INFINERA CORP
Form 10-Q
November 02, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 25, 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: 001-33486

Infinera Corporation

(Exact name of registrant as specified in its charter)

Delaware	**77-0560433**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification No.)**

169 Java Drive

Sunnyvale, CA 94089

(Address of principal executive offices, including zip code)

(408) 572-5200

(Registrant s telephone number, including area code)

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

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

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

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of October 29, 2010, 101,231,836 shares of the registrant s Common Stock, $0.001 par value, were issued and outstanding.

INFINERA CORPORATION

QUARTERLY REPORT ON FORM 10-Q

FOR THE FISCAL QUARTER ENDED SEPTEMBER 25, 2010

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PART I. FINANCIAL INFORMATION

Item 1. ***Condensed Consolidated Financial Statements***

INFINERA CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

(Unaudited)

	September 25, 2010	December 26, 2009[1]
ASSETS		
Current assets:		
Cash and cash equivalents	$ 97,976	$ 109,859
Short-term investments	174,940	143,350
Short-term restricted cash	1,856	1,533
Accounts receivable	64,058	69,483
Other receivables	3,221	927
Inventories, net	88,694	68,872
Deferred inventory costs	6,940	5,891
Prepaid expenses and other current assets	11,068	8,313
Total current assets	448,753	408,228
Property, plant and equipment, net	47,134	43,656
Deferred inventory costs, non-current	3,141	4,438
Long-term investments	11,118	18,255
Cost-method investment	4,500	
Long-term restricted cash	2,219	2,480
Deferred tax asset	7,649	12,449
Other non-current assets	2,215	2,439
Total assets	$ 526,729	$ 491,945
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 45,880	$ 31,129
Accrued expenses	17,088	13,929
Accrued compensation and related benefits	18,031	19,248
Accrued warranty	5,560	6,091
Deferred revenue	18,386	18,295
Deferred tax liability	7,649	12,649
Total current liabilities	112,594	101,341
Accrued warranty, non-current	5,364	5,049
Deferred revenue, non-current	4,714	8,080
Other long-term liabilities	5,749	8,968

Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.001 par value Authorized shares 25,000 and no shares issued and outstanding		
Common stock, $0.001 par value Authorized shares 500,000 as of September 25, 2010 and December 26, 2009 Issued and outstanding shares 100,960 as of September 25, 2010 and 96,874 as of December 26, 2009	101	97
Additional paid-in capital	801,766	747,580
Accumulated other comprehensive loss	(1,007)	(1,810)
Accumulated deficit	(402,552)	(377,360)
Total stockholders equity	398,308	368,507
Total liabilities and stockholders equity	$ 526,729	$ 491,945

(1) Derived from consolidated financial statements

The accompanying notes are an integral part of these condensed consolidated financial statements.

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INFINERA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(Unaudited)

	Three Months Ended September 25, 2010	Three Months Ended September 26, 2009	Nine Months Ended September 25, 2010	Nine Months Ended September 26, 2009
Revenue:				
Product	$ 115,121	$ 73,690	$ 299,323	$ 193,912
Ratable product and related support and services	1,460	892	4,738	3,206
Services	13,480	8,826	33,158	21,802
Total revenue	130,061	83,408	337,219	218,920
Cost of revenue:				
Cost of product	58,552	47,473	171,660	137,037
Cost of ratable product and related support and services	874	444	2,558	1,532
Cost of services	6,223	5,049	14,285	9,681
Restructuring costs (credit) related to cost of revenue	(60)	2,736	(182)	2,736
Total cost of revenue	65,589	55,702	188,321	150,986
Gross profit	64,472	27,706	148,898	67,934
Operating expenses:				
Research and development	29,886	23,611	87,292	70,445
Sales and marketing	14,847	12,364	41,566	34,945
General and administrative	15,609	10,373	45,794	31,978
Restructuring and other costs		601	159	601
Total operating expenses	60,342	46,949	174,811	137,969
Income (loss) from operations	4,130	(19,243)	(25,913)	(70,035)
Other income (expense), net:				
Interest income	283	441	1,093	1,956
Total other-than-temporary impairment losses				(2,747)
Portion of loss recognized in other comprehensive loss		(161)		1,653
Net credit impairment losses recognized in earnings		(161)		(1,094)
Other gain (loss), net	172	870	(352)	(138)
Total other income (expense), net	455	1,150	741	724
Income (loss) before income taxes	4,585	(18,093)	(25,172)	(69,311)
Provision for (benefit from) income taxes	225	(1,561)	20	(1,340)
Net income (loss)	$ 4,360	$ (16,532)	$ (25,192)	$ (67,971)

Net income (loss) per common share								
Basic	$	0.04	$	(0.17)	$	(0.26)	$	(0.71)
Diluted	$	0.04	$	(0.17)	$	(0.26)	$	(0.71)
Weighted average shares used in computing net income (loss) per common share								
Basic		99,976		95,864		98,647		95,100
Diluted		105,159		95,864		98,647		95,100

The accompanying notes are an integral part of these condensed consolidated financial statements.

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INFINERA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended	
	September 25, 2010	September 26, 2009
Cash Flows from Operating Activities:		
Net loss	$ (25,192)	$ (67,971)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	11,594	12,064
Non-cash restructuring and other costs	100	2,404
Net credit impairment losses in earnings		1,094
Amortization of premium on investments	2,753	289
Stock-based compensation expense	39,961	25,733
Unrealized loss on Put Rights	1,696	2,540
Unrealized holding gain for trading securities	(1,696)	(3,141)
Non-cash tax benefit	(411)	
Tax benefit (reversal) from stock option transactions		(593)
Reduction of tax benefit from stock option transactions		248
Gain on disposal of assets	(139)	(117)
Other gain	(71)	(113)
Changes in assets and liabilities:		
Accounts receivable	5,425	15,324
Other receivables	(430)	(1,105)
Inventories, net	(19,787)	(12,728)
Prepaid expenses and other current assets	21	(2,331)
Deferred inventory costs	114	21
Other non-current assets	4,911	(4,795)
Accounts payable	15,024	(1,875)
Accrued liabilities and other expenses	(6,856)	8,749
Deferred revenue	(3,275)	(3,922)
Accrued warranty	(215)	197
Net cash provided by (used in) operating activities	23,527	(30,028)
Cash Flows from Investing Activities:		
Purchase of available-for-sale investments	(212,307)	(136,338)
Purchase of cost-method investment	(4,500)	
Proceeds from sale of available-for-sale investments		1,536
Proceeds from maturities and calls of investments, and exercise of Put Rights	184,662	93,157
Proceeds from disposal of assets	284	206
Purchase of property and equipment	(15,639)	(11,599)
Change in restricted cash	(61)	(1,148)
Net cash used in investing activities	(47,561)	(54,186)
Cash Flows from Financing Activities:		
Proceeds from issuance of common stock	12,341	8,545
Reduction of tax benefit from stock option transactions		(248)
Repurchase of common stock	(14)	(19)
Payments for purchase of assets under financing arrangement	(262)	

Net cash provided by financing activities	12,065	8,278
Effect of exchange rate changes on cash	86	111
Net change in cash and cash equivalents	(11,883)	(75,825)
Cash and cash equivalents at beginning of period	109,859	166,770
Cash and cash equivalents at end of period	$ 97,976	$ 90,945
Supplemental disclosures of cash flow information:		
Cash paid for income taxes	$ 882	$ 1,245

The accompanying notes are an integral part of these condensed consolidated financial statements.

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INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The Company prepared its interim condensed consolidated financial statements that accompany these notes in conformity with U.S. generally accepted accounting principles (U.S. GAAP) and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the SEC), consistent in all material respects with those applied in the Company s Annual Report on Form 10-K for the fiscal year ended December 26, 2009.

The Company has made estimates and judgments affecting the amounts reported in its condensed consolidated financial statements and the accompanying notes. The Company s actual results may differ materially from these estimates. The accounting estimates that require most significant, difficult, and subjective judgment include revenue recognition, stock-based compensation, inventory valuation, allowances for doubtful accounts, accrued warranty, fair value measurement of investments, cash equivalents, derivative instruments, other-than-temporary impairments related to investments and accounting for income taxes.

The interim financial information is unaudited, but reflects all normal adjustments that are, in management s opinion, necessary to provide a fair statement of results for the interim periods presented. The Company reclassified certain amounts reported in previous periods to conform to the current presentation. This interim information should be read in conjunction with the consolidated financial statements in the Company s Annual Report on Form 10-K for the fiscal year ended December 26, 2009.

2. Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2010-06 (ASU 2010-06), Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements. ASU 2010-06 requires an entity to disclose separately the amounts of significant transfers in and out of Level I and II fair value measurements, and describe the reasons for the transfers. Also, it requires additional disclosure regarding purchases, sales, issuances and settlements of Level III measurements. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for the additional disclosure of Level III measurements, which is effective for fiscal years beginning after December 15, 2010. Effective in the first quarter of 2010, the Company adopted the provisions of ASU 2010-06 which resulted in the enhancement of certain disclosures but did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

FASB ASU 2009-13 updates the existing guidance on accounting for multiple-element revenue arrangements. Specifically, this guidance expands the criteria in Subtopic 605-25, Revenue Recognition-Multiple-Element Arrangements, for when individual deliverables within a multiple-element arrangement may be treated as separate units of accounting. In addition, the guidance modifies the manner in which the transaction consideration is allocated across the separately identified deliverables or units of accounting by no longer permitting the residual method of allocating arrangement consideration. This standard will be effective for the first annual period beginning on or after June 15, 2010 and may be applied retrospectively, for all periods presented or prospectively, with early adoption permitted. Effective for the first quarter of 2010, the Company elected to early adopt ASU 2009-13 with prospective application. See Note 3, Summary of Significant Accounting Policies, to the Notes to Condensed Consolidated Financial Statements for further discussion of the impact of the early adoption of this standard on the Company s consolidated financial position, results of operations or cash flows.

FASB ASU 2009-14 significantly changes the accounting for revenue arrangements that include both tangible product and software elements. This new standard amends the scope of pre-existing software revenue guidance by excluding non-software components of software-reliant tangible products in addition to software products bundled with tangible products where the software components and non-software components function together to deliver the products essential functionality. This standard will be effective for the first annual period beginning on or after June 15, 2010 and may be applied retrospectively, for all periods presented or prospectively, with early adoption permitted. Effective for the first quarter of 2010, the Company elected to early adopt ASU 2009-14 with prospective application. See Note 3, Summary of Significant Accounting Policies, to the Notes to Condensed Consolidated Financial Statements for further discussion of the impact of the early adoption of this standard on the Company s consolidated financial position, results of operations or cash flows.

INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Summary of Significant Accounting Policies

There have been no material changes in the Company s significant accounting policies for the nine months ended September 25, 2010 as compared to those disclosed in the Company s Annual Report on Form 10-K for the fiscal year ended December 26, 2009, except for changes in the accounting for revenue recognition as a result of new accounting standards and updates to the Company s derivative instruments policy to include cash flow hedges as described below.

Revenue Recognition

In October 2009, the FASB amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of industry specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple deliverable revenue arrangements to:

- provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
- require an entity to allocate revenue in an arrangement using estimated selling price (ESP) of deliverables if a vendor does not have vendor-specific objective evidence (VSOE) of selling price or third-party evidence (TPE) of selling price; and
- eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

The Company elected to early adopt this accounting guidance at the beginning of its first quarter of 2010 on a prospective basis for applicable transactions entered into or materially modified after December 26, 2009.

In connection with its adoption of these standards, the Company re-evaluated the appropriate revenue recognition treatment of its products and determined that the majority of its products, which have both software and non-software components that function together to deliver the products essential functionality, are scoped out of the previous software specific revenue recognition guidance.

Substantially all of the Company s product sales are sold in combination with software support services comprised of either software warranty or software subscription services. The Company also periodically sells training, installation and deployment services, spares management and on-site hardware replacement services with its product sales. Training services include the right to a specified number of training classes and installation and deployment services may include customer site assessments, equipment installation and testing. Training and installation and deployment services are generally delivered over a 90-120 day period. Software warranty provides customers with maintenance releases and patches during the warranty support period. Software subscription also includes maintenance releases and patches and provides customers with rights to receive unspecified software product upgrades released during the support period. These support services are generally delivered over a one-year period. Spares management and on-site hardware replacement services include the replacement of defective units at customer sites in accordance with specified service level agreements and are generally delivered over a one-year period.

The Company recognizes product revenue when all of the following have occurred: (1) it has entered into a legally binding arrangement with the customer; (2) delivery has occurred, which is when product title and risk of loss have transferred to the customer; (3) customer payment is deemed fixed and determinable; and (4) collectability is reasonably assured.

The Company allocates revenue to each element in its multiple-element arrangements based upon their relative selling prices. The Company determines the selling price for each deliverable based on a selling price hierarchy. The selling price for a deliverable is based on its VSOE if available, TPE if VSOE is not available, or ESP if neither VSOE nor TPE is available. Revenue allocated to each element is then recognized when the basic revenue recognition criteria for that element has been met.

VSOE of selling price is used in the selling price allocation in all instances where it exists. VSOE of selling price for products and services is determined when a substantial majority of the selling prices fall within a reasonable range when sold separately. In certain instances, the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements. This mainly occurs where insufficient standalone sales transactions have occurred or where pricing for that element has not been consistent.

TPE of selling price can be established by evaluating largely interchangeable competitor products or services in standalone sales to similarly situated customers. As the Company s products contain a significant element of proprietary technology and the solution offered differs substantially from that of competitors, it is typically difficult to obtain the reliable standalone competitive pricing necessary to establish TPE.

