not receive critical components from our limited source of suppliers in a timely manner, we will be unable to meet our customers' product delivery requirements. Any failure to meet a customer's delivery requirements could materially adversely affect our business, operating results and financial condition and could materially damage customer relationships.

Our target customer base is concentrated, and the loss of one or more of our customers could harm our business.

The target customers for our products are network service providers that operate voice, data and video communications networks. There are a limited number of potential customers in our target market. During 2010, Etisalat accounted for 24% of net revenue and we expect that a significant portion of our future revenue will depend on sales of our products to a limited number of customers. As a result, our revenue for any quarter may be subject to significant volatility based on changes in orders from one or a small number of key customers. Any failure of one or more customers to purchase products from us for any reason, including any downturn in their businesses, would seriously harm our business, financial condition and results of operations.

Industry consolidation may lead to increased competition and may harm our operating results.

There has been a trend toward industry consolidation in the communications equipment market for several years. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an

evolving industry and as companies are acquired or are unable to continue operations. We believe that industry consolidation may result in stronger competitors that are better able to compete as sole-source vendors for customers. This could have a material adverse effect on our business, financial condition and results of operations. Furthermore, rapid consolidation could result in a decrease in the number of customers we serve. Loss of a major customer could have a material adverse effect on our business, financial condition and results of operations.

We are exposed to the credit risk of some of our customers and to credit exposures in weakened markets, which could result in material losses.

Recent industry and economic conditions have weakened the financial position of some of our customers and their ability to access capital to finance their business operations, including capital expenditures. To sell to some of these customers, we may be required to assume incremental risks of uncollectible accounts or to extend credit or credit support. While we monitor these situations carefully and attempt to take appropriate measures to protect ourselves, including factoring credit arrangements to financial institutions, it is possible that we may have to defer revenue until cash is collected or write-down or write-off uncollectible accounts. Such write-downs or write-offs, if large, could have a material adverse effect on our results of operations and financial condition.

The market we serve is highly competitive and we may not be able to compete successfully.

Competition in the communications equipment market is intense. This market is characterized by rapid change, converging technologies and a migration to networking solutions that offer superior advantages. We are aware of many companies in related markets that address particular aspects of the features and functions that our products provide. Currently, our primary competitors include Alcatel-Lucent, Calix, Huawei, and ZTE, among others. We also may face competition from other large communications equipment companies or other companies that may enter our market in the future. In addition, a number of companies have introduced products that address the same network needs that our products address, both domestically and abroad. Many of our competitors have longer operating histories, greater name recognition, larger customer bases and greater financial, technical, sales and marketing resources than we do and may be able to undertake more extensive marketing efforts, adopt more aggressive pricing policies and provide more customer financing than we can. In particular, we are encountering price-focused competitors from Asia, especially China, which places pressure on us to reduce our prices. If we are forced to reduce prices in order to secure customers, we may be unable to sustain gross margins at desired levels or achieve profitability. Competitive pressures could result in increased pricing pressure, reduced profit margins, increased sales and marketing expenses and failure to increase, or the loss of, market share, any of which could reduce our revenue and adversely affect our financial results. Moreover, our competitors may foresee the course of market developments more accurately than we do and could develop new technologies that render our products less valuable or obsolete.

In our markets, principal competitive factors include:

- product performance;
- interoperability with existing products;
- scalability and upgradeability;
- conformance to standards;
- breadth of services;
- reliability;
- ease of installation and use;
- geographic footprints for products;

- ability to provide customer financing;
- price;
- technical support and customer service; and
- brand recognition.

If we are unable to compete successfully against our current and future competitors, we may have difficulty obtaining or retaining customers, and we could experience price reductions, order cancellations, increased expenses and reduced gross margins, any of which could have a material adverse effect on our business, financial condition and results of operations.

Our success largely depends on our ability to retain and recruit key personnel, and any failure to do so would harm our ability to meet key objectives.

Our future success depends upon the continued services of our executive officers and our ability to identify, attract and retain highly skilled technical, managerial, sales and marketing personnel who have critical industry experience and relationships that we rely on to build our business, including Morteza Ejabat, our co-founder, Chairman, President and Chief Executive Officer, and Kirk Misaka, our Chief Financial Officer. The loss of the services of any of our key employees, including Messrs. Ejabat and Misaka, could delay the development and production of our products and negatively impact our ability to maintain customer relationships, which would harm our business, financial condition and results of operations.

Any strategic acquisitions or investments we make could disrupt our operations and harm our operating results.

As of December 31, 2010, we had acquired twelve companies or product lines since we were founded in 1999. Further, we may acquire additional businesses, products or technologies in the future. On an ongoing basis, we may evaluate acquisitions of, or investments in, complementary companies, products or technologies to supplement our internal growth. Also, in the future, we may encounter difficulties identifying and acquiring suitable acquisition candidates on reasonable terms.

If we do complete future acquisitions, we could:

- issue stock that would dilute our current stockholders' percentage ownership;
- consume a substantial portion of our cash resources;
- incur substantial debt;
- assume liabilities;
- increase our ongoing operating expenses and level of fixed costs;
- record goodwill and non-amortizable intangible assets that will be subject to impairment testing and potential periodic impairment charges;
- incur amortization expenses related to certain intangible assets;
- incur large and immediate write-offs; and
- become subject to litigation.

Any acquisitions or investments that we make in the future will involve numerous risks, including:

- difficulties in integrating the operations, technologies, products and personnel of the acquired companies;

- unanticipated costs;
- diversion of management's time and attention away from normal daily operations of the business and the challenges of managing larger and more widespread operations resulting from acquisitions;
- difficulties in entering markets in which we have no or limited prior experience;
- insufficient revenues to offset increased expenses associated with acquisitions and where competitors in such markets have stronger market positions; and
- potential loss of key employees, customers, distributors, vendors and other business partners of the companies we acquire following and continuing after announcement of acquisition plans.

Mergers and acquisitions of high-technology companies are inherently risky and subject to many factors outside of our control, and we cannot be certain that our previous or future acquisitions will be successful and will not materially adversely affect our business, operating results or financial condition. We do not know whether we will be able to successfully integrate the businesses, products, technologies or personnel that we might acquire in the future or that any strategic investments we make will meet our financial or other investment objectives. Any failure to do so could seriously harm our business, financial condition and results of operations.

Sales to communications service providers are especially volatile, and weakness in sales orders from this industry may harm our operating results and financial condition.

Sales activity in the service provider industry depends upon the stage of completion of expanding network infrastructures, the availability of funding, and the extent to which service providers are affected by regulatory, economic and business conditions in the country of operations. Although some service providers may be increasing capital expenditures over the depressed levels that have prevailed over the last few years, weakness in orders from this industry could have a material adverse effect on our business, operating results and financial condition. Slowdowns in the general economy, overcapacity, changes in the service provider market, regulatory developments and constraints on capital availability have had a material adverse effect on many of our service provider customers, with many of these customers going out of business or substantially reducing their expansion plans. These conditions have materially harmed our business and operating results, and we expect that some or all of these conditions may continue for the foreseeable future. Finally, service provider customers typically have longer implementation cycles; require a broader range of service including design services; demand that vendors take on a larger share of risks; often require acceptance provisions, which can lead to a delay in revenue recognition; and expect financing from vendors. All these factors can add further risk to business conducted with service providers.

Decreased effectiveness of share-based compensation could adversely affect our ability to attract and retain employees.

We have historically used stock options as a key component of our employee compensation program in order to align the interests of our employees with the interests of our stockholders, encourage employee retention and provide competitive compensation and benefit packages. If the trading price of our common stock declines, this would reduce the value of our share-based compensation to our present employees and could affect our ability to retain them. In addition, in recent periods, some of our employee stock options have had exercise prices in excess of our stock price, which reduces their value to employees and could affect our ability to retain present, or attract prospective employees. To address these issues, in the fourth quarter of 2008, we conducted an exchange offer, or the Exchange Offer, in which eligible employees, officers and directors of Zhonghe could exchange outstanding options to purchase shares of Zhonghe common stock previously granted under our equity incentive compensation plans with an exercise price per share equal to or greater than \$1.75 on a one-for-one basis for the grant of new options to purchase shares of Zhonghe common stock. Options to acquire approximately 2.9 million shares of Zhonghe common stock were tendered in the Exchange Offer for new options with an exercise price of \$0.50 per share, as adjusted for the one-for-five reverse stock split effected on March 11, 2010.

Difficulties relating to obtaining stockholder approval of equity compensation plans could also make it harder or more expensive for us to grant share-based payments to employees in the future.

Due to the international nature of our business, political or economic changes or other factors in a specific country or region could harm our future revenue, costs and expenses and financial condition.

We currently have international operations consisting of sales and technical support teams in various locations around the world. We expect to continue expanding our international operations in the future. The successful management and expansion of our international operations requires significant human effort and the commitment of substantial financial resources. Further, our international operations may be subject to certain risks and challenges that could harm our operating results, including:

- trade protection measures and other regulatory requirements which may affect our ability to import or export our products into or from various countries;
- political considerations that affect service provider and government spending patterns;
- differing technology standards or customer requirements;
- developing and customizing our products for foreign countries;
- fluctuations in currency exchange rates;
- longer accounts receivable collection cycles and financial instability of customers;
- difficulties and excessive costs for staffing and managing foreign operations;
- potentially adverse tax consequences; and
- changes in a country's or region's political and economic conditions.

Any of these factors could harm our existing international operations and business or impair our ability to continue expanding into international markets.

Compliance or the failure to comply with current and future environmental regulations could cause us significant expense.

We are subject to a variety of federal, state, local and foreign environmental regulations. If we fail to comply with any present and future regulations, we could be subject to future liabilities, the suspension of production or a prohibition on the sale of our products. In addition, such regulations could require us to incur other significant expenses to comply with environmental regulations, including expenses associated with the redesign of any non-compliant product. From time to time new regulations are enacted, and it is difficult to anticipate how such regulations will be implemented and enforced. For example, in 2003 the European Union enacted the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment Directive (RoHS) and the Waste Electrical and Electronic Equipment Directive (WEEE), for implementation in European Union member states. We are aware of similar legislation that is currently in force or is being considered in the United States, as well as other countries, such as Japan and China. Our failure to comply with any of such regulatory requirements or contractual obligations could result in our being liable for costs, fines, penalties and third-party claims, and could jeopardize our ability to conduct business in countries in the jurisdictions where these regulations apply.

Adverse resolution of litigation may harm our operating results or financial condition.

We are a party to various lawsuits and claims in the normal course of our business. Litigation can be expensive, lengthy, and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular lawsuit could have a material

adverse effect on our business, operating results and financial condition. For additional information regarding litigation in which we are involved, see Item 3, “Legal Proceedings,” contained in Part I of this report.

Our intellectual property rights may prove difficult to protect and enforce.

We generally rely on a combination of copyrights, patents, trademarks and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, consultants and corporate partners, and control access to and distribution of our proprietary information. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our technology is difficult, and we do not know whether the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as extensively as in the United States. We cannot assure you that our pending, or any future, patent applications will be granted, that any existing or future patents will not be challenged, invalidated, or circumvented, or that any existing or future patents will be enforceable. While we are not dependent on any individual patents, if we are unable to protect our proprietary rights, we may find ourselves at a competitive disadvantage to others who need not incur the substantial expense, time and effort required to create the innovative products.

We may be subject to intellectual property infringement claims that are costly and time consuming to defend and could limit our ability to use some technologies in the future.

Third parties have in the past and may in the future assert claims or initiate litigation related to patent, copyright, trademark and other intellectual property rights to technologies and related standards that are relevant to us. The asserted claims or initiated litigation can include claims against us or our manufacturers, suppliers or customers alleging infringement of their proprietary rights with respect to our existing or future products, or components of those products. We have received correspondence from companies claiming that many of our products are using technology covered by or related to the intellectual property rights of these companies and inviting us to discuss licensing arrangements for the use of the technology. Regardless of the merit of these claims, intellectual property litigation can be time consuming and costly, and result in the diversion of technical and management personnel. Any such litigation could force us to stop selling, incorporating or using our products that include the challenged intellectual property, or redesign those products that use the technology. In addition, if a party accuses us of infringing upon its proprietary rights, we may have to enter into royalty or licensing agreements, which may not be available on terms acceptable to us, if at all. If we are unsuccessful in any such litigation, we could be subject to significant liability for damages and loss of our proprietary rights. Any of these results could have a material adverse effect on our business, financial condition and results of operations.

We rely on the availability of third party licenses.

Many of our products are designed to include software or other intellectual property licensed from third parties. It may be necessary in the future to seek or renew licenses relating to various elements of the technology used to develop these products. We cannot assure you that our existing and future third-party licenses will be available to us on commercially reasonable terms, if at all. Our inability to maintain or obtain any third-party license required to sell or develop our products and product enhancements could require us to obtain substitute technology of lower quality or performance standards, or at greater cost.

The long and variable sales cycles for our products may cause revenue and operating results to vary significantly from quarter to quarter.

The target customers for our products have substantial and complex networks that they traditionally expand in large increments on a periodic basis. Accordingly, our marketing efforts are focused primarily on prospective customers that may purchase our products as part of a large-scale network deployment. Our target customers typically require a lengthy evaluation, testing and product qualification process. Throughout this process, we are

often required to spend considerable time and incur significant expense educating and providing information to prospective customers about the uses and features of our products. Even after a company makes the final decision to purchase our products, it may deploy our products over extended periods of time. The timing of deployment of our products varies widely, and depends on a number of factors, including our customers' skill sets, geographic density of potential subscribers, the degree of configuration and integration required to deploy our products, and our customers' ability to finance their purchase of our products as well as their operations. As a result of any of these factors, our revenue and operating results may vary significantly from quarter to quarter.

The communications industry is subject to government regulations, which could harm our business.

The FCC has jurisdiction over the entire communications industry in the United States and, as a result, our existing and future products and our customers' products are subject to FCC rules and regulations. Changes to current FCC rules and regulations and future FCC rules and regulations could negatively affect our business. The uncertainty associated with future FCC decisions may cause network service providers to delay decisions regarding their capital expenditures for equipment for broadband services. In addition, international regulatory bodies establish standards that may govern our products in foreign markets. Changes to or future domestic and international regulatory requirements could result in postponements or cancellations of customer orders for our products and services, which would harm our business, financial condition and results of operations. Further, we cannot be certain that we will be successful in obtaining or maintaining regulatory approvals that may, in the future, be required to operate our business.

The ability of unaffiliated stockholders to influence key transactions, including changes of control, may be limited by significant insider ownership, provisions of our charter documents and provisions of Delaware law.

At December 31, 2010, our executive officers, directors and entities affiliated with them beneficially owned, in the aggregate, approximately 26% of our outstanding common stock. These stockholders, if acting together, will be able to influence substantially all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions. Circumstances may arise in which the interests of these stockholders could conflict with the interests of our other stockholders. These stockholders could delay or prevent a change in control of our company even if such a transaction would be beneficial to our other stockholders. In addition, provisions of our certificate of incorporation, bylaws and Delaware law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to certain stockholders.

Our business and operations are especially subject to the risks of earthquakes and other natural catastrophic events.

Our corporate headquarters, including a significant portion of our research and development operations, are located in Northern California, a region known for seismic activity. Additionally, some of our facilities, including our manufacturing facilities, are located near geographic areas that have experienced hurricanes in the past. A significant natural disaster, such as an earthquake, hurricane, fire, flood or other catastrophic event, could severely affect our ability to conduct normal business operations, and as a result, our future operating results could be materially and adversely affected.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our worldwide headquarters are located in Oakland, California. In September 2010, we sold the land and buildings in Oakland, California which we had previously owned. As part of the sale transaction, we leased back

one of the three buildings which is used for our executive offices, research and product development activities, and administrative and marketing activities.

In addition to our Oakland headquarters, we also lease facilities for manufacturing, research and development purposes at locations including Largo, Florida; Alpharetta, Georgia; Portsmouth, New Hampshire and Westlake Village, California. We also maintain smaller offices to provide sales and customer support at various domestic and international locations. We believe that our existing facilities are suitable and adequate for our present purposes.

ITEM 3. LEGAL PROCEEDINGS

We are subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, we do 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 4. RESERVED

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Price Range of Common Stock

Our common stock was listed on the Nasdaq Global Market under the symbol "ZHNE" until September 28, 2009, when our common stock was transferred to the Nasdaq Capital Market, where it is also listed under the symbol "ZHNE". The following table sets forth, for the periods indicated, the high and low per share sales prices of our common stock as reported on Nasdaq.

2010:	<u>High</u>	<u>Low</u>
Fourth Quarter ended December 31, 2010	\$3.24	\$1.87
Third Quarter ended September 30, 2010	2.10	1.13
Second Quarter ended June 30, 2010	2.99	1.38
First Quarter ended March 31, 2010	3.35	2.00
2009:		
	<u>High</u>	<u>Low</u>
Fourth Quarter ended December 31, 2009	\$3.80	\$1.65
Third Quarter ended September 30, 2009	4.65	1.30
Second Quarter ended June 30, 2009	1.90	0.90
First Quarter ended March 31, 2009	1.10	0.40

All per share prices reflect the one-for-five reverse stock split effected on March 11, 2010.

As of December 31, 2010, there were 1,352 registered stockholders of record. A substantially greater number of holders of Zhone common stock are "street name" or beneficial holders, whose shares are held of record by banks, brokers and other financial institutions.

Dividend Policy

We have never paid or declared any cash dividends on our common stock or other securities and do not anticipate paying cash dividends in the foreseeable future. Any future determination to pay cash dividends will be at the discretion of the Board of Directors, subject to any applicable restrictions under our debt and credit agreements, and will be dependent upon our financial condition, results of operations, capital requirements, general business condition and such other factors as the Board of Directors may deem relevant.

Recent Sales of Unregistered Securities

There were no unregistered sales of equity securities during 2010.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data has been derived from our consolidated financial statements and should be read in conjunction with the consolidated financial statements and notes thereto, and with "Management's Discussion and Analysis of Financial Condition and Results of Operations." During the years ended December 31, 2010, 2009, 2008, 2007 and 2006, we recorded charges of zero, zero, \$70.4 million, zero, and \$113.7 million, respectively, related to the impairment of acquisition related intangibles and goodwill as discussed in Note 3 to the consolidated financial statements.

	As of December 31,				
	2010	2009	2008	2007	2006
	(in thousands, except per share data)				
Statement of Operations Data:					
Net revenue	\$129,036	\$126,501	\$146,160	\$175,448	\$ 194,344
Cost of revenue (1)	79,864	81,106	101,096	116,370	131,749
Gross profit	49,172	45,395	45,064	59,078	62,595
Operating expenses:					
Research and product development (1)	21,188	22,113	27,063	32,720	36,099
Sales and marketing (1)	23,982	22,042	28,269	33,192	38,225
General and administrative (1)	9,855	9,933	15,609	10,170	14,036
Gain on sale of fixed assets	(1,959)	—	(455)	(659)	—
Gain on sale of intangible assets	—	—	(4,397)	(5,000)	—
Amortization of intangible assets	—	—	—	—	2,764
Impairment of intangible assets and goodwill	—	—	70,401	—	113,666
Total operating expenses	53,066	54,088	136,490	70,423	204,790
Operating loss	(3,894)	(8,693)	(91,426)	(11,345)	(142,195)
Interest expense	(996)	(1,331)	(1,625)	(2,213)	(2,774)
Interest income	7	47	708	1,813	2,328
Other income, net	1	121	78	37	239
Loss before income taxes	(4,882)	(9,856)	(92,265)	(11,708)	(142,402)
Income tax provision (benefit)	(101)	171	270	394	264
Net loss	\$ (4,781)	\$ (10,027)	\$ (92,535)	\$ (12,102)	\$ (142,666)
Basic and diluted net loss per share (2)	\$ (0.16)	\$ (0.33)	\$ (3.08)	\$ (0.40)	\$ (4.80)
Shares used in per-share calculation (2)	30,393	30,200	30,068	29,925	29,745
(1) Amounts include stock-based compensation cost as follows:					
Cost of revenue	\$ 94	\$ 104	\$ 158	\$ 296	\$ 892
Research and product development	362	414	479	717	1,632
Sales and marketing	421	484	511	603	1,380
General and administrative	1,388	1,258	1,203	1,250	1,601
(2) All share and per share amounts reflect the one-for-five reverse stock split effected on March 11, 2010.					

	As of December 31,				
	2010	2009	2008	2007	2006
	(in thousands)				
Balance Sheet Data:					
Cash, cash equivalents and short-term investments	\$ 21,174	\$ 21,766	\$ 36,243	\$ 50,165	\$ 64,310
Working capital	49,402	53,843	62,007	77,496	83,872
Total assets	90,111	110,259	123,449	223,406	240,182
Long-term debt, including current portion	—	18,696	19,078	19,405	27,049
Stockholders' equity	\$ 49,415	\$ 51,673	\$ 59,297	\$149,547	\$ 157,604

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 750 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 \$1,020.4 million as of December 31, 2010. If we are unable to access or raise the capital needed to meet liquidity needs and finance capital expenditures and working capital, or if the economic, market and geopolitical conditions in the United States and the rest of the world do not improve or deteriorate, we may experience material adverse impacts on our business, operating results and financial condition. During 2009, we implemented several activities intended to reduce costs, improve operating efficiencies and change our operations to more closely align them with our key strategic focus, which included headcount reductions. During 2010, we continued to focus on cost control and operating efficiency along with restrictions on discretionary spending. The most significant cost-cutting measure during 2010 was the sale in September 2010 of our land and buildings located in Oakland, California and extinguishment of related debt in a sale and leaseback transaction with LBA Realty, LLC, or LBA Realty. The sale and leaseback transaction will allow us to reduce occupancy costs going forward and improved the current financial position by eliminating the related debt which was due in April 2011.

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.

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. In 2008 and 2009, we received additional contingent consideration of \$1.1 million and \$0.4 million, respectively, related to the buyer's usage of inventory related to the GigaMux legacy product line. We received no additional contingent consideration in 2010 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, 2009, and 2010, we recognized additional gains of \$0.2 million, \$0.2 million, and \$0.3 million, respectively, which were recorded in cost of revenue. We will continue to record additional gain 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 consolidated 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 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. 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.

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.

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 the Exchange Offer to exchange certain stock options issued to eligible employees, officers and directors of Zhonghe under Zhonghe'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 \$1.75 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 2.9 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 \$0.50, 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.

On March 31, 2010, our board of directors approved the acceleration of vesting of all unvested options to purchase shares of Zhone common stock issued in connection with the Exchange Offer that were held by members of Zhone's senior management. The acceleration was effective as of March 31, 2010. Options to purchase an aggregate of approximately 0.9 million shares of Zhone common stock were subject to the acceleration and resulted in a compensation charge of \$0.9 million which was fully expensed on March 31, 2010. The acceleration of these options was undertaken in recognition of the achievement of certain performance objectives by Zhone's senior management.

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. We have 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 2009, we assumed that we would no longer be able to sublease the remaining excess space due to the continued deterioration in the real estate market. Accordingly, during 2009, we increased our excess lease liability balance by \$0.6 million, with a corresponding charge to general and administrative expenses.

RESULTS OF OPERATIONS

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

	Year ended December 31,		
	2010	2009	2008
Net revenue	100%	100%	100%
Cost of revenue	<u>62%</u>	<u>64%</u>	<u>69%</u>
Gross profit	<u>38%</u>	<u>36%</u>	<u>31%</u>
Operating expenses:			
Research and product development	16%	18%	19%
Sales and marketing	19%	17%	19%
General and administrative	8%	8%	11%
Gain on sale of fixed assets	(2)%	0%	0%
Gain on sale of intangible assets	0%	0%	(3)%
Impairment of goodwill	<u>0%</u>	<u>0%</u>	<u>48%</u>
Total operating expenses	<u>41%</u>	<u>43%</u>	<u>94%</u>
Operating loss	(3)%	(7)%	(63)%
Interest expense	(1)%	(1)%	(1)%
Interest income	0%	0%	1%
Other income	<u>0%</u>	<u>0%</u>	<u>0%</u>
Loss before income taxes	(4)%	(8)%	(63)%
Income tax provision	<u>0%</u>	<u>0%</u>	<u>0%</u>
Net loss	<u>(4)%</u>	<u>(8)%</u>	<u>(63)%</u>

2010 COMPARED WITH 2009

Net Revenue

Information about our net revenue for products and services for 2010 and 2009 is summarized below (in millions):

	2010	2009	Increase (Decrease)	% change
Products	\$124.6	\$120.9	\$ 3.7	3%
Services	<u>4.4</u>	<u>5.6</u>	<u>(1.2)</u>	<u>(21)%</u>
	<u>\$129.0</u>	<u>\$126.5</u>	<u>\$ 2.5</u>	<u>2%</u>

Information about our net revenue for North America and international markets for 2010 and 2009 is summarized below (in millions):

	<u>2010</u>	<u>2009</u>	<u>Increase (Decrease)</u>	<u>% change</u>
Revenue by geography:				
United States	\$ 45.3	\$ 50.1	\$(4.8)	(10)%
Canada	4.9	5.5	(0.6)	(11)%
Total North America	<u>50.2</u>	<u>55.6</u>	<u>(5.4)</u>	<u>(10)%</u>
Latin America	24.4	18.0	6.4	36%
Europe, Middle East, Africa	51.6	48.7	2.9	6%
Asia Pacific	2.8	4.2	(1.4)	(33)%
Total International	<u>78.8</u>	<u>70.9</u>	<u>7.9</u>	<u>11%</u>
Total	<u>\$129.0</u>	<u>\$126.5</u>	<u>\$ 2.5</u>	<u>2%</u>

Net revenue increased 2% or \$2.5 million to \$129.0 million for 2010 compared to \$126.5 million for 2009. The increase in net revenue was primarily attributable to an increase in product revenue, which in 2010 increased 3% or \$3.7 million compared to 2009. The increase was primarily due to increased sales in our SLMS product portfolio related to the continued success of our MXK product launch. Service revenue decreased 21% or \$1.2 million compared to 2009, primarily due to a decrease in gross sales accompanied by the timing of services performed and revenue earned. Service revenue represents revenue from maintenance and other services associated with product shipments.

International net revenue increased 11% or \$7.9 million to \$78.8 million in 2010 and represented 61% of total net revenue compared with 56% in 2009. The increase in international net revenue was primarily due to higher demand in Latin America as a result of recent growth in demand for our products. In addition to the growth experienced in Latin America, we experienced continued growth associated with one customer in the Middle East (Etisalat) that accounted for 24% of net revenue in 2010. The increase in international net revenue was partially offset by a decrease in domestic net revenue of 10% or \$5.4 million to \$50.2 million in 2010 compared to \$55.6 million in 2009. The decrease was primarily the result of the continued weak economic conditions in the United States during 2010.

Etisalat accounted for 24% and 19% of net revenue in 2010 and 2009, 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 \$1.2 million or 2% to \$79.9 million for 2010, compared to \$81.1 million for 2009. Total cost of revenue was 62% of net revenue for 2010, compared to 64% of net revenue for 2009, which resulted in an increase in gross profit percentage from 36% in 2009 to 38% in 2010. The gross margin increased as compared with prior periods primarily due to increased sales volume and the reduction in cost of revenue for the period resulting from greater sales of products with higher gross margin, such as our MXK products.

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 the future. In addition, continued 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 4% or \$0.9 million to \$21.2 million for 2010 compared to \$22.1 million for 2009. The decrease was primarily due to a reduction in non-personnel expenses resulting from the introduction of our MXK product to the market mid-year 2009 causing a decrease in prototype and rework expenses of \$0.7 million in 2010. 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 increased 9% or \$2.0 million to \$24.0 million for 2010 compared to \$22.0 million for 2009. The increase was primarily attributable to increases in marketing expenses of \$1.3 million as we continue to grow our brand awareness which included increases of \$0.5 million in personnel-related costs and \$0.8 million in non-personnel costs. In addition, overall sales and customer service expenses increased \$0.7 million compared to 2009, mainly due to increased personnel-related expenses, including \$0.3 million of additional headcount expenses incurred to support operations in the Middle East.

General and Administrative Expenses

General and administrative expenses remained flat at \$9.9 million for both 2010 and 2009. There were continued reductions made in personnel-related costs of \$0.3 million in 2010 compared to 2009 and \$0.4 million in cost savings related to decreased property taxes resulting from our September 2010 sale of the Oakland, California campus. These decreases were offset by a \$0.2 million increase in software maintenance expenses, and \$0.5 million increase in other miscellaneous expenses.

Gain on Sale of Fixed Assets

Gain on sale of fixed assets was \$2.0 million for 2010. The gain in 2010 was attributable to the sale of our Oakland, California campus, consisting of land and three buildings, in September 2010, as discussed in Note 5 of the consolidated financial statements. There were no similar sales of fixed assets in 2009.

Interest Expense

Interest expense for 2010 decreased by \$0.3 million to \$1.0 million compared to \$1.3 million in 2009, primarily due to a decrease in outstanding debt balances and continued low interest rates during 2010. This includes the effect of our September 2010 extinguishment of debt associated with the sale of our Oakland, California campus as discussed in Note 7 of the consolidated financial statements.

Interest Income

Interest income for 2010 decreased by \$0.1 million to zero compared to \$0.1 million in 2009 due to lower average balances of cash and short-term investments and the continued low interest rates during 2010.

Other Income

Other income for 2010 decreased by \$0.1 million to zero compared to \$0.1 million in 2009 due to decreased sublease rental income received during 2010 as leases expired during the period.

Income Tax Provision

During the years ended December 31, 2010 and 2009, we recorded an income tax benefit of \$0.1 million and an income tax provision of \$0.2 million, respectively, related to foreign and state taxes. No material

provision or benefit for income taxes was recorded in 2010 and 2009, 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.

2009 COMPARED WITH 2008

Revenue

Information about our net revenue for products and services for 2009 and 2008 is summarized below (in millions):

	<u>2009</u>	<u>2008</u>	<u>Increase (Decrease)</u>	<u>% change</u>
Products	\$120.9	\$141.9	\$(21.0)	(15)%
Services	5.6	4.3	1.3	30%
	<u>\$126.5</u>	<u>\$146.2</u>	<u>\$(19.7)</u>	<u>(13)%</u>

Information about our net revenue for North America and international markets for 2009 and 2008 is summarized below (in millions):

	<u>2009</u>	<u>2008</u>	<u>Increase (Decrease)</u>	<u>% change</u>
Revenue by geography:				
United States	\$ 50.1	\$ 60.8	\$(10.7)	(18)%
Canada	5.5	5.4	0.1	2%
Total North America	<u>55.6</u>	<u>66.2</u>	<u>(10.6)</u>	<u>(16)%</u>
Latin America	18.0	32.2	(14.2)	(44)%
Europe, Middle East, Africa	48.7	43.9	4.8	11%
Asia Pacific	4.2	3.9	0.3	8%
Total International	<u>70.9</u>	<u>80.0</u>	<u>(9.1)</u>	<u>(11)%</u>
Total	<u>\$126.5</u>	<u>\$146.2</u>	<u>\$(19.7)</u>	<u>(13)%</u>

Net revenue decreased 13% or \$19.7 million to \$126.5 million for 2009 compared to \$146.2 million for 2008. The decrease in net revenue was attributable to a decrease in product revenue, which in 2009, decreased 15% or \$21.0 million compared to 2008. The decrease was primarily due to the global recession and credit contraction which caused many of our customers to defer or reduce their network expansion. Service revenue increased 30% or \$1.3 million compared to 2008. Service revenue represents revenue from maintenance and other services associated with product shipments.

International net revenue decreased 11% or \$9.1 million to \$70.9 million in 2009 and represented 56% of total net revenue compared with 55% in 2008. The decrease in international revenue was primarily due to lower demand in Latin America as a result of the global economic downturn and credit contraction. The decrease in Latin America was offset by an increase in revenue in Europe, Middle East and Africa in 2009 due to increased sales of our new products. We experienced significant growth associated with one international customer (Etisalat) that accounted for 19% of net revenue in 2009.

During 2009, Etisalat accounted for 19% of net revenue and no customer accounted for 10% or more of net revenue in 2008.

Cost of Revenue and Gross Profit

Total cost of revenue, including stock-based compensation, decreased \$20.0 million, or 20% to \$81.1 million for 2009, compared to \$101.1 million for 2008. Total cost of revenue was 64% of net revenue for 2009, compared to 69% of net revenue for 2008, which resulted in an increase in gross profit percentage from 31% in 2008 to 36% in 2009. The increase in gross profit percentage during 2009 was attributed to the change in product mix and decrease in personnel-related costs for 2009. The change in product mix was mainly due to an increase of \$12.8 million in sales of the MXK product as compared with 2008, which has a higher gross margin. Personnel related costs for 2009 decreased over 2008 by \$3.3 million primarily due to headcount reductions and economies of scale.

In January 2008, we sold inventory and certain assets related to 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 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 GigaMux legacy product line, we recognized a gain of \$1.3 million during the first quarter of 2008 that was recorded in cost of revenue. Additional gains of \$1.1 million and \$0.4 million were recognized in 2008 and 2009, respectively, related to certain earnout provisions which were recorded in cost of revenue.

Research and Product Development Expenses

Research and product development expenses decreased 18% or \$5.0 million to \$22.1 million for 2009 compared to \$27.1 million for 2008. The decrease was primarily due to restructuring efforts to streamline processes, which reduced personnel-related costs by \$3.1 million and prototype costs by \$1.2 million.

Sales and Marketing Expenses

Sales and marketing expenses decreased 22% or \$6.3 million to \$22.0 million for 2009 compared to \$28.3 million for 2008. The decrease was primarily attributable to reductions in personnel-related costs of \$1.8 million from lower headcount as we realigned our resources to focus on emerging markets and also due to lower commission expenses of \$1.5 million related to decreased sales, and a reduction in travel expenses of \$1.0 million and trade show expenses of \$0.9 million.

General and Administrative Expenses

General and administrative expenses decreased 37% or \$5.7 million to \$9.9 million for 2009 compared to \$15.6 million for 2008. The decrease was primarily due to a reduction in personnel-related costs of \$0.8 million, accounting and legal fees of \$0.8 million and bad debt expenses of \$0.8 million. 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 during the second quarter of 2008.

Gain on Sale of Fixed Assets

Gain on sale of fixed assets was \$0.5 million for 2008. The gain in 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 2009.

Gain on Sale of Intangible Assets

Gain on sale of intangible assets was \$4.4 million for 2008. The gain in 2008 was attributable to the sale of intangible assets associated with our sale of the GigaMux legacy product line sold in January 2008 and the sale of our non-strategic legacy patents. There were no similar sales of intangible assets for 2009.

Impairment of Intangible Assets and Goodwill

We review goodwill and other long-lived assets, including intangible assets, for impairment annually or whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. 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 December 31, 2008, we had no remaining goodwill or intangible assets.

Interest Expense

Interest expense for 2009 decreased by \$0.3 million to \$1.3 million compared to \$1.6 million in 2008 due to a decrease in the outstanding debt balances and a reduction in interest rates during 2009.

Interest Income

Interest income for 2009 decreased by \$0.6 million to \$0.1 million compared to \$0.7 million in 2008 due to lower average balances of cash and short-term investments and a reduction in interest rates during 2009.

Income Tax Provision

During the years ended December 31, 2009 and 2008, we recorded an income tax provision of \$0.2 million and \$0.3 million, respectively, related to foreign and state taxes. No material provision or benefit for income taxes was recorded in 2009 and 2008, 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, available credit facilities, and sales of equity and debt instruments, based on our operating requirements and market conditions.

At December 31, 2010, cash, cash equivalents and short-term investments were \$21.2 million compared to \$21.8 million at December 31, 2009. This amount included cash and cash equivalents of \$21.2 million at December 31, 2010 compared to \$21.5 million at December 31, 2009. The decrease in cash and cash equivalents of \$0.3 million was attributable to net cash used in investing activities and financing activities of \$2.3 million and \$0.1 million, respectively, offset by net cash provided by operating activities of \$2.1 million.