ESP represents the best estimate of the price at which the Company would transact a sale if the product or service was sold on a standalone basis. The Company determines ESP for a product or service by considering multiple factors including, but not limited to

INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

customer type, geography, market conditions, competitive landscape, gross margin objectives and pricing practices. The determination of ESP is made through formal approval by the Company s management, taking into consideration the overall go-to-market pricing strategy.

As the Company s go-to-market strategies evolve, the Company may modify its pricing practices in the future, which could result in changes in selling prices, including both VSOE and ESP. As a result, the Company s future revenue recognition for multiple element arrangements could differ materially from that recorded in the current period. The Company regularly reviews VSOE, TPE and ESP and maintains internal controls over the establishment and update of these inputs.

The Company limits the amount of revenue recognition for delivered elements to the amount that is not contingent on the future delivery of products or services, future performance obligations or subject to customer-specified return or refund privileges. The Company evaluates each deliverable in an arrangement to determine whether they represent separate units of accounting. Under the new revenue recognition guidance, more of the Company s products and services qualify as separate units of accounting based on the selling price hierarchy for determination of relative selling price.

The Company s adoption of the new accounting guidance for revenue recognition resulted in an increase in total revenues of $15.2 million, from $114.9 million to $130.1 million, and $22.0 million, from $315.2 million to $337.2 million in the three and nine months ended September 25, 2010, respectively. In addition, the new accounting guidance for revenue recognition resulted in an increase in net income of $7.3 million, from a net loss of $2.9 million to net income of $4.4 million, and a decrease of net loss of $10.0 million, from $35.2 million to $25.2 million in the three and nine months ended September 25, 2010, respectively.

These increases in revenues are primarily related to an increase in net product revenues from bundled arrangements which would have previously been deferred until all deliverables had been completed or recognized ratably over the longest undelivered service period as VSOE of selling price had not been established for the undelivered element. In addition, the Company recognized product revenue on a number of purchase orders which had been partially shipped at the end of the first, second and third quarters of 2010. The impact of the new revenue recognition guidance in future periods will depend on the number of bundled arrangements entered into by the Company with undelivered elements for which VSOE of selling price had not been established under the existing software revenue recognition guidance.

The Company has a limited number of software offerings which are not required to deliver the tangible product s essential functionality and can be sold separately. Revenue from sales of these software products and related post-contract support will continue to be accounted for under software revenue recognition rules. The Company s multiple-element arrangements may therefore have a software deliverable that is subject to the existing software revenue recognition guidance. The revenue for these multiple-element arrangements is allocated to the software deliverable and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy in the new revenue recognition accounting guidance. Revenues related to these software offerings are not expected to be material.

Revenue arrangements entered into prior to the first quarter of 2010 continue to be accounted for under the Company s previous revenue recognition policy.

Services revenue includes software subscription services, training, installation and deployment services, spares management, on-site hardware replacement services and extended hardware warranty services. Revenue from software subscription, spares management, on-site hardware replacement services and extended hardware warranty contracts is deferred and is recognized ratably over the contractual support period, which is generally one year. Revenue related to training and installation and deployment services is recognized as the services are completed.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. In addition, shipping documents and customer acceptances, when applicable, are used to verify delivery and transfer of title. Revenue is recognized only when title and risk of loss pass to customers. In instances where acceptance of the product occurs upon formal written acceptance, revenue is deferred until such written acceptance has been received. The Company assesses whether the fee is fixed or determinable based on the payment terms associated with the transaction. Payment terms to customers generally range from net 30 to 120 days from invoice, which are considered to be standard payment terms. However, payment terms greater than 120 days but less than or equal to one year from invoice may be considered standard if payment is supported by an irrevocable commercial letter of credit (LOC) issued by a creditworthy bank or the LOC has been accepted and confirmed by a creditworthy bank. In the event payment terms are provided that differ from the Company s standard business practices, the fees are deemed to not be fixed or determinable and, therefore, revenue is not recognized until the fees become fixed or determinable which the Company believes is when they are legally due and payable. The Company assesses its ability to collect from its customers based primarily on the creditworthiness and past payment history of the customer.

INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For sales to resellers, the same revenue recognition criteria apply. It is the Company s practice to identify an end-user prior to shipment to a reseller. The Company does not offer rights of return or price protection to its resellers.

Shipping charges billed to customers are included in product revenue and related shipping costs are included in product cost. The Company reports revenue net of any required taxes collected from customers and remitted to government authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

Derivative Instruments

The Company is exposed to foreign currency exchange rate fluctuations in the normal course of its business. As part of its risk management strategy, the Company uses derivative instruments, specifically forward contracts, to reduce the impact of foreign exchange fluctuations on earnings. The forward contracts are with one high-quality institution and the Company monitors the creditworthiness of the counter party consistently. The Company s objective is to offset gains and losses resulting from these exposures with losses and gains on the derivative contracts used to hedge them, thereby reducing volatility of earnings or protecting fair values of assets. None of the Company s derivative instruments contain credit-risk related contingent features, any rights to reclaim cash collateral or any obligation to return cash collateral. The Company does not have any leveraged derivatives. The Company does not use derivative contracts for trading or speculative purposes.

The Company enters into foreign currency exchange forward contracts to manage its exposure to fluctuations in foreign exchange rates that arise primarily from its Euro denominated receivables. Gains and losses on these contracts are intended to offset the impact of foreign exchange rate changes on the underlying foreign currency denominated accounts receivable, and therefore, do not subject the Company to material balance sheet risk. As of September 25, 2010, the Company did not designate foreign currency exchange forward contracts related to Euro denominated receivables as hedges for accounting purposes.

The Company also uses foreign currency exchange forward contracts to hedge exposures related to forecasted sales denominated in Euro. These contracts are designated as cash flow hedges and match the underlying forecasted transactions in duration. The contracts are carried on the balance sheet at fair value, and the effective portion of the contracts gains and losses is recorded as Accumulated other comprehensive loss until the forecasted transaction occurs. For foreign currency exchange forward contracts designated as cash flow hedges, the Company evaluates and calculates the effectiveness of each hedge quarterly, using the critical terms match method. When the forecasted transaction occurs, the Company reclassifies the related gain or loss on the cash flow hedge to revenue. If the underlying forecasted transactions do not occur, or it becomes probable that they will not occur, the gain or loss on the related cash flow hedge is recognized immediately in earnings.

Concentration of Credit Risk

Financial instruments that are potentially subject to concentrations of credit risk consist primarily of cash equivalents, short-term investments, long-term investments, cost-method investments and accounts receivable. Investment policies have been implemented that limit investments to investment-grade securities.

As of September 25, 2010, the Company held $9.1 million (par value) of investments comprised of auction rate securities (ARS), which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7 to 35 days. These securities have historically traded at par value and are callable at par value at the option of the issuer. Interest is typically paid at the end of each auction period or semiannually. Since February 2008, most of the auctions for these ARS have failed and there is no assurance that future auctions will succeed. As a result, the Company s ability to liquidate its investment in the near term may be limited. These ARS were purchased from a single broker, who to date, has not offered to repurchase these ARS from the Company. Of these ARS, $5.0 million and $4.1 million (par value) are AAA and A3 rated, respectively, and are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. During the three and nine months ended September 25, 2010, $0.2 million and $0.6 million of these ARS (par value), respectively, were called at par value. It is not clear when the Company will be able to liquidate these investments.

On June 30, 2010, the Company elected to sell back to UBS Financial Service, Inc. (UBS), $24.5 million (par value), of ARS, and received net cash proceeds of $24.5 million, equal to the par value for its UBS ARS. This completes the full recovery of par value for these UBS ARS. As of September 25, 2010, the Company held ARS with a par value of $9.1 million.

See Note 4, Fair Value Measurements and Other-Than-Temporary Impairments, to the Notes to Condensed Consolidated Financial Statements for more information.

In May 2010, the Company invested $4.5 million in a privately-held company. This investment has been accounted for as a cost-basis investment, as the Company owns less than 20% of the voting securities and does not have the ability to exercise significant

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INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

influence over operating and financial policies of the entity. See Note 5, Cost-method Investment, to the Notes to Condensed Consolidated Financial Statements for more information.

The risk with respect to accounts receivable is mitigated by ongoing credit evaluations that the Company performs on its customers. As the Company expands its sales internationally, it may experience increased levels of customer credit risk associated with those regions. Collateral is generally not required for accounts receivable but may be used in the future to mitigate credit risk associated with customers located in certain geographical regions.

The following customers represented more than 10% of the Company s total revenue for the periods presented:

	Three Months Ended		Nine Months Ended	
	September 25, 2010	September 26, 2009	September 25, 2010	September 26, 2009
Level 3 Communications	19%	10%	17%	19%
Customer A	11%	<10%	10%	<10%
Customer B	<10%	15%	<10%	10%
Customer C	<10%	15%	<10%	<10%
Customer D	<10%	11%	<10%	<10%

In July 2009, the Company was informed by Level 3 Communications (Level 3) that they intended to use another dense wavelength division multiplexing (DWDM) vendor in their network. The Company believes that this vendor may ultimately be given a significant portion of Level 3 s new network deployments. This change may impact the revenue the Company receives from Level 3 in the future, although the Company cannot predict the timing of such impact.

As of September 25, 2010, the Company had amounts due from two customers that represented approximately 16% and 13% of the Company s accounts receivable balance. As of December 26, 2009, the Company had amounts due from two customers that represented approximately 21% and 13% of the Company s accounts receivable balance.

The Company depends on a single or limited number of suppliers for components and raw materials. The Company generally purchases these single or limited source components and materials through standard purchase orders and does not have long-term contracts with many of these limited-source suppliers. While the Company seeks to maintain sufficient reserve stock of such components and materials, the Company s business and results of operations could be adversely affected by a stoppage or delay in receiving such components and materials, the receipt of defective parts, an increase in the price of such components and materials or the Company s inability to obtain reduced pricing from its suppliers in response to competitive pressures.

4. Fair Value Measurements and Other-Than-Temporary Impairments

Fair Value Measurements

Pursuant to the accounting guidance for fair value measurements and its subsequent updates, fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and it considers assumptions that market participants would use when pricing the asset or liability.

Valuation techniques used by the Company are based upon observable and unobservable inputs. Observable or market inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company s assumptions about market participant assumptions based on best information available. Observable inputs are the preferred source of values. These two types of inputs create the following fair value hierarchy:

Level I	Quoted prices in active markets for identical assets or liabilities.
Level II	Inputs other than Level I that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. In addition, Level II could include unobservable inputs that are not significant to the fair value of the assets or liabilities.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Level III	Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company measures its cash equivalents, derivative instruments, debt securities and Put Rights at fair value and classifies its securities in accordance with the fair value hierarchy.

The Company s money market funds are classified within Level I of the fair value hierarchy and are valued based on quoted prices in active markets for identical securities.

The Company classifies its certificates of deposit, commercial paper, corporate bonds, U.S. agency notes and derivative instruments within Level II of the fair value hierarchy as follows:

Certificates of Deposit

The Company reviews market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day. In the absence of any observable market transactions for a particular security, the fair market value at period end would be equal to the par value. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.

Commercial Paper

The Company reviews market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day and then follows a revised accretion schedule to determine the fair market value at period end. In the absence of any observable market transactions for a particular security, the fair market value at period end is derived by accreting from the last observable market price. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data accreted mathematically to par, and result in the classification of these securities as Level II of the fair value hierarchy.

Corporate Bonds

The Company reviews trading activity and pricing for each of the corporate bond securities in its portfolio as of the measurement date and determines if pricing data of sufficient frequency and volume in an active market exists in order to support Level I classification of these securities. Since sufficient quoted pricing for identical securities is not available, the Company obtains market pricing and other observable market inputs for similar securities from a number of industry standard data providers. In instances where multiple prices exist for similar securities, these prices are used as inputs into a distribution-curve to determine the fair market value at period end. As a result, the Company classifies its corporate bonds as Level II of the fair value hierarchy.

U.S. Agency Notes

The Company reviews trading activity and pricing for its U.S. agency notes as of the measurement date. When sufficient quoted pricing for identical securities is not available, the Company uses market pricing and other observable market inputs for similar securities obtained from a number of industry standard data providers. These inputs represent quoted prices for similar assets in active markets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.

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Derivative Instruments

As discussed in Note 6, Derivative Instruments, to the Notes to Condensed Consolidated Financial Statements, the Company mainly holds non-speculative foreign exchange forward contracts to hedge certain foreign currency exchange exposures. The Company estimates the fair values of derivatives based on quoted market prices or pricing models using current market rates. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, credit risk, foreign exchange rates, and forward and spot prices for currencies. As a result, the Company classifies its derivative instruments as Level II of the fair value hierarchy.

Auction Rate Securities

The Company s ARS are classified within Level III because they are valued, in part, by using inputs that are unobservable in the market and are significant to the valuation. The recent uncertainties in the credit markets have affected all of the Company s ARS and auctions for these securities have failed to settle on their respective settlement dates. In light of these developments, to determine the fair value for the Company s ARS, the Company used a combination of the market approach and income approach. The market approach uses pricing based on transactions in an inactive secondary market for similar or comparable securities. In addition, the Company performed its own discounted cash flow analysis. Management determined that it was most appropriate to value the ARS using the market approach and income approach equally given the facts and circumstances as of September 25, 2010, and therefore incorporated both valuations in the Company s fair value measurement.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the Company s ARS, as of September 25, 2010, are as follows:

Contractual cash flow

The model assumed that the principal amount or par value for these securities will be repaid at the end of the estimated workout period. In addition, future interest payments were estimated as described in each individual prospectus and based on the then-current U.S. Treasury Bill rate adjusted for a failed auction premium of 150 basis points (bps) for A3 rated securities and 150 bps to 350 bps for AAA rated securities.

ARS discount rate

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the estimated workout period of the securities. As of the measurement date, these rates were then adjusted by a factor that ranged from 230 bps to 400 bps, representing an estimate of the market student loan spread and a discount factor to reflect the lack of liquidity and credit risk associated with these securities. The Company held $5.0 million par value of AAA rated securities and $4.1 million par value of ARS that were downgraded to A3 rating during 2009. The Company s ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. The discount rate does, however, include a discount factor to reflect the issuer s credit risk and its potential inability to perform its obligations under the terms of the ARS agreements. The Company s valuation analysis indicates that the estimated credit risk element included in the discount rate was 210 bps for A3 rated securities and 340 bps for AAA rated securities.

Estimated maturity

The Company estimated the workout period of its ARS as the weighted-average life of the underlying trust loan portfolio where this information was available from servicing and other trust reports. In a small number of instances where this information was not available, the Company used the weighted-average life of the loan portfolio of a similar trust. The estimated time to maturity of the securities as of the measurement date was

15.5 years and 17.5 years.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following tables represent the Company s fair value hierarchy for its assets and liabilities measured at fair value on a recurring basis:

	As of September 25, 2010 (In thousands)			
	Level I	Level II	Level III	Total
Assets				
Money market funds	$ 38,050	$	$	$ 38,050
Certificates of deposit		720		720
Commercial paper		66,998		66,998
Corporate bonds		119,450		119,450
ARS available-for-sale			7,987	7,987
Derivatives		222		222
Total Assets	$ 38,050	$ 187,390	$ 7,987	$ 233,427
Liabilities				
Derivatives	$	$ 140	$	$ 140
Total Liabilities	$	$ 140	$	$ 140

	As of December 26, 2009 (In thousands)			
	Level I	Level II	Level III	Total
Money market funds	$ 69,691	$	$	$ 69,691
Certificates of deposit		720		720
Commercial paper		33,435		33,435
Corporate bonds		42,410		42,410
U.S. agency notes		31,915		31,915
ARS available-for-sale			7,671	7,671
ARS trading securities			49,911	49,911
Put Rights			10,864	10,864
Total Assets	$ 69,691	$ 108,480	$ 68,446	$ 246,617

During the three and nine months ended September 25, 2010, there were no transfers of assets or liabilities between Level I and Level II and there were no transfers into or out of Level III financial assets. The following table presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable (Level III) inputs for the three and nine months ended September 25, 2010 and September 26, 2009:

Three Months Ended

Calls

	June 26, 2010	Total Net Gains Included In Other Comprehensive Loss		September 25, 2010
		(In thousands)		
ARS available-for-sale	$ 7,709	$ 436(1)	$ (158)(2)	$ 7,987
ARS trading securities	20,284		(20,284)(2)	
Put Rights	4,216		(4,216)(2)	
Total	$ 32,209	$ 436	$ (24,658)	$ 7,987

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INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

		Nine Months Ended Total Net Gains Included In			
	December 26, 2009	Other Income (Expense), Net	Other Comprehensive Loss	Calls	September 25, 2010
			(In thousands)		
ARS available-for-sale	$ 7,671	$	$ 789[1]	$ (473)[2]	$ 7,987
ARS trading securities	49,911	1,696[3]		(51,607)[2]	
Put Rights	10,864	(1,696)[4]		(9,168)[2]	
Total	$ 68,446	$	$ 789	$ (61,248)	$ 7,987

(1) Amount represents the change in the non-credit loss related OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.

(2) Amount represents the fair market value of the securities called and the related Put Rights. Realized gains on these calls for the three and nine months ended September 25, 2010 were immaterial.

(3) Unrealized holding gains for ARS trading securities were included in Other gain (loss), net in the accompanying condensed consolidated statements of operations.

(4) Amount represents the decrease in the fair value of the Put Rights recorded as Other gain (loss), net in the accompanying condensed consolidated statements of operations.

		Three Months Ended Total Net Gains (Losses) Included In			
	June 27, 2009	Other Income (Expense), Net	Other Comprehensive Loss	Calls	September 26, 2009
			(In thousands)		
ARS available-for-sale	$ 7,203	$ (161)[1]	$ 516[2]	$ (135)[5]	$ 7,423
ARS trading securities	50,311	1,619[3]		(3,259)[5]	48,671
Put Rights	14,317	(991)[4]		(1,177)[5]	12,149
Total	$ 71,831	$ 467	$ 516	$ (4,571)	$ 68,243

		Nine Months Ended Total Net Gains (Losses) Included In			
	December 27, 2008	Other Income (Expense), Net	Other Comprehensive Loss	Calls	September 26, 2009

	(In thousands)				
ARS available-for-sale	$ 7,361	$ (1,094)(1)	$ 1,341(6)	$ (185)(5)	$ 7,423
ARS trading securities	48,888	3,141(3)		(3,358)(5)	48,671
Put Rights	15,866	(2,540)(4)		(1,177)(5)	12,149
Total	$ 72,115	$ (493)	$ 1,341	$ (4,720)	$ 68,243

(1) Amount represents the credit loss related OTTI recorded as a component of Other income (expense), net in the accompanying condensed consolidated statements of operations.

(2) Amount represents the non-credit loss related to OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.

(3) Amount represents the increase in the fair value of the ARS trading securities recorded as Other gain (loss), net in the accompanying condensed consolidated statements of operations.

(4) Amount represents the decrease in the fair value of the Put Rights recorded as Other gain (loss), net in the accompanying condensed consolidated statements of operations.

(5) Amount represents the fair market value of the securities called and the related Put Rights. Realized gains on these calls for the three and nine months ended September 26, 2009 were immaterial.

(6) For the nine months ended September 26, 2009, the amount includes the reversal of $2.6 million of an unrealized loss balance as of December 27, 2008 and a $1.3 million non-credit loss related to OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.

INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Investments at fair value as of September 25, 2010 and December 26, 2009 were as follows:

	September 25, 2010				
	Adjusted Amortized Cost	Non-credit OTTI	Gross Unrealized Gains (In thousands)	Gross Unrealized Losses	Estimated Fair Value
Money market funds	$ 38,050	$	$	$	$ 38,050
Certificates of deposit	720				720
Commercial paper	67,015		5	(21)	66,999
Corporate bonds	119,452		41	(43)	119,450
ARS	8,068[(1)]	(81)			7,987[(3)]
Total available-for-sale investments	$ 233,305	$ (81)	$ 46	$ (64)	$ 233,206

	December 26, 2009				
	Adjusted Amortized Cost	Non-credit OTTI	Gross Unrealized Gains (In thousands)	Gross Unrealized Losses	Estimated Fair Value
Money market funds	$ 69,691	$	$	$	$ 69,691
Certificates of deposit	720				720
Commercial paper	33,436			(1)	33,435
Corporate bonds	42,426		22	(38)	42,410
U.S. agency notes	31,905		10		31,915
ARS	8,594[(2)]	(923)			7,671[(3)]
Total available-for-sale investments	$ 186,772	$ (923)	$ 32	$ (39)	$ 185,842
ARS trading securities	60,775			(10,864)	49,911[(3)]
Put Rights			10,864		10,864
Total investments	$ 247,547	$ (923)	$ 10,896	$ (10,903)	$ 246,617

(1) Amount represents the par value less $1.1 million of credit-related OTTI recognized through earnings as of September 25, 2010.

(2) Amount represents the par value less $1.1 million of credit-related OTTI recognized through earnings as of December 26, 2009.

(3) Amount reflects investments in a continuous loss position for twelve months or longer.

Substantially all of the Company s investments in certificates of deposit, commercial paper, corporate bonds and U.S. agency notes have a contractual maturity term of less than one year, and ARS have contractual maturity terms of up to 35 years. The Company recorded credit-related other-than-temporary impairment (OTTI) for available-for-sale investments in Other income (expense), net beginning in the second quarter of 2009. Proceeds from maturities and calls of investments, and exercise of Put Rights were $184.7 million in the nine months ended September 25, 2010. Proceeds from maturities of available-for-sale investments were $93.2 million in the nine months ended

September 26, 2009. Gross realized gains (losses) on short-term and long-term investments were immaterial for both periods. The specific identification method is used to account for gains and losses on available-for-sale investments.

In October 2008, the Company elected to participate in a rights offering by UBS, which provided the Company with Put Rights to sell back all of its ARS purchased from UBS at par value of $65.7 million, at anytime during a two-year period beginning June 30, 2010. As of June 26, 2010, $41.2 million of the Company s ARS trading securities had been called at par value. On June 30, 2010, the Company elected to exercise the Put Rights and as a result, received net cash proceeds of $24.5 million, representing a full recovery of par value. All related assets and liabilities have been removed from the balance sheet and there was no impact to the Company s condensed consolidated statements of operations.

After this transaction, the Company s ARS portfolio consists of the remaining $9.1 million (par value as of September 25, 2010) of available-for-sale ARS that is not subject to the UBS Put Rights. In 2009, the Company deemed these securities to be OTTI. See the section below titled, Other-Than-Temporary Impairments, for further discussion.

INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other-Than-Temporary Impairments

As of September 25, 2010, the Company held $9.1 million (par value) of available-for-sale ARS with two issuers, one of which is AAA rated and the other of which is A3 rated. These ARS have contractual maturity terms of up to 35 years. During the second quarter of 2009, the Company determined that it did not intend to sell these securities and did not believe that it was more likely than not that it would be required to sell the securities before recovery of their par value. However, given that the present value of the expected cash flows for these securities was below their par value, as of June 27, 2009, an initial OTTI of $2.7 million, equal to the difference between the fair value and the amortized cost basis, had occurred. This OTTI write-down was separated into an amount representing credit loss, which is recognized as Other gain (loss), net in the Company s condensed consolidated statements of operations, and an amount related to all other factors, which is recorded in Accumulated other comprehensive loss in the Company s condensed consolidated balance sheets. In determining if a credit loss had occurred, the Company isolated the credit loss related portion of the discount rate used to derive the fair market value of the securities and applied this to the expected cash flows in order to determine the portion of the OTTI that was credit loss related. This credit loss related portion of the discount rate is based on the financial condition of the issuer, rating agency credit ratings for the security and credit related yield spreads on similar securities offered by the same issuer.

These ARS had a net increase in fair value of $0.4 million for the three months ended September 25, 2010 and a net increase in fair value of $0.8 million for the nine months ended September 25, 2010. These changes were recognized in Accumulated other comprehensive loss in the Company s condensed consolidated balance sheet. The Company did not recognize any additional OTTI credit loss on any of its securities during the three and nine months ended September 25, 2010.

During the three and nine months ended September 25, 2010, $0.2 million and $0.6 million of these ARS (par value), respectively, were called at par value. The amortized cost basis for these securities was reduced to reflect the calls during the period, resulting in a lower cost basis for these securities of $8.1 million as of September 25, 2010.

A roll-forward of amortized cost, cumulative OTTI recognized in earnings and Accumulated other comprehensive loss is as follows:

	Amortized Cost	Cumulative OTTI in Earnings	Unrealized Gain	OTTI Loss in Accumulated Other Comprehensive Loss	Accumulated Other Comprehensive Loss
			(In thousands)		
Balance at December 26, 2009	$ 8,594	$ (1,057)	$ 569	$ (1,492)	$ (923)
Unrealized gain			789		789
Call on investments	(526)	75		53	53
Balance at September 25, 2010	$ 8,068	$ (982)	$ 1,358	$ (1,439)	$ (81)

The Company believes that the credit risk associated with its available-for-sale ARS could change significantly in the future based on market conditions and continued uncertainties in the financial markets. The ARS student loan credit spread may be subject to significant volatility and it is difficult to predict future fluctuations. A 10% deterioration in the ARS student loan credit spread would result in $0.3 million of additional OTTI credit loss recognized in earnings in the Company s condensed consolidated statements of operations for the third quarter of 2010.

5. Cost-method Investment

In May 2010, the Company invested $4.5 million in a privately-held company. This investment is accounted for as a cost-basis investment, as the Company owns less than 20% of the voting securities and does not have the ability to exercise significant influence over operating and financial policies of the entity. The Company s investment is in an entity that is not publicly traded and, therefore, no established market for the securities exists. The fair value of a cost-method investment is not estimated if there is no identified event or change in circumstances that would have a significant adverse effect on the fair value of the investment. The Company s cost-method investment is carried at historical cost in its condensed consolidated financial statements and measured at fair value on a nonrecurring basis. If the Company believes that the carrying value of the cost basis investment is in excess of estimated fair value, the Company s policy is to record an impairment charge in Other income (expense), net in the accompanying condensed consolidated statements of operations to adjust the carrying value to estimated fair value, when the impairment is deemed other-than-temporary. The Company will regularly evaluate the carrying value of this cost-method investment for impairment. As of September 25, 2010, no event had occurred that would adversely affect the carrying value of this investment. The Company did not record any impairment charges for this cost-method investment during the three and nine months ended September 25, 2010.

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INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments

Foreign Currency Exchange Forward Contracts

The Company enters into foreign currency exchange forward contracts to manage its exposure to fluctuations in foreign exchange rates that arise primarily from its Euro denominated receivables. Gains and losses on these contracts are intended to offset the impact of foreign exchange rate changes on the underlying foreign currency denominated accounts receivable, and therefore, do not subject the Company to material balance sheet risk. The forward contracts are with one high-quality institution and the Company monitors the creditworthiness of the counterparty consistently. The forward contracts entered into during the three months and nine months ended September 25, 2010 were denominated in Euros and typically had maturities of no more than 30 days. The contracts were settled for U.S. dollars at maturity at rates agreed to at inception of the contracts. As of September 25, 2010, the Company did not designate foreign currency exchange forward contracts related to Euro denominated receivables as hedges for accounting purposes, and accordingly changes in the fair value of these instruments are included in Other gain (loss), net in the accompanying condensed consolidated statements of operations. For the three and nine months ended September 25, 2010, the before-tax effect of foreign currency exchange forward contracts not designated as hedging instruments was a loss of $0.7 million and a gain of $0.2 million, respectively, included in Other gain (loss), net in the condensed consolidated statement of operations.