Operating Activities

For fiscal year 2010, net cash provided by operating activities consisted of a net loss of \$4.8 million, adjusted for non-cash charges totaling \$2.7 million and a decrease in operating assets totaling \$4.2 million. The most significant components of the changes in net operating assets were a decrease in accounts receivable of \$6.6 million partially offset by a decrease in accounts payable of \$3.1 million. The decrease in accounts receivable related to significant cash collections, primarily related to Etisalat, which were in turn used to pay down outstanding payables causing the related decrease in the accounts payable balance.

For fiscal year 2009, net cash used in operating activities consisted of a net loss of \$10.0 million, adjusted for non-cash charges totaling \$5.9 million and an increase in operating assets totaling \$4.4 million. The most

significant components of the changes in net operating assets were an increase in accounts receivable of \$15.2 million offset by a decrease in inventories of \$10.5 million. The increase in accounts receivable was primarily due to the aging of Etisalat balances which accounted for 66% of net accounts receivable as of December 31, 2009. The decrease in inventories was primarily due to better utilization of inventory during 2009.

Investing Activities

For fiscal year 2010, net cash used in investing activities consisted primarily of purchases of property and equipment of \$3.2 million offset by proceeds from the sale of our Oakland, California campus and extinguishment of related debt of \$0.6 million (as discussed in Note 7 of the consolidated financial statements) and proceeds from the maturity of short-term investments of \$0.3 million. As part of our September 2010 sale and leaseback transaction with LBA Realty, we moved into another building at the Oakland location and performed significant build-out of new labs and redesigned office spaces resulting in an increase in property and equipment purchases as compared to 2009.

For fiscal year 2009, net cash provided by investing activities consisted primarily of proceeds from the sale and maturity of short-term investments of \$2.9 million offset by purchases of short-term investments of \$0.3 million and equipment purchases of \$0.8 million.

Financing Activities

For fiscal year 2010, net cash used in financing activities consisted of repayment of the secured real estate debt of \$0.3 million for the period before the sale of the Oakland, California campus and extinguishment of the related debt transaction as discussed in Note 5 of the consolidated financial statements. This was partially offset by the proceeds related to exercise of stock options and purchases made under our 2002 Employee Stock Purchase Plan, or ESPP of \$0.2 million.

For fiscal year 2009, net cash used in financing activities consisted primarily of repayment of the debt and credit facility of \$5.4 million primarily in connection with the replacement of our existing revolving line of credit and letter of credit facility with SVB with a new revolving line of credit and letter of credit in March 2009.

Cash Management

Our primary source of liquidity comes from our cash and cash equivalents, which totaled \$21.2 million at December 31, 2010, and our \$25.0 million SVB Facility. 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. At current revenue levels, we anticipate that some portion of our existing cash and cash equivalents will continue to be consumed by operations.

Under the SVB Facility, we have the option of borrowing funds at agreed upon interest rates. The amount that we are able to borrow under the SVB Facility varies based on the eligible accounts receivable, as defined in the agreement, as long as the principal amount outstanding does not exceed \$25.0 million. In addition, under the SVB Facility, we are able to utilize the facility as security for letters of credit.

Under the SVB Facility, \$10.0 million was outstanding at December 31, 2010. In addition, \$6.4 million was committed as security for various letters of credit and \$7.7 million was unused and available for borrowing as of December 31, 2010. As of December 31, 2010, the amounts borrowed under the SVB Facility bore interest, payable monthly, at a floating rate that was SVB's prime rate plus 2.5%, with a minimum interest rate of 6.5%. The interest rate was 6.5% at December 31, 2010.

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 December 31, 2010, we were not in compliance with the financial covenant regarding minimum EBITDA under the SVB Facility. On January 19, 2011, we entered into an amendment with SVB in which SVB agreed to waive our obligation to comply with the financial covenant regarding minimum EBITDA for the compliance period ending December 31, 2010.

In January 2011, we repaid the \$10.0 million outstanding under the SVB Facility. On March 14, 2011, we renewed the SVB Facility to provide liquidity and working capital through March 13, 2012 and amended the interest rate applicable to amounts borrowed under the SVB Facility, as discussed in Note 16 to the consolidated financial statements.

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 \$6.5 million as of December 31, 2010. 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 \$2.7 million as of December 31, 2010, which we believe is adequate to cover costs incurred to exit the excess portion of these facilities, net of estimated sublease income. Our operating lease commitments also include \$3.0 million of future minimum lease payments spread over the five-year lease term under the lease agreement we entered into with LBA Realty in September 2010 with respect to our Oakland, California campus following the sale of our campus to LBA Realty in a sale-leaseback transaction.

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. For example, during the year ended December 31, 2008, we sold \$10.2 million of customer trade receivables to SVB on a non-recourse basis in exchange for cash. The sale of the receivables did not represent a securitization, and there was no continuing involvement or interests in the receivables by us after the sale. 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, represent a concentration of credit risk because a significant portion of the accounts receivable balance at any point in time typically consists of large balances due from a relatively small number of customer account balances. As of December 31, 2010, Etisalat accounted for 30% of net accounts receivable, and receivables from customers in countries other than the United States of America represented 74% of net 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, inventory purchase commitments and debt.

We expect that operating losses and negative cash flows from operations may continue. In order to meet our liquidity needs and finance our capital expenditures and working capital needs for our business, we may be required to sell assets, issue debt or equity securities or borrow on unfavorable terms. Continued uncertainty regarding financial institutions' ability and inclination to lend may negatively impact our ability to access debt

financing or to refinance existing indebtedness in the future on favorable terms, or at all. We may be unable to sell assets, issue securities or access additional indebtedness to meet these needs 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 available credit facilities will be sufficient to satisfy our anticipated cash requirements for the foreseeable future.

Contractual Commitments and Off-Balance Sheet Arrangements

At December 31, 2010, our future contractual commitments by fiscal year were as follows (in thousands):

	Total	Payments due by period				
		2011	2012	2013	2014	2015 and thereafter
Operating leases	\$10,045	\$ 5,291	\$2,910	\$690	\$654	\$500
Purchase commitments	7,320	7,320	—	—	—	—
Line of credit	10,000	10,000	—	—	—	—
Total future contractual commitments	<u>\$27,365</u>	<u>\$22,611</u>	<u>\$2,910</u>	<u>\$690</u>	<u>\$654</u>	<u>\$500</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. For operating leases that include contractual commitments for operating expenses and maintenance, estimates of such amounts are included based on current rates. Payments made under operating leases will be treated as rent expense for the facilities currently being utilized. Of the total \$10.0 million operating lease amount, \$2.7 million has been recorded as a liability on our balance sheet as of December 31, 2010.

Purchase Commitments

The purchase commitments shown above represent non-cancellable inventory purchase commitments as of December 31, 2010. 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

The line of credit obligation has been recorded as a liability on our balance sheet. The line of credit obligation amount shown above represents the scheduled principal repayment under our SVB Facility, but not the associated interest payments which may vary based on changes in market interest rates. At December 31, 2010, the interest rate under our SVB Facility was 6.5%.

As of December 31, 2010, we had \$10.0 million outstanding under the SVB Facility and an additional \$6.4 million committed as security for various letters of credit, as discussed in Note 7 to the consolidated financial statements.

Sale-leaseback of Oakland, California Campus

On September 28, 2010, we sold our Oakland, California campus, consisting of land and three buildings, to LBA Realty for approximately \$18.8 million. As part of the sale transaction, LBA Realty agreed to settle our secured real estate debt which was secured by the Oakland, California campus for a net sum of \$17.6 million.

In connection with the sale, we entered into a Multi-Tenant Commercial/Industrial Lease Agreement, or the Lease Agreement, to rent one of the buildings from LBA Realty for a five-year term, commencing from the closing of the sale. The initial annual rent under the Lease Agreement is approximately \$0.6 million, with periodic rent escalations at a rate of approximately 2% per annum. Under the Lease Agreement, in October 2010, we also received a non-refundable tenant improvement allowance of \$1.7 million for the required alterations to the property being leased back. The tenant improvement allowance amount will be amortized over the term of the lease as an offset to rent expense.

Recent Accounting Pronouncements

In September 2009, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements*. As summarized in ASU 2009-13, ASC Topic 605 has been amended (1) to provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and the consideration allocated; (2) to require an entity to allocate revenue in an arrangement using estimated selling prices of deliverables if a vendor does not have Vendor-Specific Objective Evidence (VSOE) or third-party evidence of selling price; and (3) to eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method. The accounting changes summarized in ASU 2009-13 are effective for fiscal years beginning on or after June 15, 2010, with early adoption permitted. Adoption may either be on a prospective basis or by retrospective application. We have assessed the impact of this amendment to the ASC on our accounting and reporting systems and processes; and do not anticipate the adoption to have a material impact on the consolidated financial statements.

In January 2010, FASB issued ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. The update requires new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements. We adopted the updated standard as of March 31, 2010. The adoption did not have any impact on the consolidated financial statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Cash, Cash Equivalents and Short-Term Investments

We consider all cash and highly liquid investments purchased with an original maturity of less than three months to be cash equivalents.

Cash, cash equivalents and short-term investments consisted of the following as of December 31, 2010 and 2009 (in thousands):

	<u>December 31, 2010</u>	<u>December 31, 2009</u>
Cash and cash equivalents	\$21,174	\$21,460
Short-term investment	<u>—</u>	<u>306</u>
	<u>\$21,174</u>	<u>\$21,766</u>

Concentration of Credit Risk

Financial instruments which potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, and accounts receivable. Cash and cash equivalents consist principally of demand deposit and money market accounts. Cash and cash equivalents are principally held with various domestic financial institutions with high credit standing. We perform ongoing credit evaluations of our customers and generally do not require collateral. Allowances are maintained for potential doubtful accounts. During the year ended December 31, 2010, Etisalat accounted for 24% of net revenue. The same customer accounted for 19% net revenue for the year ended December 31, 2009.

As of December 31, 2010, Etisalat receivables, which are denominated in United Arab Emirates Dirhams, a currency that tracks to the U.S. dollar, accounted for 30% of net accounts receivable. As of December 31, 2009, the same customer accounted for 66% of net accounts receivable.

As of December 31, 2010 and December 31, 2009, receivables from customers in countries other than the United States represented 74% and 82%, respectively, of net accounts receivable.

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to our outstanding debt. As of December 31, 2010, our outstanding debt balance was \$10.0 million, comprising borrowings under the SVB Facility. As of December 31, 2010, interest on borrowings under the SVB Facility accrued on the unpaid principal balance at a variable interest rate (which adjusted every six months) equal to the sum of the LIBOR rate plus 2.5% 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 debt remained constant over a year, a 2% increase in the interest rate would decrease pre-tax income and cash flow by approximately \$0.2 million. On March 14, 2011, we renewed the SVB Facility to provide liquidity and working capital through March 13, 2012 and amended the interest rate applicable to amounts borrowed under the SVB Facility, as discussed in Note 16 to the consolidated financial statements.

Foreign Currency 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 intercompany receivables and payables. Accordingly, our operating results are exposed to changes in exchange rates between the U.S. dollar and those currencies. During 2010 and 2009, we did not hedge any of our foreign currency exposure. During both 2010 and 2009, we recorded \$0.1 million of foreign exchange loss in other income (expense) on our statements of operations.

We have performed sensitivity analyses as of December 31, 2010 and 2009, using a modeling technique that measures the impact 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 \$0.2 million and \$0.1 million for 2010 and 2009, respectively. 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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

**ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

	<u>Page</u>
Report of Independent Registered Public Accounting Firm	46
Consolidated Balance Sheets	47
Consolidated Statements of Operations	48
Consolidated Statements of Stockholders' Equity and Comprehensive Income	49
Consolidated Statements of Cash Flows	51
Notes to Consolidated Financial Statements	52

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Zhong Technologies, Inc.:

We have audited the accompanying consolidated balance sheets of Zhong Technologies, Inc. and subsidiaries (“the Company”) as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders’ equity and cash flows for each of the years in the three-year period ended December 31, 2010. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Zhong Technologies, Inc. and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP

San Francisco, California
March 15, 2011

ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES

**Consolidated Balance Sheets
December 31, 2010 and 2009
(In thousands, except par value)**

	2010	2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 21,174	\$ 21,460
Short-term investments	—	306
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$2,433 in 2010 and \$5,042 in 2009	29,747	37,107
Inventories	31,048	30,228
Prepaid expenses and other current assets	2,514	2,098
Total current assets	84,483	91,199
Property and equipment, net	5,274	18,961
Restricted cash	58	58
Other assets	296	41
Total assets	\$ 90,111	\$ 110,259
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 11,864	\$ 14,914
Line of credit	10,000	10,000
Current portion of long-term debt	—	411
Accrued and other liabilities	13,217	12,031
Total current liabilities	35,081	37,356
Long-term debt, less current portion	—	18,285
Other long-term liabilities	5,615	2,945
Total liabilities	40,696	58,586
Stockholders' equity:		
Common stock, \$0.001 par value. Authorized 180,000 shares; issued and outstanding 30,555 and 30,272 shares as of December 31, 2010 and 2009, respectively	30	30
Additional paid-in capital	1,069,513	1,066,974
Other comprehensive income	277	293
Accumulated deficit	(1,020,405)	(1,015,624)
Total stockholders' equity	49,415	51,673
Total liabilities and stockholders' equity	\$ 90,111	\$ 110,259

See accompanying notes to consolidated financial statements.

ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES

Consolidated Statements of Operations
Years ended December 31, 2010, 2009 and 2008
(In thousands, except per share data)

	2010	2009	2008
Net revenue	\$129,036	\$126,501	\$146,160
Cost of revenue (1)	79,864	81,106	101,096
Gross profit	49,172	45,395	45,064
Operating expenses:			
Research and product development (1)	21,188	22,113	27,063
Sales and marketing (1)	23,982	22,042	28,269
General and administrative (1)	9,855	9,933	15,609
Gain on sale of fixed assets	(1,959)	—	(455)
Gain on sale of intangible assets	—	—	(4,397)
Impairment of goodwill	—	—	70,401
Total operating expenses	53,066	54,088	136,490
Operating loss	(3,894)	(8,693)	(91,426)
Interest expense	(996)	(1,331)	(1,625)
Interest income	7	47	708
Other income	1	121	78
Loss before income taxes	(4,882)	(9,856)	(92,265)
Income tax (benefit)/provision	(101)	171	270
Net loss	\$ (4,781)	\$ (10,027)	\$ (92,535)
Basic and diluted net loss per share	\$ (0.16)	\$ (0.33)	\$ (3.08)
Weighted average shares outstanding used to compute basic and diluted net loss per share	30,393	30,200	30,068
(1) Amounts include stock-based compensation cost as follows:			
Cost of revenue	94	104	158
Research and product development	362	414	479
Sales and marketing	421	484	511
General and administrative	1,388	1,258	1,203

See accompanying notes to consolidated financial statements.

ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity and Comprehensive Income
Years ended December 31, 2010, 2009 and 2008 (In thousands)

	Common stock		Additional paid-in capital	Other comprehensive income	Accumulated deficit	Total stockholders' equity
	Shares	Amount				
Balances as of December 31, 2007	30,005	\$ 30	\$1,061,969	\$ 610	\$ (913,062)	\$149,547
Exercise of stock options for cash	6	—	6	—	—	6
Issuance of common stock in connection with employee stock purchase plan	111	—	288	—	—	288
Issuance of common stock for director services	15	—	81	—	—	81
Stock-based compensation	—	—	2,270	—	—	2,270
Comprehensive loss:						
Net loss	—	—	—	—	(92,535)	(92,535)
Foreign currency translation adjustment	—	—	—	(355)	—	(355)
Unrealized loss on available for sale securities	—	—	—	(5)	—	(5)
Total comprehensive loss	—	—	—	—	—	(92,895)
Balances as of December 31, 2008	30,137	30	1,064,614	250	(1,005,597)	59,297
Exercise of stock options for cash	20	—	13	—	—	13
Issuance of common stock in connection with employee stock purchase plan	83	—	87	—	—	87
Issuance of common stock for services	32	—	66	—	—	66
Stock-based compensation	—	—	2,194	—	—	2,194
Comprehensive loss:						
Net loss	—	—	—	—	(10,027)	(10,027)
Foreign currency translation adjustment	—	—	—	48	—	48
Unrealized loss on available for sale securities	—	—	—	(5)	—	(5)
Total comprehensive loss	—	—	—	—	—	(9,984)

49

See accompanying notes to consolidated financial statements.

	Common stock		Additional paid-in capital	Other comprehensive income	Accumulated deficit	Total stockholders' equity
	Shares	Amount				
Balances as of December 31, 2009	30,272	30	1,066,974	293	(1,015,624)	51,673
Exercise of stock options for cash	104	—	75	—	—	75
Issuance of common stock in connection with employee stock purchase plan	151	—	199	—	—	199
Issuance of common stock for director services	28	—	69	—	—	69
Stock-based compensation	—	—	2,196	—	—	2,196
Comprehensive loss:						
Net loss	—	—	—	—	(4,781)	(4,781)
Foreign currency translation adjustment	—	—	—	(16)	—	(16)
Unrealized loss on available for sale securities	—	—	—	—	—	—
Total comprehensive loss						(4,797)
Balances as of December 31, 2010	<u>30,555</u>	<u>\$ 30</u>	<u>\$1,069,513</u>	<u>\$277</u>	<u>\$(1,020,405)</u>	<u>\$49,415</u>

See accompanying notes to consolidated financial statements.

ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows
Years ended December 31, 2010, 2009 and 2008
(In thousands)

	2010	2009	2008
Cash flows from operating activities:			
Net loss	\$(4,781)	\$(10,027)	\$(92,535)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	1,585	1,834	2,204
Stock-based compensation	2,265	2,260	2,351
Impairment of goodwill	—	—	70,401
Gain on sale of intangible assets	—	—	(4,397)
Gain on sale of fixed assets	(1,959)	—	(455)
Loss on disposal of fixed assets	—	2	—
(Accretion) or impairment of investments	—	44	(169)
Provision for sales returns and doubtful accounts	761	1,780	3,143
Changes in operating assets and liabilities:			
Accounts receivable	6,599	(15,222)	6,450
Inventories	(820)	10,478	3,992
Prepaid expenses and other current assets	(333)	556	1,150
Other assets	(155)	14	21
Accounts payable	(3,050)	2,195	(8,557)
Accrued and other liabilities	1,944	(2,379)	(823)
Net cash provided by (used in) operating activities	<u>2,056</u>	<u>(8,465)</u>	<u>(17,224)</u>
Cash flows from investing activities:			
Proceeds from sale of intangible assets	—	—	4,397
Proceeds from sale of assets	573	—	502
Purchases of property and equipment	(3,169)	(794)	(1,436)
Purchases of short-term investments	—	(308)	(10,879)
Proceeds from maturity of short-term investments	306	2,945	20,412
Changes in restricted cash	—	65	63
Net cash (used in) provided by investing activities	<u>(2,290)</u>	<u>1,908</u>	<u>13,059</u>
Cash flows from financing activities:			
Proceeds from issuance of common stock and warrants	274	100	294
Repayment under credit facilities	—	(5,000)	—
Repayment of debt	(310)	(382)	(327)
Net cash used in financing activities	<u>(36)</u>	<u>(5,282)</u>	<u>(33)</u>
Effect of exchange rate changes on cash	<u>(16)</u>	<u>48</u>	<u>(355)</u>
Net decrease in cash and cash equivalents	<u>(286)</u>	<u>(11,791)</u>	<u>(4,553)</u>
Cash and cash equivalents at beginning of year	<u>21,460</u>	<u>33,251</u>	<u>37,804</u>
Cash and cash equivalents at end of year	<u>\$21,174</u>	<u>\$ 21,460</u>	<u>\$ 33,251</u>
Supplemental disclosures of cash flow information:			
Cash paid during period for:			
Taxes	\$ 75	\$ 171	\$ 371
Interest	1,101	1,339	1,639
Non-cash investing and financing activities:			
Sale of Oakland, California campus and extinguishment of related debt (Refer to Note 5)			

See accompanying notes to consolidated financial statements.

ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES

Notes to 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 network equipment for telecommunications, wireless and cable operators worldwide. 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 consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation.

(c) Reverse Stock Split

On March 11, 2010, the Company effected a one-for-five reverse stock split. All share and per share information included in the Company’s consolidated financial statements and accompanying notes presented herein reflect the retroactive effect of the one-for-five reverse stock split, as discussed in Note 8.

(d) 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 2009 and 2010. As of December 31, 2010, the Company had approximately \$21.2 million in cash and cash equivalents and \$10.0 million of current debt outstanding under its revolving line of credit and letter of credit facility (the “SVB Facility”). The Company renewed and amended the SVB Facility on March 14, 2011 to provide liquidity and working capital through March 13, 2012, as discussed in Note 16. Continued uncertainty regarding financial institutions’ ability and inclination to lend may negatively impact the Company’s ability to refinance its existing indebtedness on favorable terms, or at all.

The global unfavorable economic and market conditions 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 continue to improve or if they deteriorate, the Company may experience material adverse impacts on its business, operating results and financial condition.

During 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, which included headcount reductions. During 2010, the Company continued to focus on cost control and operating

efficiency along with restrictions on discretionary spending. The most significant cost-cutting measure during this period was the sale in September 2010 of the Company's land and buildings located in Oakland, California and extinguishment of related debt in a sale and leaseback transaction with LBA Realty, LLC ("LBA Realty"). The sale and leaseback transaction will allow the Company to reduce occupancy costs going forward and improved the current financial position by eliminating the related debt which was due in April 2011.

The Company expects that operating losses and negative cash flows from operations may 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 be required to sell assets, issue debt or equity securities or borrow on unfavorable terms. Continued uncertainty regarding financial institutions' ability and inclination to lend 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. The Company may be unable to sell assets, issue securities or access additional indebtedness to meet these needs on favorable terms, or at all. 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.

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 available credit facilities will be sufficient to satisfy its anticipated cash requirements for the foreseeable future.

(e) Use of Estimates

The preparation of the 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.

(f) Revenue Recognition

The Company recognizes revenue when the earnings process is complete. The Company recognizes 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 or if the fees are not fixed or determinable. When significant post-delivery obligations exist, revenue is deferred until such obligations are fulfilled. The Company's arrangements generally do not have any significant post-delivery obligations. If the Company's arrangements include customer acceptance provisions, revenue is recognized upon obtaining the signed acceptance certificate from the customer, unless the Company 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, the Company uses 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. The Company also considers 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. The Company offers products and services such as support, education and training, hardware upgrades and post-warranty support. For multiple element revenue arrangements, the Company establishes 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. The Company makes 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. The Company recognizes 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, the Company uses historical rates of return from the distributors to provide for estimated product returns. The Company accrues for warranty costs, sales returns and other allowances at the time of shipment based on historical experience and expected future costs.

(g) Allowances for Sales Returns and Doubtful Accounts

The Company records 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 accounts receivable. The Company bases its 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, the Company's future revenue could be adversely affected.

The Company records an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make payments for amounts owed to the Company. The allowance for doubtful accounts is recorded as a charge to general and administrative expenses. The Company bases its allowance on periodic assessments of its customers' liquidity and financial condition through analysis of information obtained from credit rating agencies, financial statement review and historical collection trends. Additional allowances may be required in the future if the liquidity or financial conditions of its customers deteriorate, resulting in impairment in their ability to make payments.

Activity under the Company's allowance for sales returns and doubtful accounts was comprised as follows (in thousands):

	Year ended December 31,		
	2010	2009	2008
Balance at beginning of year	\$ 5,042	\$ 5,155	\$ 5,941
Charged to revenue	616	1,800	2,356
Charged to (reversal of) expense	144	(20)	787
Utilization	<u>(3,369)</u>	<u>(1,893)</u>	<u>(3,929)</u>
Balance at end of year	<u>\$ 2,433</u>	<u>\$ 5,042</u>	<u>\$ 5,155</u>

The allowance for doubtful accounts was \$1.7 million and \$3.8 million as of December 31, 2010 and 2009, respectively.

(h) 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, the Company is 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 the Company experiences a higher incidence of inventory obsolescence due to rapidly changing technology and customer requirements, the Company may incur significant charges for excess inventory.

(i) Operating Lease Liabilities

As a result of the acquisition of Paradyne Networks, Inc. (“Paradyne”) in September 2005, the Company assumed certain lease liabilities for facilities in Largo, Florida. The Company has 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 the Company employs different assumptions in future periods, the future 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.

(j) Foreign Currency Translation

For operations outside the United States, the Company translates assets and liabilities of foreign subsidiaries, whose functional currency is the local currency, at end of period exchange rates. Revenues and expenses are translated at monthly average rates of exchange prevailing during the year. The adjustment resulting from translating the financial statements of such foreign subsidiaries, is included in accumulated other comprehensive income (loss), which is reflected as a separate component of stockholders’ equity. Realized gains and losses on foreign currency transactions are included in other income (expense) in the accompanying consolidated statement of operations. During 2010, 2009 and 2008, the Company recorded a \$0.1 million realized foreign exchange loss for each period in other income (expense) on its statements of operations.

(k) Cash and Cash Equivalents, and Short-Term Investments

The Company considers all cash and highly liquid investments purchased with an original maturity of less than three months to be cash equivalents.

Short-term investments include securities with original maturities greater than three months and less than one year and are available for use in current operations or other activities. Short-term investments consist principally of commercial paper, corporate debentures and bonds. Short-term investments have been classified as available for sale. Under this classification, the investments are reported at fair value, with unrealized gains and losses excluded from results of operations and reported, net of tax, as a component of other comprehensive loss in stockholders’ equity. Realized gains and losses and declines in value judged to be other than temporary are included in results of operations. Gains and losses from the sale of securities are based on the specific-identification method.

Cash, cash equivalents, and short-term investments as of December 31, 2010 and December 31, 2009 consisted of the following (in thousands):

	<u>December 31, 2010</u>	<u>December 31, 2009</u>
Cash and Cash Equivalents:		
Cash	\$16,957	\$19,050
Money Market Funds	<u>4,217</u>	<u>2,410</u>
	<u>\$21,174</u>	<u>\$21,460</u>
Short-term investments:		
Corporate Securities	<u>—</u>	<u>306</u>
	<u>\$ —</u>	<u>\$ 306</u>

As of December 31, 2010 and December 31, 2009, the fair value equaled cost of the cash and cash equivalents and short-term investments.

(l) 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 December 31, 2010 and 2009 due to the relatively short maturities of these instruments. The carrying value of the Company’s debt obligations at December 31, 2010 and 2009 approximate their fair value.

(m) Concentration of Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. Cash and cash equivalents consist principally of demand deposit and money market accounts. Cash and cash equivalents are principally held with various domestic financial institutions with high credit standing. The Company performs ongoing credit evaluations of its customers and generally does not require collateral. Allowances are maintained for potential doubtful accounts. During the year ended December 31, 2010, Emirates Telecommunications Corporation (“Etisalat”) accounted for 24% of net revenue. For the year ended December 31, 2009, the same customer accounted for 19% of net revenue.

The target customers for the Company’s products are network service providers that operate voice, data and video communications networks. There are a limited number of potential customers in this target market. The Company expects that a significant portion of the Company’s future revenue will depend on sales of its products to a limited number of customers. Any failure of one or more customers to purchase products from the Company for any reason, including any downturn in their businesses, would seriously harm the Company’s business, financial condition and results of operations.

Etisalat accounted for 30% and 66% of net accounts receivable as of December 31, 2010 and December 31, 2009, respectively. Etisalat receivables are denominated in United Arab Emirates Dirhams, a currency that tracks to the U.S. dollar.

As of December 31, 2010 and December 31, 2009, receivables from customers in countries other than the United States represented 74% and 82%, respectively, of net accounts receivable.

From time to time, the Company may provide or commit to extend credit or credit support to its customers. This financing may include extending the terms for product payments to customers. Depending upon market conditions, the Company may seek to factor these arrangements to financial institutions and investors to reduce the amount of its financial commitments associated with such arrangements. For example, during the year ended December 31, 2008, the Company sold \$10.2 million of customer trade

receivables to SVB on a non-recourse basis in exchange for cash. The sale of receivables did not represent a securitization, and there was no continuing involvement or interests in the receivables by the Company after the sale. As of December 31, 2010, the Company did not have any significant customer financing commitments or guarantees.

The Company's products are concentrated in the communications equipment market, which is highly competitive and subject to rapid change. Significant technological changes in the industry could adversely affect operating results. The Company's inventories include components that may be specialized in nature, and subject to rapid technological obsolescence. The Company actively manages inventory levels, and the Company considers technological obsolescence and potential changes in product demand based on macroeconomic conditions when estimating required allowances to reduce recorded inventory amounts to market value. Such estimates could change in the future.

The Company's growth and ability to meet customer demands are also dependent on its ability to obtain timely deliveries of components from suppliers and contract manufacturers. The Company depends on contract manufacturers and sole or limited source suppliers for several key components. If the Company were unable to obtain these components on a timely basis, the Company would be unable to meet its customers' product delivery requirements which could adversely impact operating results. While the Company is not solely dependent on one contract manufacturer, it expects to continue to rely on contract manufacturers to fulfill a portion of its product manufacturing requirements.

(n) Property and Equipment

Property and equipment are stated at cost and depreciated using the straight-line method over their estimated useful lives. Useful life for buildings is 30 years. Useful lives for laboratory and manufacturing equipment range from 10 to 30 years. Useful lives of all other property and equipment range from 3 to 5 years. Leasehold improvements are generally amortized over the shorter of their useful lives or the remaining lease term.

(o) Goodwill

Costs in excess of the fair value of tangible and identifiable intangible assets acquired and liabilities assumed in a purchase business combination are recorded as goodwill. The Company tests for goodwill impairment at least annually using a two-step approach. The Company evaluates goodwill on an annual basis in November, at a minimum, and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The Company has determined that it operates in a single segment with one operating unit. The Company performs the annual goodwill impairment test using the market approach. If the carrying amount of the reporting unit exceeds its fair value, indication of goodwill impairment exists and a second step is performed to measure the amount of impairment loss, if any. During the year ended December 31, 2008, the Company recorded non-cash goodwill impairment charges of \$70.4 million. As a result, the goodwill was fully impaired as of December 31, 2008, as discussed in Note 3.

(p) Purchased Intangibles and Other Long-Lived Assets

The Company reviews 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 fully 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. Any assets to be disposed of would be

separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and would no longer be depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet.

(q) Accounting for Stock-Based Compensation

The Company has adopted the Black Scholes model to estimate the fair value of options. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's consolidated statement of operations.

Awards of stock options granted to consultants under the Company's share-based compensation plans are accounted for at fair value determined by using the Black Scholes option pricing. These options are generally immediately exercisable and expire seven to ten years from the date of grant. The Company values non-employee options using the Black Scholes model. Non-employee options subject to vesting are valued as they become vested.

The Company attributes the values of the stock-based compensation to expense using the straight line method.

(r) Income Taxes

The Company uses the asset and liability method to account for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting and the income tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. The Company has recorded a full valuation allowance against its net deferred tax assets at December 31, 2010 and 2009 due to the significant uncertainty regarding whether the deferred tax assets will be realized.

(s) Net Loss per Common Share

Basic net loss per share is computed by dividing the net loss applicable to holders of common stock for the period by the weighted average number of shares of common stock outstanding during the period. The calculation of diluted net loss per share gives effect to common stock equivalents; however, potential common equivalent shares are excluded if their effect is antidilutive. Potential common equivalent shares are composed of common stock subject to repurchase rights and incremental shares of common equivalent shares issuable upon the exercise of stock options and warrants, and the conversion of convertible debt.

(t) Other Comprehensive Income (Loss)

Other comprehensive income (loss) is recorded directly to stockholders' equity and includes unrealized gains and losses which have been excluded from the consolidated statements of operations. These unrealized gains and losses consist of foreign currency translation adjustments and unrealized gains and losses on available-for-sale securities.

(u) Recent Accounting Pronouncements

In September 2009, the Financial Accounting Standards Board ("FASB") issued an Accounting Standards Update ("ASU") 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements*. As summarized in ASU 2009-13, ASC Topic 605 has been amended (1) to provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and the consideration allocated; (2) to require an entity to allocate revenue in an arrangement

using estimated selling prices of deliverables if a vendor does not have Vendor-Specific Objective Evidence (“VSOE”) or third-party evidence of selling price; and (3) to eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method. The accounting changes summarized in ASU 2009-13 are effective for fiscal years beginning on or after June 15, 2010, with early adoption permitted. Adoption may either be on a prospective basis or by retrospective application. The Company has assessed the impact of this amendment to the ASC on its accounting and reporting systems and processes and does not anticipate the adoption to have a material impact on the consolidated financial statements.

In January 2010, FASB issued ASU 2010-06, *Fair Value Measurements and Disclosures* (Topic 820): *Improving Disclosures about Fair Value Measurements*. The update requires new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements. The Company adopted the updated standard as of March 31, 2010. The adoption did not have any impact on the Company’s consolidated financial statements.

(2) Operating Lease Liabilities

As a result of the acquisition of Paradyne in September 2005, the Company assumed certain lease liabilities for facilities in Largo, Florida. The Company has 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 \$6.5 million as of December 31, 2010, of which \$2.7 million was accrued for excess facilities, net of contractual and estimated sublease income. 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 2009, the Company assumed that it would no longer be able to sublease the remaining excess space due to the continued deterioration in the real estate market. Accordingly, during 2009, the Company increased its excess lease liability balance by \$0.6 million, 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):

	<u>Exit costs</u>
Balance at December 31, 2009	\$ 4,418
Cash payments, net	<u>(1,691)</u>
Balance at December 31, 2010	<u>\$ 2,727</u>

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

	<u>Exit costs</u>
Future lease payments for excess space	\$3,492
Less: contractual sublease income	<u>(765)</u>
Balance at December 31, 2010	<u>\$2,727</u>

The current portion of the excess lease liability as of December 31, 2010 of \$1.8 million is classified in “Accrued and other liabilities” and the long-term portion of \$0.9 million is classified in “Other long-term liabilities” in the accompanying consolidated balance sheet.

(3) Long-lived Assets, Goodwill and Other Acquisition-Related Intangible Assets

Impairment

The Company tests goodwill for impairment using a two step approach on an annual basis in November, or when certain indicators of impairment exist. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit using the market approach. The Company has determined that it operates in a single segment with one reporting unit. If the carrying amount of the reporting unit exceeds its fair value, a second step is performed to measure the amount of impairment loss, if any. In 2008, the Company determined that the reporting unit's carrying value exceeded its fair value and the second step was performed, resulting in a goodwill impairment loss of \$70.4 million. The Company has not incurred any additional goodwill since the 2008 impairment.

The Company reviews 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. The amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired asset.

The Company estimates the fair value of its long-lived assets based on a combination of the market, income and replacement cost approaches. In the application of the impairment testing, the Company is 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. As of December 31, 2010, the Company's long-lived assets consisted of \$5.3 million of net property and equipment.

Sale of Intangible Assets

During 2008, the Company sold some of its non-strategic patents for \$1.1 million. The resulting \$1.1 million gain was recorded within operating expenses as gain on sale of intangible assets. There were no similar sales of intangible assets during 2009 or 2010.

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. In 2008 and 2009, the Company received additional contingent consideration of \$1.1 million and \$0.4 million, respectively, related to the buyer's usage of inventory related to the GigaMux legacy product line. The Company received no additional contingent consideration in 2010 related to the GigaMux legacy product line.

(4) Fair Value Measurement

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.

The Company utilizes 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 tables represent the Company's financial assets and liabilities at fair value on a recurring basis as of December 31, 2010 and December 2009, respectively, and the basis for that measurement:

Fair value measurements as of December 31, 2010 (In thousands)

	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)	\$4,217	\$4,217	\$—	\$—
Total	<u>\$4,217</u>	<u>\$4,217</u>	<u>\$—</u>	<u>\$—</u>

Fair value measurements as of December 31, 2009 (In thousands)

	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)	\$2,410	\$2,410	\$—	\$—
Corporate securities (2)	\$ 306	\$ —	\$306	\$—
Total	<u>\$2,716</u>	<u>\$2,410</u>	<u>\$306</u>	<u>\$—</u>

(1) Included in cash and cash equivalents on the Company's consolidated balance sheet.

(2) Included in short-term investments on the Company's consolidated balance sheet.