Cash Flow Hedges

The Company uses foreign currency exchange forward contracts to hedge exposures related to forecasted sales denominated in Euro. These contracts are designated as cash flow hedges and match the underlying forecasted transactions in duration. The contracts are carried on the balance sheet at fair value, and the effective portion of the contracts gains and losses is recorded as Accumulated other comprehensive income until the forecasted transaction occurs. For foreign currency exchange forward contracts designated as cash flow hedges, the Company evaluates and calculates the effectiveness of each hedge quarterly, using the critical terms match method. When the forecasted transaction occurs, the Company reclassifies the related gain or loss on the cash flow hedge to revenue. If the underlying forecasted transactions do not occur, or it becomes probable that they will not occur, the gain or loss on the related cash flow hedge is recognized immediately in earnings. During the three and nine months ended September 25, 2010, there were no gains or losses on cash flow hedges recognized in earnings resulting from hedge ineffectiveness.

The before-tax effect of foreign currency forward contracts designated as cash flow hedges was as follows:

	Three Months Ended September 25, 2010	Nine Months Ended September 25, 2010
	(In thousands)	
Gain recognized in total revenue	$	$ 26[1]
Gain (loss) recognized in Accumulated other comprehensive loss	$ (426)	$ 329
Gain reclassed from Accumulated other comprehensive loss to total revenue	$ 44	$ 103

(1) Amount represents gain recognized in total revenue related to forward contracts initiated during the first quarter of 2010.

Over the next twelve months, it is expected that $0.1 million of derivative net gain recorded in Accumulated other comprehensive loss as of September 25, 2010 will be reclassified into earnings as an adjustment to revenues. The maximum length of time over which forecasted foreign denominated revenues are hedged is 36 months.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of derivative instruments in the Company s condensed consolidated balance sheets as of September 25, 2010 was as follows:

	Notional[1]	Fair Values of Derivative Instruments Prepaid Expense and Other assets	Other Accrued Liabilities
		(In thousands)	
Derivatives designated as hedging instruments:			
Foreign currency exchange forward contracts	$ 5,736	$ 222	$ 22
Derivatives not designated as hedging instruments:			
Foreign currency exchange forward contracts	$ 9,664		118
Total derivatives		$ 222	$ 140

(1) Represents the gross notional amount (at fair value) of the forward contracts that were outstanding as of September 25, 2010.

As of December 26, 2009, there was a $14.0 million notional amount of Euro denominated currency exchange forward contracts outstanding with an immaterial fair value amount due to the fact that the contract was entered and valued at the end of the period.

7. Balance Sheet Components

Inventories, Net

Inventories, net consist of the following:

	September 25, 2010	December 26, 2009
	(In thousands)	
Raw materials	$ 10,969	$ 6,870
Work in process	36,523	32,054
Finished goods	41,202	29,948
Total inventory	$ 88,694	$ 68,872

Included in finished goods inventory at September 25, 2010 and December 26, 2009 were $8.1 million and $8.0 million, respectively, of inventory at customer locations for which product acceptance had not occurred.

INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Property, Plant and Equipment, Net

Property, plant and equipment, net is comprised of the following:

	September 25, 2010	December 26, 2009
	(In thousands)	
Computer hardware	$ 6,800	$ 5,976
Computer software	6,409	5,984
Laboratory and manufacturing equipment	90,408	77,831
Furniture and fixtures	711	651
Leasehold improvements	17,063	16,384
	$ 121,391	$ 106,826
Less accumulated depreciation and amortization	(74,257)	(63,170)
Property, plant and equipment, net	$ 47,134	$ 43,656

Accrued Expenses

Accrued expenses are comprised of the following:

	September 25, 2010	December 26, 2009
	(In thousands)	
Loss contingency related to non-cancelable purchase commitments	$ 2,260	$ 2,029
Taxes payable	1,331	3,907
Restructuring accrual	127	644
Royalties	1,789	1,673
Accrued rebate	2,682	
Other accrued expenses	8,899	5,676
Total accrued expenses	$ 17,088	$ 13,929

8. Restructuring and Other Related Costs

In July 2009, the Company announced a restructuring plan under which it closed its Maryland-based semiconductor fabrication plant (the Maryland FAB) and consolidated these activities into its primary fabrication plant location in Sunnyvale, California (the Sunnyvale FAB). This consolidation of activities into one location was expected to facilitate collaboration across integration platforms in support of the Company s next generation products. As a result, during 2009, the Company recorded $3.9 million of restructuring and other related costs including severance and related expenses, equipment and facilities-related costs, operating lease termination costs, and other exit costs. Equipment and facilities-related costs consist of increased depreciation expense related to restructured assets caused by shortening the useful life or updating the salvage value of depreciable fixed assets to coincide with the end of production under the approved restructuring plan. The Company substantially completed its restructuring actions in the fourth quarter of 2009.

The types of restructuring and other related costs (credits) recorded were the following:

	Three Months Ended September 25, 2010			Nine Months Ended September 25, 2010		
	Cost of Revenue	Operating Expenses	Total	Cost of Revenue	Operating Expenses	Total
			(In thousands)			
Severance and related expenses (credits)	$	$	$	$ (144)	$ 55	$ (89)
Equipment and facilities-related expenses (credits)	(60)		(60)	(38)		(38)
Lease termination					104	104
Total	$ (60)	$	$ (60)	$ (182)	$ 159	$ (23)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cumulative restructuring and other related costs through September 25, 2010 totaled $3.9 million.

The following table sets forth the activity and balance of the restructuring liability account for severance and operating lease and contract termination costs for the nine months ended September 25, 2010:

	Severance and Related Expenses (In thousands)
Balance at December 26, 2009	$ 644
Provision	211
Payments	(580)
Change in estimates	(148)
Balance at September 25, 2010	$ 127

9. Comprehensive Income (Loss)

The components of Accumulated other comprehensive income (loss) are as follows:

	September 25, 2010	December 26, 2009
	(In thousands)	
Accumulated net unrealized loss on foreign currency translation adjustment	$ (379)	$ (565)
Accumulated unrealized gain on cash flow hedges	199	
Accumulated unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments	(81)	(923)
Accumulated unrealized holding loss on all other available-for-sale investments	(20)	(7)
Accumulated tax effect on items in accumulated other comprehensive loss	(726)	(315)
Total accumulated other comprehensive loss	$ (1,007)	$ (1,810)

The following table reconciles net loss to comprehensive income (loss):

	Three Months Ended		Nine Months Ended	
	September 25, 2010	September 26, 2009	September 25, 2010	September 26, 2009
	(In thousands)			
Net income (loss)	$ 4,360	$ (16,532)	$ (25,192)	$ (67,971)
Change in foreign currency translation gain (loss)	225	10	186	127
Accumulated unrealized gain (loss) on cash flow hedges	(471)		199	
	453	516	842	1,341

Change in unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments				
Change in unrealized gain (loss) on all other available-for-sale investments	134	48	(13)	286
Change in tax effect on items in accumulated other comprehensive loss	(47)		(411)	
Total comprehensive income (loss)	$ 4,654	$ (15,958)	$ (24,389)	$ (66,217)

10. Basic and Diluted Net Income (Loss) Per Common Share

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of vested common shares outstanding during the period. Diluted net income (loss) per common share is computed using net income (loss) and the weighted average number of common shares outstanding plus potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the assumed exercise of outstanding stock options, assumed vesting of outstanding restricted stock units (RSUs) and performance stock units (PSUs), assumed exercise of outstanding warrants, and assumed issuance of stock under the employee stock purchase plan using the treasury stock method.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table sets forth the computation of net income (loss) per basic and diluted share:

	Three Months Ended		Nine Months Ended	
	September 25, 2010	September 26, 2009	September 25, 2010	September 26, 2009
	(In thousands, except per share amounts)			
Numerator:				
Net income (loss)	$ 4,360	$ (16,532)	$ (25,192)	$ (67,971)
Denominator:				
Basic weighted average common shares outstanding	99,976	95,864	98,647	95,100
Effect of dilutive securities:				
Stock options	2,652			
Restricted stock units	1,367			
Performance stock units	1,084			
Employee stock purchase plan shares	46			
Warrants to purchase common stock	34			
Diluted weighted average common shares outstanding	105,159	95,864	98,647	95,100
Net income (loss) per common share				
Basic	$ 0.04	$ (0.17)	$ (0.26)	$ (0.71)
Diluted	$ 0.04	$ (0.17)	$ (0.26)	$ (0.71)

The Company excluded 5.6 million shares of outstanding stock options, 1.6 million of RSUs, 1.0 million of PSUs and an immaterial amount of warrants from the calculation of diluted earnings per common share in the three months ended September 25, 2010 because their effect would be anti-dilutive.

The Company incurred a net loss for the nine months ended September 25, 2010 and the three and nine months ended September 26, 2009 and as a result, potential common shares from options, stock awards, employee stock purchase plan shares and warrants totaling 20.4 million shares, 21.3 million shares and 21.3 million shares, respectively, were not included in the net loss per common share calculation, as their inclusion would have been anti-dilutive.

As of September 25, 2010 and September 26, 2009, the Company had the following equity awards outstanding which will increase the basic weighted average number of common shares outstanding at the time, if and when, the options are exercised or the restricted stock units and performance stock units are released:

	As of	
	September 25, 2010	September 26, 2009
	(In thousands)	
Stock options outstanding	9,588	13,340

Restricted stock units	6,925	4,636
Performance stock units	3,135	2,461
Employee stock purchase plan shares	656	678
Warrants to purchase common stock	124	224
Total	20,428	21,339

11. Litigation and Contingencies

Legal Matters

On May 9, 2006, the Company and Level 3 were sued by Cheetah Omni, LLC (Cheetah) in the U.S. District Court for the Eastern District of Texas Texarkana Division for alleged infringement of patent no. 6,795,605 (the 605 Patent), and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of the Company s DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys fees, associated interest and Cheetah s costs incurred in the lawsuit. Cheetah s complaint does not request a specific dollar amount for these compensatory damages. The Company is contractually obligated to

INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

indemnify Level 3 for damages suffered by Level 3 to the extent its product supplied by the Company is found to infringe, and it has assumed the defense of this matter. On July 20, 2006, the Company and Level 3 filed an amended response denying all infringement claims under the 605 Patent and asserting that the claims of the 605 Patent are invalid and that the DTN System does not infringe the 605 Patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent no. 7,142,347 (the 347 Patent) to the lawsuit. On December 18, 2006, the Company and Level 3 filed responses to Cheetah s second amended complaint denying all infringement claims under the 347 Patent and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, the Company and Level 3 filed responses to Cheetah s third amended complaint denying all infringement claims, and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On March 14, 2007, the Company submitted requests to the U.S. Patent and Trademark Office (the U.S. PTO) for *inter partes* reexamination of the 605 Patent and the 347 Patent asking the U.S. PTO to reexamine the patents based on prior art in order to invalidate the patents or limit the scope of each patent s claims. On March 21, 2007, the Company and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of the 605 Patent and the 347 Patent.

On April 11, 2007, the Company, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. PTO as to whether it will reexamine the 605 Patent and the 347 Patent; and (2) if the U.S. PTO decides to reexamine either the 605 Patent and the 347 Patent, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. PTO. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. PTO also ordered reexamination of the 605 Patent. On August 1, 2007, the U.S. PTO ordered reexamination of the 347 Patent. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations.

In a communication the Company received from the U.S. PTO dated December 4, 2009, the Company was advised that various claims in the 347 Patent reexamination have been allowed, while other claims have been rejected. In a communication the Company received from the U.S. Patent and Trademark Office dated June 22, 2010, the Company was advised that various claims in the 605 Patent reexamination have been allowed, while other claims have been rejected. The Company has appealed the allowance of certain claims in the 347 Patent reexamination to the Board of Patent Appeals and Interferences at the U.S. PTO and will have an opportunity to appeal the allowance of certain claims in the 605 Patent reexamination. The Company does not know when the U.S. PTO reexamination process will be completed.

On January 26, 2010, Cheetah s counsel filed a motion requesting the court to lift the stay in order to litigate those claims relating to the 347 Patent reexamination that the U.S. PTO allowed. The court denied the motion on April 16, 2010. On April 30, 2010, Cheetah filed a motion for reconsideration of the order denying Cheetah s motion to lift the stay. On May 17, 2010, the Company filed its opposition to Cheetah s motion for reconsideration. On August 24, 2010, after a hearing on the matter, the court issued an order keeping the stay in place. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

On May 14, 2010, Aloft Media, LLC (Aloft) filed a complaint in the U.S. District Court for the Eastern District of Texas Tyler Division alleging that the Company infringes U.S. patent nos. 7,593,910 and 7,596,538. On August 2, 2010, the Company filed its answer to Aloft s complaint denying all infringement claims and asserting counterclaims. On August 25, 2010, Aloft filed its answer to the Company s counterclaims. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

In addition to the matters described above, 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 effect on its consolidated financial position, results of operations, or cash flows.

12. Stockholders Equity

Stock Option Exchange Program

On June 11, 2009, the Company s stockholders approved a one-time stock option exchange program (the Option Exchange Program). On January 25, 2010, the Company launched the Option Exchange Program pursuant to which eligible employees were able to exchange certain outstanding stock options under the Company s 2007 Equity Incentive Plan with an exercise price greater than or equal to $8.16 per share and a grant date on or before January 25, 2009, for a lesser amount of new RSUs or for new stock options for

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

senior executives. The Option Exchange Program was available for employees of the Company residing in the U.S., India and the U.K. who held eligible options. The Option Exchange Program expired on February 22, 2010, and there were options to purchase 4,926,790 shares tendered for exchange. All surrendered options were canceled effective as of the expiration of the Option Exchange Program, and immediately thereafter, the Company granted (i) new options to purchase an aggregate of 1,564,727 shares of the Company s common stock with an exercise price of $7.61 per share and (ii) RSUs for 814,017 shares of the Company s common stock. The Option Exchange Program did not result in any significant incremental stock-based compensation expense.

Equity Incentive Plans

As of September 25, 2010, there were a total of 8.9 million shares available for grant under the Company s 2007 Equity Incentive Plan. The following tables summarize the Company s stock award activity and related information for the nine months ended September 25, 2010:

	Number of Options	Weighted-Average Exercise Price Per Share	Aggregate Intrinsic Value
	(In thousands, except per share data)		
Outstanding at December 26, 2009	14,568	$ 8.25	$ 35,462
Options granted	751	$ 7.84	
Options granted in connection with the stock option exchange program	1,565	$ 7.61	
Options exercised	(1,735)	$ 3.86	$ 10,284
Options canceled	(634)	$ 8.43	
Options canceled in connection with the stock option exchange program	(4,927)	$ 13.53	
Outstanding at September 25, 2010	9,588	$ 6.18	$ 63,957
Vested and expected to vest	9,489		$ 63,487

	Number of Restricted Stock Units	Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value
	(In thousands, except per share data)		
Outstanding at December 26, 2009	5,066	$ 9.44	$ 45,287
RSUs granted	2,590	$ 8.87	
RSUs released	(1,147)	$ 9.60	$ 11,014
RSUs granted in connection with the stock option exchange program	814	$ 7.80	
RSUs canceled	(398)	$ 9.22	
Outstanding at September 25, 2010	6,925	$ 9.02	$ 88,841
Expected to vest	6,487		$ 83,233

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Number of Performance Stock Units	Weighted-Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value
	(In thousands, except per share data)		
Outstanding at December 26, 2009	3,304	$ 10.51	$ 29,541
PSUs granted			
PSUs released			
PSUs canceled	(169)	$ 10.25	
Outstanding at September 25, 2010	3,135	$ 10.53	$ 40,227
Expected to vest	3,012		$ 38,648

The aggregate intrinsic value of unexercised options, unreleased RSUs and PSUs is calculated as the difference between the closing price of the Company s common stock of $12.83 at September 24, 2010 and the exercise prices of the underlying equity awards. The aggregate intrinsic value of the options which have been exercised and RSUs released is calculated as the difference between the fair market value of the common stock at the date of exercise or release and the exercise price of the underlying equity awards.

Employee Stock Options

During the three months ended September 25, 2010, the Company granted options to employees and members of the board of directors to purchase an aggregate of 0.1 million shares of common stock at a weighted-average exercise price of $6.67 per share. During the nine months ended September 25, 2010, the Company granted options to employees and members of its board of directors to purchase an aggregate of 2.3 million shares at a weighted-average price of $7.68 per share. The options granted during the nine months ended September 25, 2010 included 1.6 million shares of common stock granted in connection with the Option Exchange Program, at a weighted-average exercise price of $7.61 per share. Options granted during these periods have exercise prices equal to the closing market prices of the Company s common stock on the dates these options were granted. The weighted-average remaining contractual term of options exercisable was 6.3 years as of September 25, 2010. Amortization of stock-based compensation for the three and nine months ended September 25, 2010 was approximately $3.6 million and $11.5 million, respectively, net of estimated forfeitures.

As of September 25, 2010, the total stock-based compensation cost related to options granted to employees and directors but not yet amortized was $19.6 million, net of estimated forfeitures of $0.5 million. These costs will be amortized on a straight-line basis over a weighted-average period of approximately 1.9 years. Total fair value of stock options granted to employees and members of the board of directors that vested during the three and nine months ended September 25, 2010 was approximately $2.8 million and $8.9 million, respectively, based on the grant date fair value.

Excluding options granted in connection with the one-time Option Exchange Program, the ranges of estimated values of employee and director stock options granted, as well as ranges of assumptions used in calculating these values during the three and nine months ended September 25, 2010 and September 26, 2009, were based on estimates as follows:

	Three Months Ended		Nine Months Ended	
Employee and Director Stock Options	**September 25, 2010**	**September 26, 2009**	**September 25, 2010**	**September 26, 2009**
Volatility	58% - 59%	62% - 63%	56% - 61%	62% - 72.5%
Risk-free interest rate	1.80% - 2.00%	2.99% - 3.07%	1.80% - 2.9%	2.13% -3.07%

Expected life	4.9 - 5.4 years	5.5 - 6.1 years	4.8 -5.4 years	5.5 - 6.1 years
Estimated fair value	$3.32 - $3.48	$4.20 - $4.25	$3.32 - $5.05	$4.06 - $5.87

Employee Stock Purchase Plan

Stock-based compensation costs related to the Company s employee stock purchase plan (ESPP) were approximately $0.7 million and $2.0 million for the three and nine months ended September 25, 2010, respectively, and approximately $0.8 million and $2.4 million for the three and nine months ended September 26, 2009, respectively. The fair value of the ESPP shares was estimated at the date of grant using the following assumptions:

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Employee Stock Purchase Plan	Three Months Ended September 25, 2010	Three Months Ended September 26, 2009	Nine Months Ended September 25, 2010	Nine Months Ended September 26, 2009
Volatility	55%	63%	45% - 55%	63% -95%
Risk-free interest rate	0.23%	0.36%	0.20% -0.23%	0.36% - 0.54%
Expected life	0.5 years	0.5 years	0.5 years	0.5 years
Estimated fair value	$2.58	$2.32	$2.13 - $2.58	$2.32 - $2.83

Restricted Stock Units

During the three and nine months ended September 25, 2010, the Company granted RSUs to employees to receive an aggregate of 0.2 million and 3.4 million shares of common stock, respectively, at no cost. Included in the RSUs granted in the nine months ended September 25, 2010 are 0.8 million shares granted in connection with the Option Exchange Program. The Company accounted for the fair value of the RSUs using the closing market price of the Company s common stock on the date of grant. Amortization of stock-based compensation related to RSUs in the three and nine months ended September 25, 2010 was approximately $6.6 million and $18.3 million, respectively. As of September 25, 2010, total stock-based compensation cost related to RSUs granted to employees and members of the board of directors but not yet amortized was approximately $47.0 million, net of estimated forfeitures of $4.8 million. These costs will be amortized on a straight-line basis over a weighted-average period of 2.4 years.

Performance Stock Units

The number of shares to be issued upon vesting of PSUs range from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of the Company s common stock price compared to NASDAQ over a three-year or four-year period. Amortization of stock-based compensation related to PSUs in the three and nine months ended September 25, 2010 was approximately $2.7 million and $7.5 million, respectively. As of September 25, 2010, total stock-based compensation cost related to PSUs granted to employees and members of the Company s board of directors but not yet amortized was approximately $17.2 million, net of estimated forfeitures of $0.7 million. These costs will be amortized on a straight-line basis over a weighted-average period of 1.8 years.

The grant date fair value of PSUs was estimated using the Monte Carlo simulation model with the following assumptions:

Performance Stock Unit Grants	Nine Months Ended September 26, 2009
Infinera volatility	70% - 75%
NASDAQ volatility	30% - 35%
Risk-free interest rate	1.25% - 1.71%
Correlation between Infinera and NASDAQ	0.56 - 0.60
Estimated fair value	$9.65 - $10.76

Common Stock Warrants

As of September 25, 2010, there were warrants to purchase 0.1 million shares of common stock outstanding with exercise prices ranging from $5.40 to $8.96 per share and a weighted-average exercise price of $6.30 per share. These warrants expire between 2011 and 2013.

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INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock-Based Compensation

The following table summarizes the effects of stock-based compensation related to awards granted to employees and members of the Company s board of directors on the Company s condensed consolidated balance sheets and statements of operations for the periods presented:

	September 25, 2010	December 26, 2009
	(In thousands)	
Stock-based compensation effects in inventory	$ 2,705	$ 2,879
Stock-based compensation effects in deferred inventory cost	$ 275	$ 201

	Three Months Ended		Nine Months Ended	
	September 25, 2010	September 26, 2009	September 25, 2010	September 26, 2009
	(In thousands)			
Stock-based compensation effects in net income (loss) before income taxes				
Cost of revenue	$ 725	$ 490	$ 1,858	$ 1,346
Research and development	3,773	2,915	10,546	7,066
Sales and marketing	2,148	1,710	6,187	4,723
General and administration	6,281	3,984	17,188	10,142
	12,927	9,099	35,779	23,277
Cost of revenue amortization from balance sheet*	1,517	987	4,182	2,457
Total stock-based compensation expense	$ 14,444	$ 10,086	$ 39,961	$ 25,734

* Stock-based compensation expense deferred to inventory and deferred inventory costs in prior periods and recognized in the current period.

13. Income Taxes

During the three and nine months ended September 25, 2010, an income tax benefit of an immaterial amount and $0.4 million, respectively, were allocated to the tax provision from continuing operations, related to the tax effects of items credited directly to other comprehensive income (OCI). Generally, the amount of tax expense or benefit allocated to continuing operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided within the intra-period tax allocation rules when there is a pre-tax loss from continuing operations and there are items charged or credited to other categories, including OCI, in the current year. The intra-period tax allocation rules related to items charged or credited directly to OCI can result in disproportionate tax effects that remain in OCI until certain events occur.

Exclusive of these intra-period allocations discussed above, the Company recorded $0.3 million and $0.4 million of tax expense during the three and nine months ended September 25, 2010, resulting in effective tax rates of 0.6% and (1.7)%, on pre-tax book income of $4.6 million and loss of $25.2 million, in the respective periods. The effective tax rate differs from the statutory rate of 35% based upon unbenefited U.S. losses, non-deductible stock-based compensation expense, and foreign taxes provided on foreign subsidiary earnings.

The realization of tax benefits of deferred tax assets is dependent upon future levels of taxable income, of an appropriate character, in the periods the items are scheduled to be deductible or taxable. Based on the available objective evidence, management believes it is more likely than not that the domestic net deferred tax assets will not be realizable. Accordingly, the Company has provided a full valuation allowance against its domestic deferred tax assets, net of deferred tax liabilities, as of September 25, 2010 and December 26, 2009. In determining future taxable income, the Company makes assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with the Company s forecasts used to manage its business. The Company intends to maintain the remaining valuation allowance until sufficient positive evidence exists to support a reversal of, or decrease, in the valuation allowance.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. Segment Information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company s chief operating decision maker is the Company s chief executive officer. The Company s chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. The Company has one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, the Company is considered to be in a single reporting segment and operating unit structure.

Revenue by geographic region is based on the shipping address of the customer. The following table sets forth revenue and long-lived assets by geographic region:

Revenue

	Three Months Ended		Nine Months Ended	
	September 25, 2010	September 26, 2009	September 25, 2010	September 26, 2009
	(In thousands)			
Americas:				
United States	$ 94,392	$ 52,871	$ 260,099	$ 146,491
Other Americas	14,012	9,136	14,882	9,135
	$ 108,404	$ 62,007	$ 274,981	$ 155,626
Europe, Middle East and Africa	20,349	20,380	54,200	55,710
Asia Pacific	1,308	1,021	8,038	7,584
Total revenue	$ 130,061	$ 83,408	$ 337,219	$ 218,920

Property, plant and equipment, net

	September 25, 2010	December 26, 2009
	(In thousands)	
United States	$ 44,499	$ 41,405
Other Americas	52	
Asia Pacific	2,583	2,251
Total property, plant and equipment, net	$ 47,134	$ 43,656

15. Guarantees

Product Warranties

Upon delivery of products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under hardware warranty. In general, hardware warranty periods range from one to five years. Hardware warranties provide the purchaser with protection in the event that the product does not perform to product specifications. During the warranty period, the purchaser s sole and exclusive remedy in the event of such defect or failure to perform is limited to the correction of the defect or failure by repair, refurbishment or replacement, at the Company s sole option and expense. The Company estimates its hardware warranty obligations based on the Company s historical experience of known product failure rates, use of materials to repair or replace defective products, and service delivery costs incurred in correcting product failures. In addition, from time to time, specific hardware warranty accruals may be made if unforeseen technical problems arise with specific products. Management periodically assesses the adequacy of the Company s recorded warranty liabilities and adjusts the amounts as necessary.

INFINERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Activity related to product warranty was as follows:

	Three Months Ended		Nine Months Ended	
	September 25, 2010	September 26, 2009	September 25, 2010	September 26, 2009
	(In thousands)			
Beginning balance	$ 11,322	$ 10,370	$ 11,140	$ 9,940
Charges to operations	2,823	3,156	9,573	8,508
Utilization	(2,266)	(1,876)	(6,894)	(4,855)
Change in estimate[1]	(955)	(1,512)	(2,895)	(3,455)
Balance at the end of the period	$ 10,924	$ 10,138	$ 10,924	$ 10,138

(1) The Company records hardware warranty liabilities based on the latest quality and cost information available as of that date. The favorable changes in estimate shown here are due to continued improvements in overall actual failure rates and the impact of these improvements on the Company s estimate of expected future returns and changes in the estimated cost of replacing failed units using either repaired or new units.

16. Related Party Transactions

The Company s former Chief Financial Officer, Mr. Duston M. Williams and the Company signed a consulting agreement, dated January 26, 2010, pursuant to which Mr. Williams will remain a consultant to the Company from June 26, 2010 until April 1, 2011. In exchange for providing these consulting services to the Company, Mr. Williams will receive the following compensation: (a) he shall continue to vest in the grant of 170,000 RSUs that were granted to him on August 10, 2009, which shall vest and be settled in full no later than March 15, 2011; (b) he shall be paid under the Company s 2010 Bonus Plan at 100% of the pro-rated amount for the actual performance for the Company for the six months from January 1, 2010 through June 26, 2010, and (c) he shall receive reimbursement of six months of COBRA premiums if he elected continuation of health (i.e., medical, dental, and vision) coverage, which he did not. Except for the grant of restricted stock units described above, Mr. Williams shall not vest in any other equity awards after June 26, 2010.