Effective January 1, 2009, the Company adopted fair value measurements 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 fair value measurement for non-financial assets and liabilities did not materially impact the Company's consolidated financial statements for the years ended December 31, 2009 or December 31, 2010, 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.

(5) Sale-leaseback of Oakland, California Campus

On September 28, 2010, the Company sold its Oakland, California campus, consisting of land and three buildings, to LBA Realty for approximately \$18.8 million. As part of the sale transaction, LBA Realty agreed to settle the Company's secured real estate debt which was secured by the Oakland, California campus for a net sum of \$17.6 million pursuant to a Discount Payoff Agreement as discussed in Note 7. The net cash proceeds from the sale of Oakland, California campus and extinguishment of related debt was \$0.6 million after offsetting the gross selling price of \$18.8 million with the closing costs of \$0.2 million, extinguishment of related debt of \$17.6 million and other miscellaneous payments of \$0.4 million. As the sale transaction and the extinguishment of debt occurred simultaneously with the same party, the gain on the extinguishment of \$0.8 million has been accounted for as sale proceeds in the sale and leaseback transaction.

In connection with the sale, the Company entered into a Multi-Tenant Commercial/Industrial Lease Agreement (the "Lease Agreement") to rent one of the buildings from LBA Realty for a five-year term, commencing from the closing of the sale. The initial annual rent under the Lease Agreement is approximately \$0.6 million, with periodic rent escalations at a rate of approximately 2% per annum. Under the Lease Agreement, in October 2010, the Company received a non-refundable tenant improvement allowance of \$1.7 million for the required alterations to the property being leased back. The tenant improvement allowance amount is being amortized over the term of the lease as an offset to rent expense.

The sale of the Oakland, California campus, consisting of land and three buildings, qualified as a 'sale' as that term is defined in Accounting Standards Codification ("ASC") 360-20, Real Estate Sales. Additionally, the subsequent leaseback of one of the buildings qualified as a normal leaseback as defined in ASU 840-40, Sale-Leaseback Transactions. The Company recognized a net gain in the condensed consolidated statement of operations for the year ended 2010 of \$2.0 million, which represents the estimated fair value in excess of the book value of the buildings sold but not leased back. The remaining gain of \$2.2 million, representing the estimated fair value in excess of the book value of the building sold and leased back, was deferred in a long-term liability account to be amortized as a reduction in rent expense over the term of the lease.

For the purposes of accounting for the sale and leaseback transaction, the estimated fair value of the buildings on an individual basis was determined by the Company based on the compilation and review of third-party evidence of the current market prices for sales of similar buildings in the geographic area where the Company's campus is situated.

(6) Balance Sheet Detail

Balance sheet detail as of December 31, 2010 and 2009 is as follows (in thousands):

	<u>2010</u>	<u>2009</u>
Inventories:		
Raw materials	\$20,539	\$ 20,898
Work in process	2,751	3,071
Finished goods	<u>7,758</u>	<u>6,259</u>
	<u>\$31,048</u>	<u>\$ 30,228</u>
Property and equipment, net:		
Land	\$ —	\$ 4,821
Buildings	—	14,007
Machinery and equipment	8,406	9,420
Computers and acquired software	3,573	3,795
Furniture and fixtures	416	313
Leasehold improvements	<u>2,006</u>	<u>376</u>
	14,401	32,732
Less accumulated depreciation and amortization	<u>(9,127)</u>	<u>(13,771)</u>
	<u>\$ 5,274</u>	<u>\$ 18,961</u>

Depreciation and amortization expense associated with property and equipment amounted to \$1.6 million, \$1.8 million and \$2.2 million for the years ended December 31, 2010, 2009 and 2008, respectively.

	<u>2010</u>	<u>2009</u>
Accrued and other liabilities (in thousands):		
Accrued warranty	\$ 1,683	\$ 1,662
Accrued compensation	2,583	2,700
Accrued exit costs	1,818	1,785
Deferred revenue	1,045	624
Other	<u>6,088</u>	<u>5,260</u>
	<u>\$13,217</u>	<u>\$12,031</u>

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 summarizes the activity related to the product warranty liability during the years ended December 31, 2010 and 2009 (in thousands):

Balance at December 31, 2008	\$ 1,979
Charged to operations	1,537
Claims/settlements	<u>(1,854)</u>
Balance at December 31, 2009	\$ 1,662
Charged to operations	1,593
Claims/settlements	<u>(1,572)</u>
Balance at December 31, 2010	<u>\$ 1,683</u>

(7) Debt

Secured Real Estate Loan

In September 2010, the Company extinguished its existing secured real estate loan secured by the Oakland, California campus for \$17.6 million as part of the sale-leaseback transaction as discussed in Note 5. The total amount outstanding under the secured real estate loan was \$18.4 million at the extinguishment date, with a maturity date of April 1, 2011. The interest rate on the secured real estate loan was 6.5% per annum. As the sale transaction and the extinguishment of debt occurred simultaneously with the same party, the gain on the extinguishment of \$0.8 million has been accounted for as sale proceeds in the sale and leaseback transaction as discussed in Note 5. As a result of the sale-leaseback transaction the secured real estate loan balance was of zero and \$18.3 million as of December 31, 2010 and December 31, 2009, respectively.

Credit Facility

In March 2010, the Company renewed its SVB Facility with Silicon Valley Bank (“SVB”) to provide liquidity and working capital through March 15, 2011.

Under the SVB Facility, the Company has the option of borrowing funds at agreed upon interest rates. The amount that the Company is able to borrow under the SVB Facility varies based on the eligible accounts receivable, as defined in the agreement, as long as the principal amount outstanding does not exceed \$25.0 million. In addition, under the SVB Facility, the Company is able to utilize the facility as security for letters of credit.

Under the SVB Facility, \$10.0 million was outstanding at December 31, 2010. In addition, \$6.4 million was committed as security for various letters of credit and \$7.7 million was unused and available for borrowing as of December 31, 2010. As of December 31, 2010, the amounts borrowed under the SVB Facility bore interest, payable monthly, at a floating rate that was SVB’s prime rate plus 2.5%, with a minimum interest rate of 6.5%. The interest rate was 6.5% at December 31, 2010.

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 December 31, 2010, the Company was not in compliance with the financial covenant regarding minimum EBITDA under the SVB Facility. On January 19, 2011, the Company entered into an amendment with SVB in which SVB agreed to waive the Company’s obligation to comply with the financial covenant regarding minimum EBITDA for the compliance period ending December 31, 2010.

On March 14, 2011, the Company renewed its SVB Facility with SVB to provide liquidity and working capital through March 13, 2012 and amended the interest rate applicable to amounts borrowed under the SVB Facility, as discussed in Note 16.

(8) Stockholders’ Equity

(a) Overview

As of December 31, 2010 and 2009, the Company’s equity capitalization consisted of 180 million authorized shares of common stock, of which 30.6 million and 30.3 million shares, respectively, were outstanding.

On March 11, 2010, the Company filed a Certificate of Amendment with the Delaware Secretary of State to amend the Company’s Certificate of Incorporation, which amendment effected a one-for-five reverse stock split

of Zhone common stock and reduced the authorized shares of Zhone common stock from 900,000,000 to 180,000,000. No fractional shares of common stock were issued as a result of the reverse stock split and shareholders of record received cash in lieu of the fractional shares to which they would otherwise have been entitled, based on the closing price of Zhone common stock on March 10, 2010. All stock options were modified for the one-for-five reverse split by decreasing the number of shares and increasing the exercise price per share on a one-for-five basis. This modification did not result in any additional stock compensation expense in the current period or future periods. References to shares of Zhone common stock, warrants and stock options (and associated dollar amounts) in this Form 10-K for the year ended December 31, 2010 are provided on a post-reverse stock split basis.

(b) Warrants

At December 31, 2010, the Company had a total of 7,238 warrants to purchase common stock outstanding at a weighted average exercise price of \$116.55 per share. Warrants to purchase 270,523 shares of common stock expired unexercised in 2009, with an aggregate exercise price of \$5.6 million. The remaining outstanding warrants will expire in the years 2013 and 2014. No warrants were exercised in 2010, 2009 or 2008.

(c) Stock-Based Compensation

As of December 31, 2010, the Company had two types of share-based compensation plans related to stock options and employee stock purchases. The compensation cost that has been charged as an expense in the statement of operations for those plans was \$2.3 million, \$2.3 million and \$2.4 million for the years ended December 31, 2010, 2009 and 2008, respectively.

The following table summarizes stock-based compensation expense for the years ended December 31, 2010, 2009 and 2008 (in thousands):

	<u>Year ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Compensation expense relating to employee stock options	\$2,098	\$2,142	\$2,140
Compensation expense relating to non-employees	69	69	81
Compensation expense relating to Employee Stock Purchase Plan	98	49	130
Stock-based compensation expense	<u>\$2,265</u>	<u>\$2,260</u>	<u>\$2,351</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. Options may be granted at an exercise price less than, equal to or greater than the fair market value on the date of grant, except that any options granted to a 10% stockholder must have an exercise price equal to at least 110% of the fair market value of the Company’s common stock on the date of grant. The Board of Directors determines the term of each option, the option exercise price and the vesting terms. Stock options are generally granted at an exercise price equal to the fair market value on the date of grant, expiring seven to ten years from the date of grant and vesting over a period of four years. On January 1 of each year, if the number of shares available for grant under the Amended and Restated 2001 Stock Incentive Plan is less than 5% of the total number of shares of common stock outstanding as of that date, the shares available for grant under the plan are automatically increased by the amount necessary to make the total number of shares available for grant equal to 5% of the total

number of shares of common stock outstanding, or by a lesser amount as determined by the Board of Directors. As of December 31, 2010, 0.2 million shares were available for grant under these plans.

The Company has estimated the fair value of stock-based payment awards on the date of grant using the Black Scholes pricing model, which is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include the Company's 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 estimated expected term of options granted was determined based on historical option exercise trends. Estimated volatility was based on historical volatility and the risk free interest rate was based on U.S. Treasury yield in effect at the time of grant for the expected life of the options. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore used an expected dividend yield of zero in the option valuation model. The Company is also required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. Historical data was used to estimate pre-vesting forfeitures and record stock-based compensation expense only for those awards that are expected to vest.

The assumptions used to value option grants for the years ended December 31, 2010, 2009 and 2008 are as follows:

	Year ended December 31,		
	2010	2009	2008
Expected term	4.7 years	4.7 years	4.7 years
Expected volatility	94%	92%	75%
Risk free interest rate	1.54%	2.36%	1.86%

The weighted average grant date fair value of options granted during the years ended December 31, 2010, 2009 and 2008 was \$1.07, \$1.80 and \$0.45 per share, respectively. The intrinsic value of options exercised for the years ended December 31, 2010, 2009 and 2008 was \$0.02 million, \$0.03 million and \$0.02 million, respectively. For the years ended December 31, 2010, 2009 and 2008, the Company received \$0.01 million, \$0.01 million and \$0.01 million in proceeds from stock option exercises, respectively.

The following table sets forth the summary of option activity under the stock option program for the year ended December 31, 2010 (in thousands, except per share data):

	<u>Options Outstanding</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value</u>
Outstanding as of December 31, 2009 . . .	4,432	\$4.05	5.65	\$4,606
Granted	889	\$1.49		
Canceled/Forfeited	(115)	\$8.83		
Exercised	(104)	\$0.71		
Outstanding as of December 31, 2010 . . .	<u>5,102</u>	\$3.54	5.01	\$7,415
Vested and expected to vest at				
December 31, 2010	<u>4,378</u>	\$3.89	4.90	\$6,524
Vested and exercisable at December 31,				
2010	<u>2,999</u>	\$5.01	4.54	\$4,823

The aggregate intrinsic value represents the total pretax intrinsic value, based on the Company's closing stock price as of December 31, 2010 of \$2.67, which would have been received by the option holders had the option holders exercised their options as of that date.

As of December 31, 2010, there was \$1.8 million of unrecognized compensation costs, adjusted for estimated forfeitures related to unvested stock-based payments granted which are expected to be recognized over a weighted average period of 1.9 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 \$1.75 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 2.9 million shares of common stock were exchanged. The new stock options issued pursuant to the Exchange Offer have an exercise price of \$0.50, 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.

On March 31, 2010, the Company’s board of directors approved the acceleration of vesting of all unvested options to purchase shares of Zhone common stock issued in connection with the Exchange Offer that were held by members of the Company’s senior management. The acceleration was effective as of March 31, 2010. Options to purchase an aggregate of approximately 0.9 million shares of Zhone common stock were subject to the acceleration and resulted in a compensation charge of \$0.9 million which was fully expensed on March 31, 2010. The acceleration of these options was undertaken in recognition of the achievement of certain performance objectives by the Company’s senior management.

Employee Stock Purchase Plan

The Company’s 2002 Employee Stock Purchase Plan (“ESPP”) allows eligible employee participants to purchase shares of the Company’s common stock at a price equal to 85% of the lower of the fair market value of the common stock at the beginning or the end of each offering period. Participation is limited to 10% of an employee’s eligible compensation, not to exceed amounts allowed by the Internal Revenue Code. During the second quarter of 2006, the number of available shares under the ESPP was increased by 0.4 million. At September 1, 2005, the Company changed from a six month offering period to a three month offering period under the ESPP. The following table summarizes shares purchased, weighted average purchase price, cash received and the aggregate intrinsic value for ESPP purchases during the years ended December 31, 2010, 2009 and 2008 (in thousands, except per share data):

	<u>Year ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Shares purchased	151	83	111
Weighted average purchase price	\$1.31	\$1.05	\$2.60
Cash received	\$ 199	\$ 87	\$ 288
Aggregate intrinsic value	\$ 38	\$ 66	\$ 50

The assumptions used to value stock purchases under the Company’s ESPP for the years ended December 31, 2010, 2009 and 2008 are as follows:

	<u>Year ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Expected term	3 months	3 months	3 months
Volatility	83%	145%	68%
Risk free interest rate	0.1%	0.2%	2.0%
Weighted average fair value per share	\$0.68	\$0.50	\$1.20

(9) Net Loss Per Share

The following table sets forth the computation of basic and diluted net loss per share (in thousands, except per share data):

	Year ended December 31,		
	2010	2009	2008
Numerator:			
Net loss	<u>\$ (4,781)</u>	<u>\$ (10,027)</u>	<u>\$ (92,535)</u>
Denominator:			
Weighted average common stock outstanding	<u>30,393</u>	<u>30,200</u>	<u>30,068</u>
Basic and diluted net loss per share	<u>\$ (0.16)</u>	<u>\$ (0.33)</u>	<u>\$ (3.08)</u>

The following tables set forth potential common stock that is not included in the diluted net loss per share calculation above because their effect would be anti-dilutive for the periods indicated (in thousands, except exercise price per share data):

	2010	Weighted average exercise price
	Warrants	7
Outstanding stock options and unvested restricted shares	5,133	\$ 3.52
	<u>5,140</u>	
	2009	Weighted average exercise price
Warrants	7	\$ 116.55
Outstanding stock options and unvested restricted shares	4,445	\$ 4.05
	<u>4,452</u>	
	2008	Weighted average exercise price
Warrants	278	\$ 23.35
Outstanding stock options and unvested restricted shares	5,310	\$ 11.45
	<u>5,588</u>	

As of December 31, 2010 and 2009, there were zero shares of issued common stock subject to repurchase.

(10) Income Taxes

The following is a summary of the components of income tax expense applicable to loss before income taxes (in thousands):

	<u>Year ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Current:			
Federal	\$(176)	\$—	\$—
State	34	70	104
Foreign	41	101	166
	<u>(101)</u>	<u>171</u>	<u>270</u>
Deferred:			
Federal	—	—	—
State	—	—	—
Foreign	—	—	—
	<u>\$(101)</u>	<u>\$171</u>	<u>\$270</u>

A reconciliation of the expected tax expense (benefit) to the actual tax expense (benefit) is as follows (in thousands):

	<u>Year ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Expected tax benefit at statutory rate (35%)	\$(1,709)	\$(3,450)	\$(32,292)
State taxes, net of Federal effect	22	46	68
Goodwill amortization and impairment	—	—	24,640
Foreign rate differential	(3,598)	(1,204)	(759)
Valuation allowance	4,535	3,960	7,764
Stock-based compensation	722	791	810
Other	(73)	28	39
	<u>\$ (101)</u>	<u>\$ 171</u>	<u>\$ 270</u>

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting and income tax purposes. Significant components of the Company's deferred tax assets and liabilities as of December 31, 2010 and 2009 are as follows (in thousands):

	<u>2010</u>	<u>2009</u>
Deferred assets:		
Net operating loss, capital loss, and tax credit carryforwards	\$ 532,036	\$ 501,894
Fixed assets and intangible assets	21,873	45,000
Inventory and other reserves	7,289	11,773
Other	102	110
	<u>561,300</u>	<u>558,777</u>
Gross deferred tax assets	561,300	558,777
Less valuation allowance	(561,300)	(558,777)
Total deferred tax assets	<u>\$ —</u>	<u>\$ —</u>

For the years ended December 31, 2010 and 2009, the net changes in the valuation allowance were an increase of \$2.5 million and an increase of \$2.4 million, respectively. The Company recorded a full valuation allowance against the net deferred tax assets at December 31, 2010 and 2009 since it is more likely than not that

the net deferred tax assets will not be realized due to the lack of previously paid taxes and anticipated taxable income.

As of December 31, 2010, the Company had net operating loss carryforwards for federal and California income tax purposes of approximately \$1,373.5 million and \$460.7 million, respectively, which are available to offset future taxable income, if any, in years through 2030. Approximately \$3.3 million and \$2.1 million net operating loss carryforwards for federal and California income tax purposes, respectively, are attributable to employee stock option deductions, the benefit from which will be allocated to paid-in-capital rather than current income when subsequently recognized. Federal and state laws impose substantial restrictions on the utilization of net operating loss and tax credit carryforwards in the event of an ownership change for tax purposes, as defined in Section 382 of the Internal Revenue Code. As a result of such ownership changes, the Company's ability to realize the potential future benefit of tax losses and tax credits that existed at the time of the ownership change will be significantly reduced. The Company's deferred tax asset and related valuation allowance would be reduced as a result. The Company has not yet performed a Section 382 study to determine the amount of reduction, if any.

As of December 31, 2010, the Company also had research credit carryforwards for federal and state income tax purposes of approximately \$20.8 million and \$7.7 million, respectively, which are available to reduce future income taxes, if any, in years through 2030 and over an indefinite period, respectively. Additionally, the Company had alternative minimum tax credit carryforwards for federal income tax purposes of approximately \$0.1 million which are available to reduce future income taxes, if any, over an indefinite period. The Company also had enterprise zone credit carryforwards for state income tax purposes of approximately \$0.2 million which are available to reduce future state income taxes, if any, over an indefinite period.

The Company may have unrecognized tax benefits included in its deferred tax assets which are subject to a full valuation allowance as of December 31, 2010 and 2009. However, the Company has not yet performed a study to determine the amount of such unrecognized tax benefits.

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

The Company or one of its subsidiaries files 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 | 2007 – 2010 |
| • California and Canada | 2006 – 2010 |
| • Brazil | 2005 – 2010 |
| • Germany and United Kingdom | 2006 – 2010 |

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.

(11) Related-Party Transactions

In the ordinary course of business, the Company's executive officers and non-employee directors are reimbursed for travel related expenses when incurred for business purposes. The Company reimburses its

Chairman, President and Chief Executive Officer, Morteza Ejabat, for the direct operating expenses incurred in the use of his private aircraft when used for business purposes. The amount reimbursed for these expenses was \$0.3 million, \$0.3 million, and \$0.5 million during the years ended December 31, 2010, 2009 and 2008, respectively.

(12) Commitments and Contingencies

Operating 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:	
2011	\$ 5,291
2012	2,910
2013	690
2014	654
2015 and Thereafter	<u>500</u>
Total minimum lease payments	<u><u>\$10,045</u></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 December 31, 2010, the Company had estimated commitments of \$6.5 million related to facilities assumed as a result of the Paradyne acquisition, of which \$2.7 million was accrued for excess facilities, which is net of estimated sublease income. The above amounts also include \$3.0 million of future minimum lease payments spread over the five-year lease term under the Lease Agreement entered into with LBA Realty in September 2010 with respect to the Company’s Oakland, California campus in connection with the sale and leaseback transaction, as discussed in Note 5. For operating leases that include contractual commitments for operating expenses and maintenance, estimates of such amounts are included based on current rates. Rent expense under operating leases, excluding rent relating to excess facilities previously accrued, totaled \$3.3 million, \$3.5 million and \$4.0 million for the years ended December 31, 2010, 2009 and 2008, respectively. Sublease rental income totaled \$1.0 million, \$1.2 million and \$1.3 million for the years ended December 31, 2010, 2009 and 2008, respectively.

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 potential claims.

Performance Bonds

In the normal course of operations, the Company arranges for the issuance of various types of surety bonds, such as bid and performance bonds, which are agreements under which the surety company guarantees that the

Company will perform in accordance with contractual or legal obligations. If the Company fails to perform under its obligations, the maximum potential payment under these surety bonds would have been \$0.8 million as of December 31, 2010.

Purchase Commitments

The Company has agreements with various contract manufacturers which include non-cancellable inventory purchase commitments. The Company's inventory purchase commitments typically allow for cancellation of orders 30 days in advance of the required inventory availability date as set by the Company at time of order. The amount of non-cancellable purchase commitments outstanding was \$7.3 million as of December 31, 2010.

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.

(13) Litigation

The Company is subject to various 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.

(14) Employee Benefit Plan

The Company maintains a 401(k) plan for its employees whereby eligible employees may contribute up to a specified percentage of their earnings, on a pretax basis, subject to the maximum amount permitted by the Internal Revenue Code. Under the 401(k) plan, the Company may make discretionary contributions. In 2010, the Company made a discretionary contribution to the plan of \$0.6 million. This was a non-elective employer contribution made from the forfeiture account to all eligible participants. The Company made no discretionary contributions to the plan in 2008 and 2009.

(15) 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 and revenue by products and services (in thousands).

	Year ended December 31,		
	2010	2009	2008
Revenue by Geography:			
United States	\$ 45,303	\$ 50,146	\$ 60,830
Canada	4,923	5,458	5,391
Total North America	50,226	55,604	66,221
Latin America	24,369	18,016	32,197
Europe, Middle East, Africa	51,596	48,657	43,820
Asia Pacific	2,845	4,224	3,922
Total International	78,810	70,897	79,939
	<u>\$129,036</u>	<u>\$126,501</u>	<u>\$146,160</u>
	Year ended December 31,		
	2010	2009	2008
Revenue by products and services:			
Products	\$124,673	\$120,939	\$141,916
Services	4,363	5,562	4,244
	<u>\$129,036</u>	<u>\$126,501</u>	<u>\$146,160</u>

(16) Subsequent Events

Revolving Line of Credit Renewal

On March 14, 2011, the Company renewed and amended its SVB Facility with SVB to provide liquidity and working capital through March 13, 2012.

Under the SVB Facility, the Company has the option of borrowing funds at agreed upon interest rates. 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, as long as the principal amount outstanding does not exceed \$25.0 million. In addition, under the SVB Facility, the Company is able to utilize the facility as security for letters of credit.

The amounts borrowed under the revolving credit facility, as amended, will bear interest, payable monthly, at a floating rate equal to the Wall Street Journal Prime Rate plus a margin of 0.0%–1.0% depending on the Company's reported quarterly EBITDA as defined in the agreement. 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 and negative covenants. If Zhone does not comply with the various covenants and other requirements under the SVB

Facility, SVB is entitled, among other things, to require the immediate repayment of all outstanding amounts and to sell Zhone's assets to satisfy the obligations under the SVB Facility.

(17) Quarterly Information (unaudited)

	Year ended December 31, 2010			
	Q1	Q2	Q3	Q4
	(in thousands, except per share data)			
Net revenue	\$31,082	\$33,255	\$33,683	\$31,016
Gross profit	11,317	12,005	13,576	12,274
Operating income (loss)	(3,002)	(1,584)	1,921	(1,229)
Net income (loss)	(3,204)	(2,002)	1,697	(1,272)
Net income (loss) per share				
Basic	\$ (0.11)	\$ (0.07)	\$ 0.06	\$ (0.04)
Diluted	(0.11)	(0.07)	0.05	(0.04)
Weighted-average shares outstanding				
Basic	30,282	30,343	30,431	30,515
Diluted	30,282	30,343	31,882	30,515
	Year ended December 31, 2009			
	(in thousands, except per share data)			
Net revenue	\$24,103	\$30,346	\$36,016	\$36,036
Gross profit	7,813	11,056	12,067	14,459
Operating income (loss)	(6,596)	(1,954)	(894)	751
Net income (loss)	(6,903)	(2,264)	(1,204)	344
Net income (loss) per share				
Basic	\$ (0.23)	\$ (0.08)	\$ (0.04)	\$ 0.01
Diluted	(0.23)	(0.08)	(0.04)	0.01
Weighted-average shares outstanding				
Basic	30,144	30,183	30,222	30,254
Diluted	30,144	30,183	30,222	32,730

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. 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 II, Item 9A, 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 Zhone 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.

Management's Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2010, the end of our fiscal year. In making this assessment, management used the criteria established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the report entitled "Internal Control-Integrated Framework." Based on our assessment of internal control over financial reporting, management has concluded that, as of December 31, 2010, our internal control over financial reporting was effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles.

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.

ITEM 9B. OTHER INFORMATION

Revolving Line of Credit Renewal

On March 14, 2011, we renewed and amended our existing SVB Facility with SVB to provide liquidity and working capital through March 13, 2012.

Under the SVB Facility, we have the option of borrowing funds at agreed upon interest rates. 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, as long as the principal amount outstanding does not exceed \$25.0 million. In addition, under the SVB Facility, we are able to utilize the facility as security for letters of credit.

The amounts borrowed under the revolving credit facility, as amended, will bear interest, payable monthly, at a floating rate equal to the Wall Street Journal Prime Rate plus a margin of 0.0%–1.0% depending on our reported quarterly EBITDA as defined in the agreement. 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 and negative covenants. If we do not comply with the various covenants and other requirements under the SVB Facility, SVB is entitled, among other things, to require the immediate repayment of all outstanding amounts and to sell our assets to satisfy the obligations under the SVB Facility. The foregoing description of the SVB Facility does not purport to be complete and is qualified in its entirety by reference to the “March 2011 Amendment” with an effective date of March 14, 2011, which is filed as Exhibit 10.23 to this report and incorporated herein by reference.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item relating to our directors and nominees, and compliance with Section 16(a) of the Securities Exchange Act of 1934 is included under the captions “Corporate Governance Principles and Board Matters,” “Ownership of Securities” and “Proposal 1: Election of Directors” in our definitive Proxy Statement for the 2011 Annual Meeting of Stockholders and is incorporated herein by reference.

The information required by this item relating to our executive officers is included under the caption “Executive Officers” in Part I of this Form 10-K and is incorporated by reference into this section.

We have adopted a Code of Conduct and Ethics applicable to all of our employees, directors and officers (including our principal executive officer, principal financial officer, principal accounting officer and controller). The Code of Conduct and Ethics is designed to deter wrongdoing and to promote honest and ethical conduct and compliance with applicable laws and regulations. The full text of our Code of Conduct and Ethics is published on our website at *www.zhong.com*. We intend to disclose future amendments to certain provisions of our Code of Conduct and Ethics, or waivers of such provisions granted to executive officers and directors, on our website within four business days following the date of such amendment or waiver.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is included under the captions “Executive Compensation” and “Compensation Committee Report” in our definitive Proxy Statement for the 2011 Annual Meeting of Stockholders and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item relating to security ownership of certain beneficial owners and management, and securities authorized for issuance under equity compensation plans is included under the captions “Ownership of Securities” and “Executive Compensation” in our definitive Proxy Statement for the 2011 Annual Meeting of Stockholders and is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is included under the captions “Certain Relationships and Related Transactions” and “Corporate Governance Principles and Board Matters” in our definitive Proxy Statement for the 2011 Annual Meeting of Stockholders and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is included under the caption “Proposal 2: Ratification of Appointment of Independent Registered Public Accounting Firm” in our definitive Proxy Statement for the 2011 Annual Meeting of Stockholders and is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

1. *Financial Statements*

The Index to Consolidated Financial Statements on page 45 is incorporated herein by reference as the list of financial statements required as part of this report.

2. *Exhibits*

The Exhibit Index on page 80 is incorporated herein by reference as the list of exhibits required as part of this report.

EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File Number	Exhibit	Filing Date	
3.1	Restated Certificate of Incorporation dated February 16, 2005	10-K	000-32743	3.1	March 16, 2005	
3.2	Certificate of Amendment of Restated Certificate of Incorporation dated March 11, 2010	10-K	000-32743	3.2	March 16, 2010	
3.3	Amended and Restated Bylaws	10-K	000-32743	3.3	March 16, 2005	
4.1	Form of Second Restated Rights Agreement dated November 13, 2003	10-Q	000-32743	4.1	May 14, 2004	
10.1	Zhone Technologies, Inc. 1999 Stock Option Plan	10	000-50263	10.2	April 30, 2003	
10.2	Zhone Technologies, Inc. Amended and Restated 2001 Stock Incentive Plan	8-K	000-32743	10.1	May 17, 2007	
10.3	Form of Stock Option Agreement for the Zhone Technologies, Inc. Amended and Restated 2001 Stock Incentive Plan	8-K	000-32743	10.1	September 1, 2006	
10.4	Zhone Technologies, Inc. Amended and Restated Special 2001 Stock Incentive Plan	10-Q	000-32743	10.28	August 15, 2002	
10.5	Form of Restricted Stock Award Agreement for the Zhone Technologies, Inc. Amended and Restated 2001 Stock Incentive Plan	8-K	000-32743	10.2	May 17, 2007	
10.6	Zhone Technologies, Inc. 2002 Employee Stock Purchase Plan	8-K	000-32743	10.1	May 17, 2006	
10.7	Incentive Awards Program Summary	8-K	000-32743	10.2	March 15, 2006	
10.8	Form of Indemnity Agreement between Zhone Technologies, Inc. and its directors and officers	10-Q	000-32743	10.20	May 14, 2004	
10.9	Letter Agreement dated November 13, 2003 between Zhone Technologies, Inc. and KKR-ZT, L.L.C.	Schedule 13D	005-61973	4	November 24, 2003	
10.10	Letter Agreement dated May 24, 2006 between Zhone Technologies, Inc. and KKR-ZT, L.L.C.	10-K	000-32743	10.10	March 8, 2007	
10.11	Letter Agreement dated November 13, 2003 between Zhone Technologies, Inc. and New Enterprise Associates VIII, Limited Partnership	Schedule 13D	005-61973	5	November 24, 2003	

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File Number	Exhibit	Filing Date	
10.13	Loan and Security Agreement dated March 30, 2001 between Zhone Technologies, Inc. and Fremont Investment and Loan	10	000-50263	10.21	April 30, 2003	
10.14	Pledge and Assignment of Cash Collateral Account dated March 30, 2001 between Zhone Technologies, Inc. and Fremont Investment and Loan	10	000-50263	10.22	April 30, 2003	
10.15	Secured Promissory Note dated March 30, 2001 between Zhone Technologies, Inc. and Fremont Investment and Loan	10	000-50263	10.23	April 30, 2003	
10.16	Second Amendment to Deed of Trust and Other Loan Documents dated December 27, 2005 between Zhone Technologies, Inc., Zhone Technologies Campus, LLC, and Fremont Investment & Loan	8-K	000-32743	10.1	December 27, 2005	
10.17	Purchase and Sale Agreement with Repurchase Options dated January 20, 2000 between Zhone Technologies, Inc. and the Redevelopment Agency of the City of Oakland	10	000-50263	10.28	April 30, 2003	
10.18	Amended and Restated Employment Agreement dated November 8, 2007 by and between Zhone Technologies, Inc. and Morteza Ejabat	10-K	000-32743	10.27	March 6, 2008	
10.19	Second Amended and Restated Loan and Security Agreement with an effective date of March 16, 2009 among Zhone Technologies, Inc., ZTI Merger Subsidiary III, Inc. and Silicon Valley Bank	10-K	000-32743	10.19	March 16, 2009	
10.20	Loan and Security Agreement (EXIM Facility) with an effective date of March 16, 2009 among Zhone Technologies, Inc., ZTI Merger Subsidiary III, Inc. and Silicon Valley Bank	10-K	000-32743	10.20	March 16, 2009	
10.21	“March 2010 Amendment” with an effective date of March 15, 2010 among Zhone Technologies, Inc., ZTI Merger Subsidiary III, Inc. and Silicon Valley Bank	10-K	000-32743	10.21	March 16, 2010	

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File Number	Exhibit	Filing Date	
10.22	“January 2011 Amendment” with an effective date of January 19, 2011 among Zhone Technologies, Inc., ZTI Merger Subsidiary III, Inc. and Silicon Valley Bank					X
10.23	“March 2011 Amendment” with an effective date of March 14, 2011 among Zhone Technologies, Inc., ZTI Merger Subsidiary III, Inc. and Silicon Valley Bank					X
10.24	Real Estate Purchase Agreement between Zhone Technologies, Inc. and LBA Realty, LLC	8-K	000-32743	10.1	September 22, 2010	
10.25	Multi-Tenant Commercial/Industrial Lease Agreement between Zhone Technologies, Inc. and LBA Realty, LLC	8-K	000-32743	10.2	September 22, 2010	
10.26	Discount Payoff Agreement between Zhone Technologies, Inc. and LBA Realty, LLC	8-K	000-32743	10.3	September 22, 2010	
21.2	List of Subsidiaries					X
23.1	Consent of Independent Registered Public Accounting Firm					X
24.1	Power of Attorney (see signature page)					X
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)					X
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)					X
32.1	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer					X

AMENDMENT TO LOAN DOCUMENTS

THIS AMENDMENT TO LOAN DOCUMENTS (this “Amendment” or the “January 2011 Amendment”) is entered into as of January 19, 2011 (the “January 2011 Amendment Date”) by and between, on the one hand, SILICON VALLEY BANK, a California corporation (“Bank”), and, on the other hand, ZTI Merger Subsidiary III, Inc., a Delaware corporation formerly known as Zhone Technologies, Inc. (“ZMS-III”, and also a “Borrower”), and Zhone Technologies, Inc., a Delaware corporation formerly known as Tellium, Inc. (“Zhone”, and also a “Borrower”) (individually and collectively, and jointly and severally, “Borrower”). Borrower’s chief executive office is located at 7195 Oakport Street, Oakland, CA 94621.

RECITALS

A. Bank and Borrower are parties to that certain Second Amended and Restated Loan and Security Agreement with an Effective Date of March 16, 2009 (as amended, modified, supplemented or restated, the “Non-Exim Loan Agreement”) in effect between Bank and Borrower, and that certain Loan and Security Agreement (EXIM FACILITY) with an Effective Date of March 16, 2009 (as amended, modified, supplemented or restated, the “Exim Loan Agreement”) in effect between Bank and Borrower. As used herein, the term “Loan Agreement” means, individually and collectively, the Non-Exim Loan Agreement and the Exim Loan Agreement. Each of the terms “January 2011 Amendment” and “January 2011 Amendment Date,” as respectively defined above, hereby is incorporated into the Loan Agreement.

B. Bank has extended credit to Borrower for the purposes permitted in the Loan Agreement.

C. Borrower has requested that Bank amend the Loan Agreement to waive the Designated Defaults (as defined in Section 2.1 below) as more fully set forth herein.

D. Bank has agreed to so amend the Loan Agreement, but only to the extent, in accordance with the terms, subject to the conditions and in reliance upon the representations and warranties set forth below.

AGREEMENT

NOW, THEREFORE, in consideration of the foregoing recitals and other good and valuable consideration, the receipt and adequacy of which is hereby acknowledged, and intending to be legally bound, the parties hereto agree as follows:

1. Definitions. Capitalized terms used but not defined in this Amendment shall have the meanings given to them in the Loan Agreement.