On May 19, 2010, the Company entered into a consulting agreement with Mr. Reed Hundt, a former member of the Company s board of directors, pursuant to which Mr. Hundt will remain a consultant to the Company from May 19, 2010 until November 30, 2011. In exchange for Mr. Hundt s consulting services to the Company, Mr. Hundt was granted 35,000 shares of RSUs which shall vest through November 2011, subject to Mr. Hundt s continued services to the Company.

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

This quarterly report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include any expectation of earnings, revenues, gross margins, costs, restructuring charges and associated costs, or other financial items; any statements of the plans, strategies and objectives of management for future operations and personnel; factors that may affect our operating results, including sales and equipment deployment; statements concerning new products or services; statements related to capital expenditures; statements related to future economic conditions or performance; statements related to market growth and demand; statements related to the impact of liquidity of our adjustable rate securities on our operations; statements related to payments made pursuant to our restructuring plan; statements related to the effect of any litigation on our operations; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, or will, and similar expressions or variations. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Form 10-Q and in our other SEC filings, including our annual report on Form 10-K for the fiscal year ended December 26, 2009 filed on March 1, 2010. Such forward-looking statements speak only as of the date of this report. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. The following discussion and analysis should be read in conjunction with our condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q.

Executive Overview

Infinera was founded in December 2000 with a unique vision for optical networking. Prior to Infinera, service provider optical networks were built from fairly commoditized products, broadly known as dense wavelength division multiplexing (DWDM) systems. The pace of bandwidth growth in service provider networks has been significant over the last few years. Thus each year, service providers generally have been consuming more space, more power, and more of their human resources to deploy and manage their optical networks. The Infinera vision is that photonic integration offers a solution to this problem. Photonic integration is predicated upon the belief that, it is possible to generate a Moore s Law -like continuous improvement in capacity per device (or chip) to help service providers scale their network bandwidth without significant increases in space, power or operational workload.

Infinera s flagship product offering is an optical telecom system, the Digital Transport Node System (DTN System). The DTN System uses photonic integrated circuits, or PICs, to generate 100 Gigabits per second (Gbps) of optical capacity per line card. This capacity is then digitally virtualized so that it can be allocated, using software, to a variety of service types. The DTN System includes intelligent software that is designed to simplify and speed the delivery and control of optical services, and to enable advanced feature capabilities. Photonic integration provides the basis for the DTN System s power and space advantages relative to conventional DWDM systems, while the DTN System s bandwidth virtualization capability and software intelligence are architected to allow Infinera customers to simplify and speed their operations tasks, and ultimately to improve operational efficiency.

Infinera s digital optical network architecture is made possible by what we believe to be the world s only commercially-deployed, large-scale PIC. Our PICs transmit and receive 100 Gbps of optical capacity and incorporate the functionality of over 60 discrete optical devices into a pair of indium phosphide chips. Their function is to convert 100 Gbps of optical capacity into electronic signals. Once electronic, these signals can be virtualized and allocated to a number of services using digital technology. The PICs enable the DTN System to deliver a wide range of transport services, with optional advanced features, quickly and easily. By contrast, competitive DWDM platforms, which do not have access to PIC technology, generally require photonics equipment to add new services to the network. Photonic engineering can be considerably slower and more difficult than digital engineering; as a result, we believe competitive platforms have less flexibility, take longer to provision, and are harder to operate than the DTN System.

In 2009, we expanded our addressable market by introducing a new product, the ATN System, which extends the benefits of an Infinera network into smaller locations in the metro access network. We also introduced new submarine network capabilities into the DTN System. As a result, Infinera now offers end-to-end optical networking solutions from the metro edge, through the regional and long-haul terrestrial network, all the way to the submarine network terminal.

Our goal is to be a leading provider of optical communications systems to operators of optical networks, including telecom carriers, cable operators, internet or content service providers, and others. Our revenue growth will depend on the continued acceptance of our products, growth of communications traffic and the proliferation of next-generation bandwidth-intensive services, which are expected to drive the need for increased levels of bandwidth. Our ability to increase revenue and achieve profitability will be directly affected by the level of acceptance of our products in the long-haul and metro DWDM markets and by our ability to cost-effectively develop and sell innovative products that leverage our technology advantages.

As of September 25, 2010, we have sold our network systems for deployment in optical networks of 77 customers worldwide, including Cox Communications, Deutsche Telekom, Global Crossing, Interoute and Level 3. We do not have long-term purchase commitments with our customers. To date, a few of our customers have accounted for a significant portion of our revenue. In particular, Level 3 accounted for approximately 19% and 17% of our revenue in the three and nine months ended September 25, 2010, respectively, and 10% and 19% of our revenue in the three and nine months ended September 26, 2009, respectively. In July 2009, we were informed by Level 3 that they intended to use another DWDM vendor in their network. We believe that this vendor may ultimately be given a significant portion of Level 3 s new network deployments. This change may impact the revenue we receive from Level 3 in the future, although we cannot predict the timing of such impact.

During the three months ended September 25, 2010, we had one other customer that represented approximately 11% of total revenue, while three other customers represented approximately 15%, 15% and 11% of total revenue during the three months ended September 26, 2009.

During the nine months ended September 25, 2010, we had one other customer that represented approximately 10% of total revenue and we had one other customer that represented over 10% of total revenue in the nine months ended September 26, 2009.

We are headquartered in Sunnyvale, California, with employees located throughout North America, Europe and the Asia Pacific region. We expect to continue to add personnel in the United States and internationally to develop our products and provide additional geographic sales and technical support coverage. We primarily sell our products through our direct sales force, with a small portion sold indirectly through resellers. We derived 99% and 98% of our revenue from direct sales to customers for the three and nine months ended September 25, 2010, respectively, and 97% and 93% of our revenue for the three and nine months ended September 26, 2009, respectively. We expect to continue generating a substantial portion of our revenue from direct sales in the future.

We will continue to make significant investments in our business, and currently management believes that operating expenses, including stock-based compensation expense, will be approximately $65 million to $70 million in the fourth quarter of 2010 and $240 million to $245 million for fiscal year 2010.

Critical Accounting Policies and Estimates

Management s Discussion and Analysis of Financial Condition and Results of Operations is based upon our condensed consolidated financial statements, which we have prepared in accordance with U.S. GAAP. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements. Management believes that there have been no significant changes during the nine months ended September 25, 2010 to the items that we disclosed as our critical accounting policies and estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 26, 2009, with the exception of our accounting policies for revenue recognition and derivative instruments as described in Note 3, Summary of Significant Accounting Policies, of the Notes to Condensed Consolidated Financial Statements.

Recent Accounting Pronouncements

For additional information on the recent accounting pronouncements impacting our business, see Note 2, Recent Accounting Pronouncements, and Note 3, Summary of Significant Accounting Policies, to the Notes to Condensed Consolidated Financial Statements.

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Results of Operations

The following sets forth, for the periods presented, certain unaudited condensed consolidated statements of operations information:

	Three Months Ended			
	September 25, 2010	% of total revenue	September 26, 2009	% of total revenue
	(In thousands, except %)			
Revenue:				
Product	$ 115,121	89%	$ 73,690	88%
Ratable product and related support and services	1,460	1%	892	1%
Services	13,480	10%	8,826	11%
Total revenue	$ 130,061	100%	$ 83,408	100%
Cost of revenue:				
Product	$ 58,552	45%	$ 47,473	57%
Ratable product and related support and services	874	1%	444	1%
Services	6,223	5%	5,049	6%
Restructuring and other costs (credit) related to cost of revenue	(60)	%	2,736	%
Total cost of revenue	$ 65,589	50%	$ 55,702	67%
Gross profit	$ 64,472	50%	$ 27,706	33%

	Nine Months Ended			
	September 25, 2010	% of total revenue	September 26, 2009	% of total revenue
	(In thousands, except %)			
Revenue:				
Product	$ 299,323	89%	$ 193,912	89%
Ratable product and related support and services	4,738	1%	3,206	1%
Services	33,158	10%	21,802	9%
Total revenue	$ 337,219	100%	$ 218,920	100%
Cost of revenue:				
Product	$ 171,660	51%	$ 137,037	63%
Ratable product and related support and services	2,558	1%	1,532	1%
Services	14,285	4%	9,681	4%
Restructuring and other costs (credit) related to cost of revenue	(182)	%	2,736	%
Total cost of revenue	$ 188,321	56%	$ 150,986	69%
Gross profit	$ 148,898	44%	$ 67,934	31%

The following table summarizes our revenue by geography and sales channel for the periods presented:

	Three Months Ended		Nine Months Ended	
	September 25, 2010	September 26, 2009	September 25, 2010	September 26, 2009
	(In thousands, except %)			
Total revenue by geography				

Domestic	$ 94,392	$ 52,871	$ 260,099	$ 146,491
International	35,669	30,537	77,120	72,429
	$ 130,061	$ 83,408	$ 337,219	$ 218,920
% Revenue by geography				
Domestic	73%	63%	77%	67%
International	27%	37%	23%	33%
	100%	100%	100%	100%
Total revenue by sales channel				
Direct	$ 128,298	$ 81,270	$ 330,789	$ 203,664
Indirect	1,763	2,138	6,430	15,256
	$ 130,061	$ 83,408	$ 337,219	$ 218,920
% Revenue by sales channel				
Direct	99%	97%	98%	93%
Indirect	1%	3%	2%	7%
	100%	100%	100%	100%

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Revenue

Total revenue increased to $130.1 million for the three months ended September 25, 2010 from $83.4 million for the corresponding period in 2009. We have experienced a recovery in overall demand and, in particular, demand from existing customers in the third quarter of 2010 as compared to the same period in 2009. Revenue levels in the three months ended September 26, 2009 as compared to the corresponding period in 2010 were significantly impacted by the downturn in the economy as new and existing customers delayed purchasing decisions and limited their new purchases. As the economic environment has improved, we have experienced increased business activity with many of our customers, including strong demand from Level 3, cable operators and our internet content customers in North America. However, we expect demand from these customers to decline in the fourth quarter of 2010 as they absorb their network purchases from prior periods. This is expected to result in a quarter-over-quarter decline in overall revenues for the fourth quarter of 2010 as compared to the third quarter of 2010. We do not have the visibility necessary to accurately predict future revenues beyond this one-quarter time horizon.

Total revenue increased to $337.2 million for the nine months ended September 25, 2010 from $218.9 million for the corresponding period in 2009. We have experienced a recovery in overall demand and, in particular, demand from existing customers in the nine months ended September 25, 2010 as compared to the same period in 2009. Revenue levels in the first half of 2009 were significantly impacted by the downturn in the economy as new and existing customers delayed purchasing decisions and limited their new purchases. As the economic environment has improved, we have experienced increased business activity with many of our customers, including strong demand from Level 3 and our cable and internet content customers in North America.

International revenue decreased to 27% of total revenue in the three months ended September 25, 2010 from 37% of total revenue in the corresponding period in 2009, and decreased to 23% of total revenue in the nine months ended September 25, 2010 from 33% of total revenue in the corresponding period in 2009. The decreases were primarily attributable to increased levels of sales to domestic customers during the periods. While we expect international revenues to continue to grow in absolute dollars on a long-term basis as we increase our sales activities in Europe, Asia Pacific and other regions, this metric may fluctuate as a percentage of total revenue depending on the size and timing of deployments both internationally and in the United States.

Total product revenue increased to $115.1 million for the three months ended September 25, 2010 from $73.7 million for the corresponding period in 2009. Total product revenue increased to $299.3 million for the nine months ended September 25, 2010 from $193.9 million for the corresponding period in 2009. The increase in product revenue in the three and nine months ended September 25, 2010 was primarily due to increased sales of our DTN System to new and existing customers reflecting an overall improvement in the economic environment.

Product and related support services revenue that is recognized ratably includes sales of products and services that were deferred under previous accounting standards, prior to our adoption of ASU 2009-13 and ASU 2009-14 as discussed in Note 3, Summary of Significant Accounting Policies, to the Notes to Condensed Consolidated Financial Statements, because VSOE of fair value had not been established for the undelivered elements. Total ratable revenue levels increased to $1.5 million for the three months ended September 25, 2010 from $0.9 million for the corresponding period in 2009. Total ratable revenue levels increased to $4.7 million for the nine months ended September 25, 2010 from $3.2 million for the corresponding period in 2009. The increase in ratable revenue in the three and nine months ended September 25, 2010 was primarily due to the recognition of the previously deferred ratable product revenue.

Total services revenue increased to $13.5 million for the three months ended September 25, 2010 from $8.8 million for the corresponding period in 2009 reflected the recognition of $1.3 million of incremental deployment services revenue. In addition, we recognized increased revenue from our spares management service of $1.1 million, our extended hardware warranty service of $0.9 million and our software subscription service of $0.6 million. Total services revenue increased to $33.2 million for the nine months ended September 25, 2010 from $21.8 million for the corresponding period in 2009 primarily reflecting the recognition of $4.6 million of incremental deployment services revenue. In addition, we recognized increased revenues from our spares management service of $2.8 million, our extended hardware warranty service of $2.7 million and our software subscription service of $1.5 million. We expect to continue to grow our extended hardware warranty and spares management services revenues in future periods.

Cost of Revenue and Gross Margin

Gross margin increased to 50% in the three months ended September 25, 2010 from 33% in the corresponding period in 2009. This significant increase in gross margin was partially due to an unusually high level of sales of our higher gross margin tributary adaptor modules in the three months ended September 25, 2010. Additionally, higher overall revenue levels in the period contributed to improved absorption of fixed costs resulting in higher gross margin. These factors resulted in unusually high gross margin levels which we currently do not expect to be repeated in the fourth quarter of 2010.