2. Amendments to Loan Documents.

2.1 Limited Waiver of Designated Defaults. Borrower has advised Bank that Borrower anticipates that it will fail to comply with the Required EBITDA for any Fiscal Quarter Financial Covenant set forth in Section 6.9(b) of the Non-Exim Loan Agreement for the compliance period ending December 31, 2010 (the "Non-Exim Designated Default"). Borrower has also advised Bank that Borrower anticipates that it will fail to comply with the Required EBITDA for any Fiscal Quarter Financial Covenant set forth in Section 6.9(b) of the Exim Loan Agreement for the compliance period ending December 31, 2010 (the "Exim Designated Default" and together with the Non-Exim Designated Default, the "Designated Defaults"). Bank and Borrower agree that the Designated Defaults are hereby waived. It is understood by the parties hereto, however, that such waiver does not constitute a waiver of any other provision or term of either the Non-Exim Loan Agreement, the Exim Loan Agreement or any related document, nor a waiver of this covenant as of any other date, nor an agreement to waive in the future this covenant or any other provision or term of the Non-Exim Loan Agreement, the Exim Loan Agreement or any related document.

3. Limitation of Amendments.

3.1 The amendments set forth in **Section 2**, above, are effective for the purposes set forth herein and shall be limited precisely as written and shall not be deemed to (a) be a consent to any amendment, waiver or modification of any other term or condition of any Loan Document, or (b) otherwise prejudice any right or remedy which Bank may now have or may have in the future under or in connection with any Loan Document, as amended.

3.2 This Amendment shall be construed in connection with and as part of the Loan Documents and all terms, conditions, representations, warranties, covenants and agreements set forth in the Loan Documents (as amended by this Amendment, as applicable) are hereby ratified and confirmed and shall remain in full force and effect.

4. Representations and Warranties. To induce Bank to enter into this Amendment, Borrower hereby represents and warrants to Bank as follows:

4.1 Immediately after giving effect to this Amendment, (a) the representations and warranties contained in the Loan Documents are true, accurate and complete in all material respects as of the date hereof (except to the extent such representations and warranties relate to an earlier date, in which case they are true and correct as of such date), and (b) no Event of Default has occurred and is continuing;

4.2 Borrower has the power and authority to execute and deliver this Amendment and to perform its obligations under the Loan Documents, as amended by this Amendment;

4.3 The certificate of incorporation of Borrower delivered to Bank on the Effective Date remain true, accurate and complete and have not been otherwise amended, supplemented or restated and are and continue to be in full force and effect;

4.4 The execution, delivery and performance by Borrower of this Amendment have been duly authorized, and do not (i) conflict with any of Borrower's organizational documents, (ii) contravene, conflict with, constitute a default under or violate any material Requirement of Law, (iii) contravene, conflict or violate, in any material respect, any applicable order, writ, judgment, injunction, decree, determination or award of any Governmental Authority by which Borrower or any its Subsidiaries or any of their property or assets (other than immaterial property and immaterial assets) may be bound or affected, (iv) require any action by, filing, registration, or qualification with, or Governmental Approval from, any Governmental Authority (except such Governmental Approvals which have already been obtained and are in full force and effect), or (v) constitute an event of default under any material agreement by which Borrower is bound; and

4.5 This Amendment has been duly executed and delivered by Borrower and is the binding obligation of Borrower, enforceable against Borrower in accordance with its terms, except as such enforceability may be limited by bankruptcy, insolvency, reorganization, liquidation, moratorium or other similar laws of general application and equitable principles relating to or affecting creditors' rights.

5. Release by Borrower and Guarantor. Each of Borrower and Guarantor (individually and collectively, "Obligor") hereby agree as follows:

5.1 FOR GOOD AND VALUABLE CONSIDERATION, Obligor hereby forever relieves, releases, and discharges Bank and its present or former employees, officers, directors, agents, representatives, attorneys, and each of them, from any and all claims, debts, liabilities, demands, obligations, promises, acts, agreements, costs and expenses, actions and causes of action, of every type, kind, nature, description or character whatsoever, whether known or unknown, suspected or unsuspected, absolute or contingent, arising out of or in any manner whatsoever connected with or related to facts, circumstances, issues, controversies or claims existing or arising from the beginning of time through and including the date of execution of this Amendment (collectively "**Released Claims**"). Without limiting the foregoing, the Released Claims shall include any and all liabilities or claims arising out of or in any manner whatsoever connected with or related to the Loan Documents, the Recitals hereto, any instruments, agreements or documents executed in connection with any of the foregoing or the origination, negotiation, administration, servicing and/or enforcement of any of the foregoing.

5.2 In furtherance of this release, Obligor expressly acknowledges and waives any and all rights under Section 1542 of the California Civil Code, which provides as follows:

"A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR EXPECT TO EXIST IN HIS OR HER FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM OR HER

MUST HAVE MATERIALLY AFFECTED HIS OR HER SETTLEMENT WITH THE DEBTOR.” (Emphasis added.)

5.3 By entering into this release, Obligor recognizes that no facts or representations are ever absolutely certain and it may hereafter discover facts in addition to or different from those which it presently knows or believes to be true, but that it is the intention of Obligor hereby to fully, finally and forever settle and release all matters, disputes and differences, known or unknown, suspected or unsuspected; accordingly, if Obligor should subsequently discover that any fact that it relied upon in entering into this release was untrue, or that any understanding of the facts was incorrect, Obligor shall not be entitled to set aside this release by reason thereof, regardless of any claim of mistake of fact or law or any other circumstances whatsoever. Obligor acknowledges that it is not relying upon and has not relied upon any representation or statement made by Bank with respect to the facts underlying this release or with regard to any of such party’s rights or asserted rights.

5.4 This release may be pleaded as a full and complete defense and/or as a cross-complaint or counterclaim against any action, suit, or other proceeding that may be instituted, prosecuted or attempted in breach of this release. Obligor acknowledges that the release contained herein constitutes a material inducement to Bank to enter into this Amendment, and that Bank would not have done so but for Bank’s expectation that such release is valid and enforceable in all events.

5.5 Obligor hereby represents and warrants to Bank, and Bank is relying thereon, as follows:

- (a) Except as expressly stated in this Amendment, neither Bank nor any agent, employee or representative of Bank has made any statement or representation to Obligor regarding any fact relied upon by Obligor in entering into this Amendment.
- (b) Obligor has made such investigation of the facts pertaining to this Amendment and all of the matters appertaining thereto, as it deems necessary.
- (c) The terms of this Amendment are contractual and not a mere recital.
- (d) This Amendment has been carefully read by Obligor, the contents hereof are known and understood by Obligor, and this Amendment is signed freely, and without duress, by Obligor.
- (e) Obligor represents and warrants that it is the sole and lawful owner of all right, title and interest in and to every claim and every other matter which it releases herein, and that it has not heretofore assigned or transferred, or purported to assign or transfer, to any person, firm or entity any claims or other matters herein released. Obligor shall indemnify Bank, defend and hold it harmless from and

against all claims based upon or arising in connection with prior assignments or purported assignments or transfers of any claims or matters released herein.

6. Fee. In consideration for Bank entering into this Amendment, Borrower shall pay Bank a fee in the mutually agreed amount of **\$10,000.00**, which fee shall be earned in full and payable concurrently with the execution and delivery of this Amendment. Such fee shall be non-refundable and in addition to all interest and other fees payable to Bank under the Loan Documents. Bank is authorized to charge such fee to Borrower's loan account.

7. Bank Expenses. Borrower shall pay to Bank, when due, all Bank Expenses (including reasonable attorneys' fees and expenses), when due, incurred in connection with or pursuant to this Amendment.

8. Counterparts. This Amendment may be executed in any number of counterparts and all of such counterparts taken together shall be deemed to constitute one and the same instrument.

9. Effectiveness. This Amendment shall be deemed effective upon the due execution and delivery by each party hereto to Bank of this Amendment.

[Remainder of page intentionally left blank; signature page immediately follows.]

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed and delivered as of the date first written above.

BANK:

Silicon Valley Bank

By /s/ Mike Meier
Name Mike Meier
Title Relationship Manager

BORROWER:

ZTI MERGER SUBSIDIARY III, INC., a
Delaware corporation

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

ZHONE TECHNOLOGIES, INC., a
Delaware corporation

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Signature Page

CONSENT

Each of the undersigned hereby expressly agrees to Section 5 of the foregoing Amendment and acknowledges that its consent to the rest of the foregoing Amendment is not required, but the undersigned nevertheless does hereby agree and consent to the entire foregoing Amendment and to the documents and agreements referred to therein and to all future modifications and amendments thereto, and any termination thereof, and to any and all other present and future documents and agreements between or among the foregoing parties. Nothing herein shall in any way limit any of the terms or provisions of the Guaranty, the Guarantor Security Agreement, or any other Loan Documents, executed by the undersigned, all of which are hereby ratified and affirmed.

GUARANTOR:

Paradyne Corporation

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Premisys Communications, Inc.

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Zhone Technologies International, Inc.

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Paradyne Networks, Inc.

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Xybridge Technologies, Inc.

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

AMENDMENT TO LOAN DOCUMENTS

THIS AMENDMENT TO LOAN DOCUMENTS (this “Amendment” or the “March 2011 Amendment”) is entered into as of March 14, 2011 (the “March 2011 Amendment Date”) by and between, on the one hand, SILICON VALLEY BANK, a California corporation (“Bank”), and, on the other hand, ZTI Merger Subsidiary III, Inc., a Delaware corporation formerly known as Zhone Technologies, Inc. (“ZMS-III”, and also a “Borrower”), and Zhone Technologies, Inc., a Delaware corporation formerly known as Tellium, Inc. (“Zhone”, and also a “Borrower”) (individually and collectively, and jointly and severally, “Borrower”). Borrower’s chief executive office is located at 7195 Oakport Street, Oakland, CA 94621.

RECITALS

A. Bank and Borrower are parties to that certain Second Amended and Restated Loan and Security Agreement with an Effective Date of March 16, 2009 (as amended, modified, supplemented or restated, the “Non-Exim Loan Agreement”) in effect between Bank and Borrower, and that certain Loan and Security Agreement (EXIM FACILITY) with an Effective Date of March 16, 2009 (as amended, modified, supplemented or restated, the “Exim Loan Agreement”) in effect between Bank and Borrower. As used herein, the term “Loan Agreement” means, individually and collectively, the Non-Exim Loan Agreement and the Exim Loan Agreement. Each of the terms “March 2011 Amendment” and “March 2011 Amendment Date,” as respectively defined above, hereby is incorporated into the Loan Agreement.

B. Bank has extended credit to Borrower for the purposes permitted in the Loan Agreement.

C. Borrower has requested that Bank amend the Loan Agreement to: (i) modify the Interest Rate under each Loan Agreement as set forth in Sections 2.1 and 2.2 below, (ii) modify the Letter of Credit Fee under each Loan Agreement as set forth in Sections 2.3 and 2.4 below, (iii) modify the Unused Combined Revolving Line Facility Fee under each Loan Agreement as set forth in Sections 2.5 and 2.6 below, (iv) modify the Combined Collateral Monitoring Fee under each Loan Agreement as set forth in Sections 2.7 and 2.8 below, (v) modify the EBITDA financial covenant under each of the Loan Agreements as set forth in Section 2.9 and 2.10 below, (vi) modify certain provisions to Section 7.7 of the Loan Agreement with respect to the Campus Real Estate Loan (as defined therein) as set forth in Section 2.11 and 2.12 below, (vii) modify the Prime Rate under each Loan Agreement as set forth in Section 2.13 and 2.14 below and (viii) modify the Revolving Line Maturity Date under each Loan Agreement as set forth in Sections 2.15 and 2.16 below; as more fully set forth herein.

D. Bank has agreed to so amend the Loan Agreement, but only to the extent, in accordance with the terms, subject to the conditions and in reliance upon the representations and warranties set forth below.

AGREEMENT

Now, **THEREFORE**, in consideration of the foregoing recitals and other good and valuable consideration, the receipt and adequacy of which is hereby acknowledged, and intending to be legally bound, the parties hereto agree as follows:

1. Definitions. Capitalized terms used but not defined in this Amendment shall have the meanings given to them in the Loan Agreement.

2. Amendments to Loan Documents.

2.1 Modified Interest Rate in Non-Exim Loan Agreement. Section 2.3(a) of the Non-Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

(a) Interest Rate. Subject to Section 2.3(b), the principal amount outstanding under the Revolving Line shall accrue interest at the applicable per annum rate set forth below, which interest shall be payable monthly.

<u>Fiscal Quarterly EBITDA</u>	<u>Applicable Rate</u>
EBITDA > \$1,000,000	Prime Rate plus 0.00% ("Level 1")
\$0 < EBITDA < \$1,000,000	Prime Rate plus 0.50% ("Level 2")
EBITDA < \$0.00	Prime Rate plus 1.00% ("Level 3")

The initial interest rate in effect on the March 2011 Amendment Date shall be Level 3.

Changes in the interest rate based on the Borrower's EBITDA as provided above shall go into effect as of the first day of the month following the fiscal quarter in which Borrower's financial statements are received, reviewed and approved by Bank (provided that if the Borrower's financial statements are received, reviewed and approved by Bank within five Business Days after the start of a month, the interest rate shall be adjusted as of the first day of such month). If, based on the EBITDA as shown in Borrower's financial statements there is to be an increase in the interest rate, the interest rate increase may be put into effect by Bank as of the first day of the month closest to the

date on which the financial statements are due, even if the delivery of the financial statements is delayed.

Thus, for example:

(A) if Borrower's EBITDA for the fiscal quarter ending June 30, 2011 is \$100 and Borrower's financial statements as of June 30, 2011 are received, reviewed and approved by Bank on July 31, 2011, then the interest rate in effect on August 1, 2011 will be a rate equal to the Prime Rate plus 0.50%.

(B) if Borrower's EBITDA for the fiscal quarter ending June 30, 2011 is \$100 and Borrower's financial statements as of June 30, 2011 are received, reviewed and approved by Bank on August 5, 2011, then the interest rate shall still be adjusted to a rate equal to the Prime Rate plus 0.50% effective on August 1, 2011.

2.2 Modified Interest Rate in Exim Loan Agreement. Section 2.3(a) of the Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

(a) Interest Rate. Subject to Section 2.3(b), the principal amount outstanding under the Revolving Line shall accrue interest at the applicable per annum rate set forth below, which interest shall be payable monthly.

<u>Fiscal Quarterly EBITDA</u>	<u>Applicable Rate</u>
EBITDA > \$1,000,000	Prime Rate plus 0.00% ("Level 1")
\$0 < EBITDA < \$1,000,000	Prime Rate plus 0.50% ("Level 2")
EBITDA < \$0.00	Prime Rate plus 1.00% ("Level 3")

The initial interest rate in effect on the March 2011 Amendment Date shall be Level 3.

Changes in the interest rate based on the Borrower's EBITDA as provided above shall go into effect as of the first day of the month following the fiscal quarter in which Borrower's financial statements are received, reviewed and

approved by Bank (provided that if the Borrower's financial statements are received, reviewed and approved by Bank within five Business Days after the start of a month, the interest rate shall be adjusted as of the first day of such month). If, based on the EBITDA as shown in Borrower's financial statements there is to be an increase in the interest rate, the interest rate increase may be put into effect by Bank as of the first day of the month closest to the date on which the financial statements are due, even if the delivery of the financial statements is delayed.

Thus, for example:

(A) if Borrower's EBITDA for the fiscal quarter ending June 30, 2011 is \$100 and Borrower's financial statements as of June 30, 2011 are received, reviewed and approved by Bank on July 31, 2011, then the interest rate in effect on August 1, 2011 will be a rate equal to the Prime Rate plus 0.50%.

(B) if Borrower's EBITDA for the fiscal quarter ending June 30, 2011 is \$100 and Borrower's financial statements as of June 30, 2011 are received, reviewed and approved by Bank on August 5, 2011, then the interest rate shall still be adjusted to a rate equal to the Prime Rate plus 0.50% effective on August 1, 2011.

2.3 Modified Letter of Credit Fee in Non-Exim Loan Agreement. Section 2.4(b) of the Non-Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

(b) Letter of Credit Fee. Bank's customary fees and expenses for the issuance or renewal of Letters of Credit, including, without limitation, a Letter of Credit Fee of 1.25% per annum of the face amount of each Letter of Credit issued, upon the issuance, each anniversary of the issuance, and the renewal, of any such Letter of Credit by Bank.

2.4 Modified Letter of Credit Fee in Exim Loan Agreement. Section 2.4(b) of the Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

(b) Letter of Credit Fee. Bank's customary fees and expenses for the issuance or renewal of Letters of Credit, including, without limitation, a Letter of Credit Fee of

1.25% per annum of the face amount of each Letter of Credit issued, upon the issuance, each anniversary of the issuance, and the renewal, of any such Letter of Credit by Bank.

2.5 Modified Unused Combined Revolving Line Facility Fee in Non-Exim Loan Agreement. Section 2.4(d) of the Non-Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

(d) Unused Combined Revolving Line Facility Fee. A fee (the “**Unused Combined Revolving Line Facility Fee**”), payable monthly, in arrears, in an amount equal to the percentages set forth below per annum of the average unused portion of the Combined Revolving Line, as determined by Bank. The unused portion of the Combined Revolving Line, for the purposes of this calculation, shall: (i) not include amounts reserved under Section 2.1.2 of this Agreement in respect of outstanding Letters of Credit issued pursuant to this Agreement and under Section 2.1.2 of the Exim Loan Agreement in respect of outstanding “Letters of Credit” issued pursuant to the Exim Loan Agreement; but shall include (y) amounts reserved under Section 2.1.3 of this Agreement in respect of FX Forward Contracts entered into pursuant to this Agreement and under Section 2.1.3 of the Exim Loan Agreement in respect of “FX Forward Contracts” entered into pursuant to the Exim Loan Agreement, and (z) amounts reserved under Section 2.1.4 of this Agreement in respect of Cash Management Services used pursuant to this Agreement and under Section 2.1.4 of the Exim Loan Agreement in respect of “Cash Management Services” used pursuant to the Exim Loan Agreement. Borrower shall not be entitled to any credit, rebate or repayment of any Unused Combined Revolving Line Facility Fee previously earned by Bank pursuant to this Section notwithstanding any termination of the Agreement, or suspension or termination of Bank’s obligation to make loans and advances hereunder or under the Exim Loan Agreement.

<u>Fiscal Quarterly EBITDA</u>	<u>Applicable Percentage</u>
EBITDA > \$1,000,000	0.25%
\$0<EBITDA<\$1,000,000	0.375%
EBITDA<\$0.00	0.50%

2.6 Modified Unused Combined Revolving Line Facility Fee in Exim Loan Agreement. Section 2.4(d) of the Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

Unused Combined Revolving Line Facility Fee. The “Unused Combined Revolving Line Facility Fee” set forth in Section 2.4(d) of the Non-Exim Loan Agreement. Borrower shall not be entitled to any credit, rebate or repayment of any Unused Combined Revolving Line Facility Fee previously earned by Bank pursuant to this Section notwithstanding any termination of the Agreement, or suspension or termination of Bank’s obligation to make loans and advances hereunder or under the Non-Exim Loan Agreement.

2.7 Modified Combined Collateral Monitoring Fee in Non-Exim Loan Agreement. Section 2.4(e) of the Non- Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

(e) Combined Collateral Monitoring Fee. [Omitted].

2.8 Modified Combined Collateral Monitoring Fee in Exim Loan Agreement. Section 2.4(e) of the Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

(e) Combined Collateral Monitoring Fee. [Omitted].

2.9 Modification of EBITDA Financial Covenant in the Non-Exim Loan Agreement. Section 6.9(b) of the Non-Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

(b) Required EBITDA for any Fiscal Quarter. For each fiscal quarter of Borrower ending on or after March 31, 2011, Borrower shall achieve EBITDA of not less than the required amount set forth below [note: amounts shown

below within pointed brackets (< \$ >) are negative amounts]:

<u>Fiscal quarter ending on:</u>	<u>Minimum EBITDA Amount</u>
March 31, 2011	<\$2,500,000.00>
June 30, 2011	<\$2,000,000.00>
September 30, 2011	<\$1,500,000.00>
December 31, 2011	<\$1,000,000.00>

2.10 Modification of EBITDA Financial Covenant in the Exim Loan Agreement. Section 6.9(b) of the Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

(b) Required EBITDA for any Fiscal Quarter. For each fiscal quarter of Borrower ending on or after March 31, 2011, Borrower shall achieve EBITDA of not less than the required amount set forth below [note: amounts shown below within pointed brackets (< \$ >) are negative amounts]:

<u>Fiscal quarter ending on:</u>	<u>Minimum EBITDA Amount</u>
March 31, 2011	<\$2,500,000.00>
June 30, 2011	<\$2,000,000.00>
September 30, 2011	<\$1,500,000.00>
December 31, 2011	<\$1,000,000.00>

2.11 Modification of Section 7.7 of the Non-Exim Loan Agreement with respect to the Campus Real Estate Loan. The portion of Section 7.7 of the Non-Exim Loan Agreement that currently reads as follows:

With respect to the real estate loan of Campus secured by the real property used by Borrower (the “Campus Real Estate Loan”), Borrower may make Investments in Campus solely for the purpose of funding, when due, regularly scheduled principal and interest payments in respect of the Campus Real Estate Loan, provided that (i) no Event of

Default has occurred and is continuing or would result therefrom, and (ii) after giving pro forma effect to such Investment, Borrower would be in compliance with the financial covenant(s) in Section 6.9. Borrower hereby represents and warrants that the current maturity date of the Campus Real Estate Loan is April 1, 2011, and Borrower hereby covenants and agrees that, no later than January 5, 2011, Borrower shall restructure the Campus Real Estate Loan on terms and conditions (including with respect to an extended maturity date) satisfactory to Bank in Bank's good faith business judgment and shall deliver to Bank evidence (satisfactory to Bank in Bank's good faith business judgment) that the Campus Real Estate Loan as so restructured is and shall be in full force and effect.

is hereby deleted.

2.12 Modification of Section 7.7 of the Exim Loan Agreement with respect to the Campus Real Estate Loan. The portion of Section 7.7 of the Exim Loan Agreement that currently reads as follows:

With respect to the real estate loan of Campus secured by the real property used by Borrower (the "Campus Real Estate Loan"), Borrower may make Investments in Campus solely for the purpose of funding, when due, regularly scheduled principal and interest payments in respect of the Campus Real Estate Loan, provided that (i) no Event of Default has occurred and is continuing or would result therefrom, and (ii) after giving pro forma effect to such Investment, Borrower would be in compliance with the financial covenant(s) in Section 6.9. Borrower hereby represents and warrants that the current maturity date of the Campus Real Estate Loan is April 1, 2011, and Borrower hereby covenants and agrees that, no later than January 5, 2011, Borrower shall restructure the Campus Real Estate Loan on terms and conditions (including with respect to an extended maturity date) satisfactory to Bank in Bank's good faith business judgment and shall deliver to Bank evidence (satisfactory to Bank in Bank's good faith business judgment) that the Campus Real Estate Loan as so restructured is and shall be in full force and effect.

is hereby deleted.

2.13 Modified Definition of Prime Rate in Non-Exim Loan Agreement. The definition of “Prime Rate” set forth in Section 13.1 of the Non-Exim Loan Agreement is hereby amended and restated to read as follows:

“**Prime Rate**” is, on any date, the highest of the prime rates most recently published in the Wall Street Journal as the base rate on corporate loans at large U.S. banks.

2.14 Modified Definition of Prime Rate in Exim Loan Agreement. The definition of “Prime Rate” set forth in Section 13.1 of the Exim Loan Agreement is hereby amended and restated to read as follows:

“**Prime Rate**” is, on any date, the highest of the prime rates most recently published in the Wall Street Journal as the base rate on corporate loans at large U.S. banks.

2.15 Modification of Revolving Line Maturity Date in the Non-Exim Loan Agreement. The definition of “Revolving Line Maturity Date” set forth in Section 13.1 of the Non-Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

“**Revolving Line Maturity Date**” is March 13, 2012.

2.16 Modification of Revolving Line Maturity Date in the Exim Loan Agreement. The definition of “Revolving Line Maturity Date” set forth in Section 13.1 of the Exim Loan Agreement is hereby amended and restated in its entirety to read as follows:

“**Revolving Line Maturity Date**” is March 13, 2012.

3. Limitation of Amendments.

3.1 The amendments set forth in **Section 2**, above, are effective for the purposes set forth herein and shall be limited precisely as written and shall not be deemed to (a) be a consent to any amendment, waiver or modification of any other term or condition of any Loan Document, or (b) otherwise prejudice any right or remedy which Bank may now have or may have in the future under or in connection with any Loan Document, as amended.

3.2 This Amendment shall be construed in connection with and as part of the Loan Documents and all terms, conditions, representations, warranties, covenants and agreements set forth in the Loan Documents (as amended by this Amendment, as applicable) are hereby ratified and confirmed and shall remain in full force and effect.

4. Representations and Warranties. To induce Bank to enter into this Amendment, Borrower hereby represents and warrants to Bank as follows:

4.1 Immediately after giving effect to this Amendment, (a) the representations and warranties contained in the Loan Documents are true, accurate and complete in all material respects as of the date hereof (except to the extent such representations and warranties relate to an earlier date, in which case they are true and correct as of such date), and (b) no Event of Default has occurred and is continuing;

4.2 Borrower has the power and authority to execute and deliver this Amendment and to perform its obligations under the Loan Documents, as amended by this Amendment;

4.3 The certificate of incorporation of Borrower delivered to Bank on the Effective Date remain true, accurate and complete and have not been otherwise amended, supplemented or restated and are and continue to be in full force and effect;

4.4 The execution, delivery and performance by Borrower of this Amendment have been duly authorized, and do not (i) conflict with any of Borrower's organizational documents, (ii) contravene, conflict with, constitute a default under or violate any material Requirement of Law, (iii) contravene, conflict or violate, in any material respect, any applicable order, writ, judgment, injunction, decree, determination or award of any Governmental Authority by which Borrower or any its Subsidiaries or any of their property or assets (other than immaterial property and immaterial assets) may be bound or affected, (iv) require any action by, filing, registration, or qualification with, or Governmental Approval from, any Governmental Authority (except such Governmental Approvals which have already been obtained and are in full force and effect), or (v) constitute an event of default under any material agreement by which Borrower is bound; and

4.5 This Amendment has been duly executed and delivered by Borrower and is the binding obligation of Borrower, enforceable against Borrower in accordance with its terms, except as such enforceability may be limited by bankruptcy, insolvency, reorganization, liquidation, moratorium or other similar laws of general application and equitable principles relating to or affecting creditors' rights.

5. Release by Borrower and Guarantor. Each of Borrower and Guarantor (individually and collectively, “Obligor”) hereby agree as follows:

5.1 FOR GOOD AND VALUABLE CONSIDERATION, Obligor hereby forever relieves, releases, and discharges Bank and its present or former employees, officers, directors, agents, representatives, attorneys, and each of them, from any and all claims, debts, liabilities, demands, obligations, promises, acts, agreements, costs and expenses, actions and causes of action, of every type, kind, nature, description or character whatsoever, whether known or unknown, suspected or unsuspected, absolute or contingent, arising out of or in any manner whatsoever connected with or related to facts, circumstances, issues, controversies or claims existing or arising from the beginning of time through and including the date of execution of this Amendment (collectively “**Released Claims**”). Without limiting the foregoing, the Released Claims shall include any and all liabilities or claims arising out of or in any manner whatsoever connected with or related to the Loan Documents, the Recitals hereto, any instruments, agreements or documents executed in connection with any of the foregoing or the origination, negotiation, administration, servicing and/or enforcement of any of the foregoing.

5.2 In furtherance of this release, Obligor expressly acknowledges and waives any and all rights under Section 1542 of the California Civil Code, which provides as follows:

“A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR EXPECT TO EXIST IN HIS OR HER FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM OR HER MUST HAVE MATERIALLY AFFECTED HIS OR HER SETTLEMENT WITH THE DEBTOR.” (Emphasis added.)

5.3 By entering into this release, Obligor recognizes that no facts or representations are ever absolutely certain and it may hereafter discover facts in addition to or different from those which it presently knows or believes to be true, but that it is the intention of Obligor hereby to fully, finally and forever settle and release all matters, disputes and differences, known or unknown, suspected or unsuspected; accordingly, if Obligor should subsequently discover that any fact that it relied upon in entering into this release was untrue, or that any understanding of the facts was incorrect, Obligor shall not be entitled to set aside this release by reason thereof, regardless of any claim of mistake of fact or law or any other circumstances whatsoever. Obligor acknowledges that it is not relying upon and has not relied upon any representation or statement made by Bank with respect to the facts underlying this release or with regard to any of such party’s rights or asserted rights.

5.4 This release may be pleaded as a full and complete defense and/or as a cross-complaint or counterclaim against any action, suit, or other proceeding that

may be instituted, prosecuted or attempted in breach of this release. Obligor acknowledges that the release contained herein constitutes a material inducement to Bank to enter into this Amendment, and that Bank would not have done so but for Bank's expectation that such release is valid and enforceable in all events.

5.5 Obligor hereby represents and warrants to Bank, and Bank is relying thereon, as follows:

(a) Except as expressly stated in this Amendment, neither Bank nor any agent, employee or representative of Bank has made any statement or representation to Obligor regarding any fact relied upon by Obligor in entering into this Amendment.

(b) Obligor has made such investigation of the facts pertaining to this Amendment and all of the matters appertaining thereto, as it deems necessary.

(c) The terms of this Amendment are contractual and not a mere recital.

(d) This Amendment has been carefully read by Obligor, the contents hereof are known and understood by Obligor, and this Amendment is signed freely, and without duress, by Obligor.

(e) Obligor represents and warrants that it is the sole and lawful owner of all right, title and interest in and to every claim and every other matter which it releases herein, and that it has not heretofore assigned or transferred, or purported to assign or transfer, to any person, firm or entity any claims or other matters herein released. Obligor shall indemnify Bank, defend and hold it harmless from and against all claims based upon or arising in connection with prior assignments or purported assignments or transfers of any claims or matters released herein.

6. Fee. In consideration for Bank entering into this Amendment, Borrower shall pay Bank a fee in the mutually agreed amount of \$175,000.00, which fee shall be earned in full and payable concurrently with the execution and delivery of this Amendment. Such fee shall be non-refundable and in addition to all interest and other fees payable to Bank under the Loan Documents. Bank is authorized to charge such fee to Borrower's loan account.

7. Bank Expenses. Borrower shall pay to Bank, when due, all Bank Expenses (including reasonable attorneys' fees and expenses), when due, incurred in connection with or pursuant to this Amendment.

8. Counterparts. This Amendment may be executed in any number of counterparts and all of such counterparts taken together shall be deemed to constitute one and the same instrument.

9. Effectiveness; Conditions Precedent to Initial Credit Extension on or after the March 2011 Amendment Date. This Amendment shall be deemed effective upon the due execution and delivery by each party hereto to Bank of this Amendment. Bank's obligation to make the initial Credit Extension on or after the March 2011 Amendment Date is subject to the condition precedent that Bank shall have received, in form and substance satisfactory to Bank, the following documents, duly executed and in full force and effect:

(a) the updated Exim Borrower Agreement (including the Economic Impact Certification, attached both as Annex B to the Exim Borrower Agreement and as Annex E to the Master Guaranty Agreement comprising the Exim Guaranty); it being acknowledged and agreed that such updated Exim Borrower Agreement, when executed and delivered, amends and restates (and is in identical form to) the prior Exim Borrower Agreement dated as of March 15, 2010.

10. Post-March 2011 Amendment Date Delivery Requirement. In order to induce Bank to execute and deliver this Amendment without prior or concurrent receipt of the following documents, Borrower and Guarantor hereby covenant and agree to deliver to Bank, as soon as practicable but in any event no later than 60 days following the March 2011 Amendment Date, the following documents, duly executed and in full force and effect:

(a) the completed updated Borrowing Resolutions for Borrower, and the completed updated certified resolutions and incumbency certificate of Guarantor, in each case in form and substance substantially identical to such documents executed and delivered by Borrower and Guarantor, respectively, in March 2010.

[Remainder of page intentionally left blank; signature page immediately follows.]

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed and delivered as of the date first written above.

BANK:

Silicon Valley Bank

By /s/ Mike Meier
Name Mike Meier
Title Relationship Manager

BORROWER:

ZTI MERGER SUBSIDIARY III, INC., a
Delaware corporation

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

ZHONE TECHNOLOGIES, INC., a
Delaware corporation

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Signature Page

CONSENT

Each of the undersigned hereby expressly agrees to Sections 5 and 10 of the foregoing Amendment and acknowledges that its consent to the rest of the foregoing Amendment is not required, but the undersigned nevertheless does hereby agree and consent to the entire foregoing Amendment and to the documents and agreements referred to therein and to all future modifications and amendments thereto, and any termination thereof, and to any and all other present and future documents and agreements between or among the foregoing parties. Nothing herein shall in any way limit any of the terms or provisions of the Guaranty, the Guarantor Security Agreement, or any other Loan Documents, executed by the undersigned, all of which are hereby ratified and affirmed.

GUARANTOR:

Paradyne Corporation

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Premisys Communications, Inc.

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Zhone Technologies International, Inc.

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Paradyne Networks, Inc.

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

Xybridge Technologies, Inc.

By /s/ Kirk Misaka
Name Kirk Misaka
Title Chief Financial Officer

LIST OF SUBSIDIARIES

<u>Subsidiary</u>	<u>State or Other Jurisdiction of Incorporation or Organization</u>
Ark Electronic Products, Inc.	Florida
Astarte Fiber Networks, Inc.	Colorado
Osicom Technologies Europe Limited	United Kingdom
Paradyne Canada, LTD	Canada
Paradyne Corporation	Delaware
Paradyne Finance Corp.	Delaware
Paradyne Networks, Inc.	Delaware
Paradyne Worldwide Corporation	Delaware
Premisys Communications, Inc.	Delaware
Premisys Communications Ltd.	United Kingdom
R-Net International, Inc.	Nevada
Sciteq Communications, Inc.	Nevada
Zhone Holdings, Inc.	Delaware
Sorrento Networks Europe SA	Belgium
Xybridge Technologies, Inc.	Texas
Zhone AB	Sweden
Zhone International Ltd.	Cayman Islands
Zhone International Limited	UK
Zhone Technologies B.V.	Netherlands
Zhone Technologies Campus, LLC	California
Zhone Technologies De Argentina SRL	Argentina
Zhone Technologies de Colombia Limitada	Colombia
Zhone Technologies do Brasil LTDA	Brazil
Zhone Technologies GMBH	Germany
Zhone Technologies, Inc.	Canada
Zhone Technologies International, Inc.	Delaware
Zhone Technologies Limited	Hong Kong
Zhone Technologies Ltd.	United Kingdom
Zhone Technologies Pte. Ltd.	Singapore
Zhone Technologies SA	Republic of South Africa
Zhone Technologies S. de R.L. de C.V.	Mexico
Zhone Technologies S.R.L.	Italy
ZTI Merger Subsidiary III, Inc.	Delaware

Consent of Independent Registered Public Accounting Firm

The Board of Directors
Zhone Technologies, Inc.:

We consent to the incorporation by reference in the registration statements on Form S-3 (Nos. 333-115306 and 333-113320) and in the registration statements on Form S-8 (Nos. 333-165510, 333-158009, 333-155321, 333-149598, 333-141153, 333-134217, 333-132336, 333-128092, 333-123369, 333-117142, 333-110713, 333-98855, 333-88732, 333-83422, 333-73352, and 333-61956) of Zhone Technologies, Inc. (the Company) of our report dated March 15, 2011, with respect to the consolidated balance sheets of Zhone Technologies, Inc. and subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2010, which report appears in the December 31, 2010 annual report on Form 10-K of the Company.

/s/ KPMG LLP

San Francisco, California
March 15, 2011

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

I, Morteza Ejabat, certify that:

1. I have reviewed this Annual Report on Form 10-K 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: March 15, 2011

/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 Annual Report on Form 10-K 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: March 15, 2011

/s/ KIRK MISAKA

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 Annual Report on Form 10-K for the fiscal year ended December 31, 2010 (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: March 15, 2011

/s/ MORTEZA EJABAT

Morteza Ejabat
Chief Executive Officer

/s/ KIRK MISAKA

Kirk Misaka
Chief Financial Officer