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Moreover, gross margin in the three months ended September 26, 2009 at 33% was unusually low due to the impact from the following one-time events:

- we recognized revenue and costs related to a large number of negative or lower margin common equipment deployments;
- we incurred restructuring and other related costs of $2.7 million related to the closure of our Maryland FAB announced in July 2009; and
- we incurred inventory write-downs for excess and obsolete inventory of $3.3 million which includes $1.5 million of inventory write-downs related to the closure of our Maryland FAB.

Gross margin increased to 44% in the nine months ended September 25, 2010 from 31% in the corresponding period in 2009. We experienced a higher level of sales of our higher gross margin tributary adaptor modules in the nine months ended September 25, 2010 as compared to the corresponding period in 2009. Additionally, the lower level gross margin in the nine months ended September 26, 2009 was primarily due to the following factors:

- we recognized revenue and costs related to a large number of negative or lower margin common equipment deployments;
- gross margin was negatively impacted by the usage of significant common equipment discounts;
- we incurred restructuring and other related costs of $2.7 million related to the closure of our Maryland FAB announced in July 2009; and
- we incurred inventory write-downs for excess and obsolete inventory of $6.6 million which includes $1.5 million of inventory write-downs related to the closure of our Maryland FAB.

See Note 8, Restructuring and Other Related Costs, to the Notes to Condensed Consolidated Financial Statements for more information on our Maryland FAB restructuring plan.

Operating Expenses

	Three Months Ended			
	September 25, 2010	% of total revenue	September 26, 2009	% of total revenue
	(In thousands, except %)			
Operating expenses:				
Research and development	$ 29,886	23%	$ 23,611	28%
Sales and marketing	14,847	11%	12,364	15%
General and administrative	15,609	12%	10,373	12%
Restructuring and other costs		%	601	1%
Total operating expenses	$ 60,342	46%	$ 46,949	56%

	Nine Months Ended			
	September 25, 2010	% of total revenue	September 26, 2009	% of total revenue
	(In thousands, except %)			
Operating expenses:				
Research and development	$ 87,292	26%	$ 70,445	32%
Sales and marketing	41,566	12%	34,945	16%
General and administrative	45,794	14%	31,978	15%
Restructuring and other costs	159	%	601	%
Total operating expenses	$ 174,811	52%	$ 137,969	63%

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The following table summarizes the stock-based compensation expense included in our operating expenses:

	Three Months Ended		Nine Months Ended	
	September 25, 2010	September 26, 2009	September 25, 2010	September 26, 2009
	(In thousands)			
Research and development	$ 3,773	$ 2,915	$ 10,546	$ 7,066
Sales and marketing	2,148	1,710	6,187	4,723
General and administration	6,281	3,984	17,188	10,142
Total	$ 12,202	$ 8,609	$ 33,921	$ 21,931

Research and Development Expenses

Research and development expenses increased by $6.3 million in the three months ended September 25, 2010 compared to the corresponding period in 2009 primarily due to increased headcount and personnel-related costs of $4.2 million comprised of $3.3 million of cash compensation and $0.9 million of stock-based compensation expense. In addition, in the three months ended September 25, 2010, we incurred $1.2 million of increased spending related to materials, prototype and new product spending, and $0.9 million of increased depreciation, professional and outside services and other costs.

Research and development expenses increased by $16.8 million in the nine months ended September 25, 2010 compared to the corresponding period in 2009 primarily due to increased headcount and personnel-related costs of $11.1 million comprised of $7.6 million of cash compensation and $3.5 million of stock-based compensation expense. In addition, in the nine months ended September 25, 2010, we incurred $6.5 million of increased materials, prototype and new product spending, and $0.3 million of professional and outside services. These costs were partially offset by $1.1 million of depreciation and other costs.

Sales and Marketing Expenses

Sales and marketing expenses increased by $2.5 million in the three months ended September 25, 2010 compared to the corresponding period in 2009 primarily due to an increase of $1.6 million in cash compensation and personnel expenses, increased stock-based compensation expense of $0.4 million, $0.2 million related to customer lab trials and marketing prototype materials and $0.3 million in travel and entertainment expenses and other costs.

Sales and marketing expenses increased by $6.6 million in the nine months ended September 25, 2010 compared to the corresponding period in 2009 primarily due to an increase of $4.4 million in cash compensation and personnel expenses, increased stock-based compensation expense of $1.5 million, $0.6 million in travel and entertainment expenses and $0.1 million in professional and outside services and other costs.

General and Administrative Expenses

General and administrative expenses increased by $5.2 million in the three months ended September 25, 2010 compared to the corresponding period in 2009 primarily due to an increase of $2.3 million of stock-based compensation expense, $1.1 million of cash compensation, $0.9 million of bad debt expense, $0.5 million related to outside professional service fees and $0.4 million of depreciation and other costs.

General and administrative expenses increased by $13.8 million in the nine months ended September 25, 2010 compared to the corresponding period in 2009 primarily due to an increase of $7.0 million of stock-based compensation expense, $4.2 million of cash compensation, $1.1 million of bad debt expense, $0.8 million of outside professional service fees and $0.7 million of depreciation and other costs.

Restructuring and Other Costs

In the nine months ended September 25, 2010, we incurred $0.2 million of restructuring and other costs associated with the closure of our Maryland FAB. We incurred $0.6 million of restructuring and other costs in the three and nine months ended September 26, 2009. This comprised of non-cash charges of $0.5 million primarily related to equipment and facilities-related costs. Additionally, we incurred $0.1 million associated with severance and related expenses, equipment and facilities-related charges and other exit costs. For more information, see Note 8, Restructuring and Other Related Costs, to the Notes to Condensed Consolidated Financial Statements.

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Other Income (Expense), Net

	Three Months Ended		Nine Months Ended	
	September 25, 2010	September 26, 2009	September 25, 2010	September 26, 2009
	(In thousands)			
Interest income	$ 283	$ 441	$ 1,093	$ 1,956
Total other-than-temporary impairment losses				(2,747)
Portion of loss recognized in other comprehensive loss		(161)		1,653
Net credit impairment losses recognized in earnings	$	$ (161)	$	$ (1,094)
Other gain (loss), net	172	870	(352)	(138)
Total income (expense), net	$ 455	$ 1,150	$ 741	$ 724

Interest income decreased by $0.2 million in the three months ended September 25, 2010 compared to the corresponding period in 2009 and decreased by $0.9 million in the nine months ended September 25, 2010 compared to the corresponding period in 2009. These decreases were due to lower interest rates on investments and lower investment balances.

We recognized net credit impairment losses of $0.2 million and $1.1 million in the three and nine months ended September 26, 2009, related to the OTTI of our available-for-sale ARS, as discussed in Note 4, Fair Value Measurements and Other-Than-Temporary Impairments, of the Notes to Condensed Consolidated Financial Statements.

Other gain (loss), net decreased by $0.7 million in the three months ended September 25, 2010 compared to the corresponding period in 2009. The decrease was primarily due to a $1.6 million gain related to an increase in the fair value of the Put Rights and a $1.0 million unrealized holding loss related to ARS trading securities recognized in the three months ended September 26, 2009.

Other gain (loss), net for the nine months ended September 25, 2010 included a $1.7 million decrease in the fair value of the Put Rights offset by a $1.7 million unrealized holding gain related to ARS trading securities compared to a $2.5 million loss due to a decrease in fair value of the Put Rights offset by a $3.1 million unrealized holding gain to ARS trading securities for the corresponding period in 2009. Additionally, in the nine months ended September 25, 2010 and September 26, 2009, we recorded $0.7 million and $1.0 million, respectively, of unrealized and realized losses due to foreign currency exchange re-measurement.

Income Tax Provision (Benefit)

During the three and nine months ended September 25, 2010, an income tax benefit of an immaterial amount and $0.4 million, respectively, were allocated to the tax provision from continuing operations, related to the tax effects of items credited directly to OCI. Generally, the amount of tax expense or benefit allocated to continuing operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided within the intra-period tax allocation rules when there is a pre-tax loss from continuing operations and there are items charged or credited to other categories, including OCI, in the current year. The intra-period tax allocation rules related to items charged or credited directly to OCI can result in disproportionate tax effects that remain in OCI until certain events occur.

Exclusive of these intra-period allocations discussed above, we recorded $0.3 million and $0.4 million of tax expense during the three and nine months ended September 25, 2010, resulting in effective tax rates of 0.6% and (1.7)%, on pre-tax book income of $4.6 million and loss of $25.2 million, in the respective periods. The effective tax rate differs from the statutory rate of 35% based upon unbenefited U.S. losses, non-deductible stock-based compensation expense, and foreign taxes provided on foreign subsidiary earnings.

The realization of tax benefits of deferred tax assets is dependent upon future levels of taxable income, of an appropriate character, in the periods the items are scheduled to be deductible or taxable. Based on the available objective evidence, management believes it is more likely than not that the domestic net deferred tax assets will not be realizable. Accordingly, we have provided a full valuation allowance against our domestic deferred tax assets, net of deferred tax liabilities, as of September 25, 2010 and December 26, 2009. In determining future taxable income, we make assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with our forecasts used to manage our business. We intend to maintain the remaining valuation allowance until sufficient positive evidence exists to support a reversal of, or decrease, in the valuation allowance.

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Liquidity and Capital Resources

	Nine Months Ended	
	September 25, 2010	September 26, 2009
	(In thousands)	
Net cash flow provided by (used in):		
Operating activities	$ 23,527	$ (30,028)
Investing activities	$ (47,561)	$ (54,186)
Financing activities	$ 12,065	$ 8,278

As of September 25, 2010, we had $98.0 million in cash and cash equivalents, $186.1 million in short-term and long-term investments and $4.1 million in short-term and long-term restricted cash. In comparison, as of December 26, 2009, we had $109.9 million in cash and cash equivalents, $161.6 million in short-term and long-term investments and $4.0 million in short-term and long-term restricted cash.

Cash, cash equivalents, short-term and long-term investments and short-term and long-term restricted cash consist generally of highly liquid investments in certificates of deposits, money market funds, commercial paper, corporate bonds and U.S. agency notes. Additionally, long-term investments include $9.1 million (par value) of available-for-sale ARS which have contractual maturity terms of up to 35 years. No agreement has been reached to sell these remaining ARS back to the original broker or on the open market and it is therefore unclear when these securities will become liquid and whether we can recover their full par value. The restricted cash balance amounts are pledged as collateral for certain stand-by and commercial letters of credit.

Operating Activities

Net cash provided by operating activities was $23.5 million for the nine months ended September 25, 2010. Cash flow provided by operating activities consisted of a net loss of $25.2 million, adjusted for non-cash charges of $53.8 million, net of working capital changes. Net cash provided by working capital changes was $5.1 million. Our working capital requirements can fluctuate significantly depending on the timing of deployments in the quarter and the acceptance, billing and payment terms on those deployments. Accounts receivable decreased by $5.4 million primarily reflecting better linearity of invoicing and collections activities in the period. Inventory increased by $19.8 million primarily due to our decision to hold increased finished goods inventory as a buffer against the recent product shortages in the supply chain and increased inventory requirements associated with our spares management service.

Net cash used in operating activities was $30.0 million in the nine months ended September 26, 2009. Cash flow used in operating activities consisted of a net loss of $68.0 million, adjusted for non-cash charges of $40.4 million, plus or minus working capital changes. Net cash provided by working capital changes was $2.5 million. Accounts receivable decreased by $14.2 million primarily due to one large customer using an early pay discount in the third quarter of 2009. This reduction in receivables was partially offset by an increase in inventory of $12.7 million primarily related to increased levels of inventory at customer sites awaiting acceptance and increased service inventory to support our new spares management service offering.

Investing Activities

Net cash used in investing activities in the nine months ended September 25, 2010 was $47.6 million compared to $54.2 million in the corresponding period of 2009. Investing activities for the nine months ended September 25, 2010 included a net usage of cash of $27.6 million from purchases, maturities and calls of investments which includes proceeds of $24.5 million related to our exercise of the Put Rights associated with our UBS ARS. Additionally, we purchased $15.6 million of capital expenditures in the period and we made a $4.5 million cost-method investment in May 2010. Investing activities for the nine months ended September 26, 2009 included a net usage of cash of $41.6 million from purchases, maturities, calls and sales of investments in the period and $11.6 million of capital expenditures.

Financing Activities

Net proceeds from financing activities in the nine months ended September 25, 2010 and September 26, 2009 were $12.1 million and $8.3 million, respectively, primarily related to proceeds from the issuance of common stock under our ESPP and other equity plans.

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Auction Rate Securities

As of September 25, 2010, we held $9.1 million (par value) of available-for-sale ARS with two issuers, one of which is AAA rated and the other of which is A3 rated. During the second quarter of 2009, we determined that we did not intend to sell these securities and did not believe that it was more likely than not that we would be required to sell the securities before recovery of their par value. However, given that the present value of the expected cash flows for these securities was below their par value, as of June 27, 2009, an initial OTTI of $2.7 million, equal to the difference between the fair value and the par value had occurred. During the three and nine months ended September 25, 2010, $0.2 million and $0.6 million of these ARS (par value), respectively, were called at par value. The amortized cost basis for these securities was reduced to reflect the calls during the period, resulting in a lower cost basis for these securities of $8.0 million as of September 25, 2010.

Failed auctions resulted in a lack of liquidity in the available-for-sale ARS but do not affect the underlying collateral of the securities. We do not anticipate that any potential lack of liquidity in our available-for-sale ARS, even for an extended period of time, will affect our ability to finance our operations, including our continued investments in research and development and planned capital expenditures. We continue to monitor efforts by the financial markets to find alternative means for restoring the liquidity of these investments. Our available-for-sale ARS investments are classified as non-current assets until we have better visibility as to when their liquidity will be restored.

Liquidity

On June 30, 2010, we exercised the Put Rights associated with the $24.5 million (par value) of the ARS covered by the UBS settlement and received cash proceeds from the sale of these securities to UBS. See Note 4, Fair Value Measurements and Other-Than-Temporary Impairments, to the Notes to Condensed Consolidated Financial Statements for more information. The remaining $9.1 million (par value) of available-for-sale ARS which are not subject to the UBS Put Rights have contractual maturity terms of up to 35 years and it is not clear when we will be able to liquidate these investments.

For the remainder of 2010, capital expenditures are expected to be in the range of approximately $6 million to $8 million, primarily for product development and manufacturing expansion related to new products. We believe that our current cash and cash equivalents and investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least 12 months. If these sources of cash are insufficient to satisfy our liquidity requirements beyond 12 months, we may require additional capital from equity or debt financings to fund our operations, to respond to competitive pressures or strategic opportunities, or otherwise. We may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of us, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock.

Contractual Obligations

The following is a summary of our contractual obligations as of September 25, 2010:

		Payments Due by Period			
	Total	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
			(In thousands)		
Purchase obligations [1]	$ 54,827	$ 54,827	$	$	$
Operating leases	8,536	3,570	3,087	1,498	381
Other contracts	5,840	5,840			
Total contractual obligations [2]	$ 69,203	$ 64,237	$ 3,087	$ 1,498	$ 381

(1) We have service agreements with our major production suppliers under which we are committed to purchase certain parts.

(2) Tax liabilities of $0.9 million are not included in the table because we are unable to determine the timing of settlement if any, of these future payments with a reasonably reliable estimate.

We had $4.0 million of standby letters of credit outstanding as of September 25, 2010. These consisted of $1.7 million related to a customer proposal guarantee, $1.4 million related to a value added tax license and duty and $0.9 million related to property leases. We had $4.0 million of standby letters of credit outstanding as of December 26, 2009. These consisted of $1.5 million related to a customer proposal guarantee, $1.5 million related to a value added tax license and duty and $1.0 million related to property leases.

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Off-Balance Sheet Arrangements

As of September 25, 2010, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

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

For quantitative and qualitative disclosures about market risk affecting us, see Quantitative and Qualitative Disclosures About Market Risk in Item 7A. of Part II of our Annual Report on Form 10-K for the fiscal year ended December 26, 2009, which is incorporated herein by reference. Our exposure to market risk has not changed materially since December 26, 2009.

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

Evaluation of Disclosure Controls and Procedures

As of September 25, 2010, an evaluation was performed by management, with the participation of our Chief Executive Officer (CEO) and our Chief Financial Officer (CFO), of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d - 15(e) under the Securities Exchange Act of 1934, as amended). Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Based on this evaluation, our CEO and CFO have concluded that, as of the end of the fiscal period covered by this quarterly report on Form 10-Q, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the U.S. Securities and Exchange Commission s rules and forms and that such information is accumulated and communicated to management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosures.

Changes in Internal Control over Financial Reporting

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations of Internal Controls

Our management, including our CEO and CFO, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within us have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving our stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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PART II. OTHER INFORMATION

Item 1. ***Legal Proceedings***

On May 9, 2006, the Company and Level 3 were sued by Cheetah in the U.S. District Court for the Eastern District of Texas Texarkana Division for alleged infringement of patent no. 6,795,605 (the 605 Patent), and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of the Company s DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys fees, associated interest and Cheetah s costs incurred in the lawsuit. Cheetah s complaint does not request a specific dollar amount for these compensatory damages. The Company is contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent its product supplied by us is found to infringe, and it has assumed the defense of this matter. On July 20, 2006, the Company and Level 3 filed an amended response denying all infringement claims under the 605 Patent and asserting that the claims of the 605 Patent are invalid and that the DTN System does not infringe the 605 Patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent no. 7,142,347 (the 347 Patent) to the lawsuit. On December 18, 2006, the Company and Level 3 filed responses to Cheetah s second amended complaint denying all infringement claims under the 347 Patent and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, the Company and Level 3 filed responses to Cheetah s third amended complaint denying all infringement claims, and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On March 14, 2007, the Company submitted requests to the U.S. PTO for inter partes reexamination of the 605 Patent and the 347 Patent asking the U.S. PTO to reexamine the patents based on prior art in order to invalidate the patents or limit the scope of each patent s claims. On March 21, 2007, the Company and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of the 605 Patent and the 347 Patent.

On April 11, 2007, the Company, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. PTO as to whether it will reexamine the 605 Patent and the 347 Patent; and (2) if the U.S. PTO decides to reexamine either the 605 Patent and the 347 Patent, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. PTO also ordered reexamination of the 605 Patent. On August 1, 2007, the U.S. PTO ordered reexamination of the 347 Patent. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations.

In a communication the Company received from the U.S. PTO dated December 4, 2009, the Company was advised that various claims in the 347 Patent reexamination have been allowed, while other claims have been rejected. In a communication the Company received from the U.S. PTO dated June 22, 2010, the Company was advised that various claims in the 605 Patent reexamination have been allowed, while other claims have been rejected. The Company has appealed the allowance of certain claims in the 347 Patent reexamination to the Board of Patent Appeals and Interferences at the U.S. Patent and Trademark Office and will have an opportunity to appeal the allowance of certain claims in the 605 Patent reexamination. The Company does not know when the U.S. PTO reexamination process will be completed.

On January 26, 2010, Cheetah s counsel filed a motion requesting the court to lift the stay in order to litigate those claims relating to the 347 Patent reexamination that the U.S. PTO allowed. The court denied the motion on April 16, 2010. On April 30, 2010, Cheetah filed a motion for reconsideration of the order denying Cheetah s motion to lift the stay. On May 17, 2010, the Company filed its opposition to Cheetah s motion for reconsideration. On August 24, 2010, after a hearing on the matter, the court issued an order keeping the stay in place. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

On May 14, 2010, Aloft Media, LLC (Aloft) filed a complaint in the U.S. District Court for the Eastern District of Texas Tyler Division alleging that the Company infringes U.S. patent nos. 7,593,910 and 7,596,538. On August 2, 2010, the Company filed its answer to Aloft s complaint denying all infringement claims and asserting counterclaims. On August 25, 2010, Aloft filed its answer to the Company s counterclaims. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

In addition to the matters described above, the Company is subject to various legal proceedings, claims and litigation arising in the

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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 effect on its consolidated financial position, results of operations, or cash flows.

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

A description of the risks and uncertainties associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risks and uncertainties associated with our business previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 26, 2009. You should carefully consider such risks and uncertainties, together with the other information contained in this report, our Annual Report on Form 10-K for the fiscal year ended December 26, 2009 and in our other public filings. If any of such risks and uncertainties actually occurs, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.

We have a history of significant operating losses and may not maintain profitability on an annual basis in the future.

For the fiscal year ended December 26, 2009, we recorded a net loss of $86.6 million. As of December 26, 2009, our accumulated deficit was $377.4 million. On September 25, 2010, our accumulated deficit was $402.6 million. We expect to continue to make significant expenditures related to the continued development of our business. These expenditures may include the addition of personnel related to the sales, marketing and research and development of our products and other costs related to the maintenance and expansion of our manufacturing facilities and research and development operations. We may therefore sustain significant operating losses and negative cash flows in the future. In addition, as a public company, we have incurred and will continue to incur significant legal, accounting and other expenses. We will have to sustain significant increased revenue and product gross margins to maintain profitability on an annual basis.

Although we achieved profitability for the first time on an annual basis for the fiscal year ended December 27, 2008 and generated net income of $78.7 million, this amount included $87.4 million of gross profit deferred from prior periods, as described in the section titled, Management s Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report on Form 10-K for the fiscal year ended December 26, 2009. Excluding the impact of this prior period amount, our results of operations for the fiscal year ended December 27, 2008 would have been a net loss of $8.7 million.

Our revenue and operating results may fluctuate significantly, which could make our future results difficult to predict and could cause our operating results to fall below investor or analyst expectations.

Our revenue and operating results may fluctuate due to a variety of factors, many of which are outside of our control. Over the past four fiscal quarters, our revenue and operating income (loss) has ranged from $90.2 million to $130.1 million and from an operating loss of $20.3 million to operating income of $4.1 million, respectively. As a result, comparing our operating results on a period-to-period basis may not be meaningful. Fluctuations in our revenue and gross margins can lead to even greater fluctuations in our operating results. Our budgeted expense levels are based, in large part, on our expectations of long-term future revenue and the development efforts associated with these future revenues. Given relatively fixed operating costs related to our personnel and facilities, particularly for our engineering personnel, any substantial adjustment to our expenses to account for lower levels of revenue will be difficult and may take time. Consequently, if our revenue does not meet projected levels in the short-term, our inventory levels and operating expenses would be high relative to revenue, resulting in additional operating losses.

In addition to other risks discussed in this section, factors that may contribute to fluctuations in our revenue and our operating results include:

- fluctuations in demand, sales cycles and prices for products and services;
- fluctuations in our product mix, including the mix of higher and lower margin products and significant mix changes resulting from new customer deployments;

reductions in customers budgets for optical communications network equipment purchases and delays in their purchasing cycles;

order cancellations or reductions or delays in delivery schedules by our customers;

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- timeliness of our customers payments for their purchases;
- our ability to control costs, including our operating expenses and the costs of components we purchase for our products;
- readiness of customer sites for installation of our products;
- the timing of product releases or upgrades by us or by our competitors. In particular, if we are required to develop additional features for our product for a customer, we may be required to defer our revenue for such customer until we have developed and delivered such additional features;
- any significant changes in the competitive dynamics of our market, including any new entrants, technological advances or substantial discounting of products;
- availability of third party suppliers to provide contract engineering and installation services for us;
- the timing of recognizing revenue in any given quarter, including the impact of recently announced revenue recognition standards and any future changes in U.S. GAAP or new interpretations of existing accounting rules; and
- general economic conditions in domestic and international markets.

If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may in the future provide to the market, the price of our common stock may decline substantially.

Our gross margin may fluctuate from quarter to quarter and may be adversely affected by a number of factors, some of which are beyond our control.

Our gross margin fluctuates from period to period and varies by customer and by product specification. Over the past four fiscal quarters, our gross margins have ranged from 38% to 50%. Our gross margins are likely to continue to fluctuate and will be affected by a number of factors, including:

- the mix in any period of the customer s purchasing our products and the mix of higher and lower margin products and services;
- significant new customer deployments, often with a higher portion of lower or negative margin common equipment;
- price discounts negotiated by our customers;
- sales volume from each customer during the period;

the amount of equipment we sell or expect to sell for a loss in any given quarter;

increased price competition, including competition from low-cost producers in China;

charges for excess or obsolete inventory;

changes in the price or availability of components for our products;

changes in our manufacturing costs, including fluctuations in yields and production volumes;

introduction of new products, with initial sales at relatively small volumes and higher product costs;

increased warranty or repair costs; and

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the period of time in which revenue is recognized.

It is likely that the average unit prices of our products will decrease over time in response to competitive pricing pressures, increased negotiated sales discounts, new product introductions by us or our competitors or other factors. In addition, some of our customer contracts contain annual technology discounts that require us to decrease the sales price of our products to these customers. In response, we will need to reduce the cost of our products through manufacturing efficiencies, design improvements and cost reductions. If these efforts are not successful or if we are unable to reduce our costs to a greater extent than the reduction in the price of our products, our revenue and gross margin will decline, causing our operating results to decline. Fluctuations in gross margin may make it difficult to manage our business and achieve or maintain profitability.

Aggressive business tactics by our competitors may harm our business.

Increased competition in our markets has resulted in aggressive business tactics by our competitors, including:

- aggressively pricing their products, including offering significant one-time discounts and guaranteed future price decreases;
- selling at a discount used equipment or inventory that had previously been written down or written off;
- announcing competing products prior to market availability combined with extensive marketing efforts;
- offering to repurchase our equipment from existing customers;
- influencing customer requirements to emphasize different product capabilities, such as greater minimum bandwidth requirements or higher transport speeds;
- providing financing, marketing and advertising assistance to customers; and
- asserting intellectual property rights.

If we fail to compete successfully against our current and future competitors, or if our current or future competitors continue or expand aggressive business tactics, including those described above, demand for our products could decline, we could experience delays or cancellations of customer orders, or we could be required to reduce our prices or increase our expenses.

Our ability to increase our revenue will depend upon continued growth of demand by consumers and businesses for additional network capacity.

Our future success depends on factors such as the continued growth of the Internet and IP traffic and the continuing adoption of high capacity, revenue-generating services to increase the amount of data transmitted over communications networks and the growth of optical communications networks to meet the increased demand for bandwidth. If demand for such bandwidth does not continue, or slows down, the need for increased bandwidth across networks and the market for optical communications network products may not continue to grow. If this growth does not continue or slows down, our product sales would be negatively impacted. In addition, if general economic conditions weaken, this may cause our customers and potential customers to slow or delay their purchase decisions, which would have an adverse affect on our business and financial condition.

Any delays in the development and introduction of our products, and any future delays in releasing new products or in releasing enhancements to our existing products may harm our business.

Since our products are based on complex technology, including, in some cases, the development of next-generation PICs and specialized application-specific integrated circuits (ASICs), we may experience unanticipated delays in developing, improving, manufacturing or deploying these products. The development process for our PICs is lengthy, and any modifications to our PICs, including the development of our next-generation PICs, entails significant development risks.

At any given time, various new product introductions and enhancements to our existing products, such as future products based on our next-generation PICs, are in the development phase and are not yet ready for commercial manufacturing or deployment. Recently, we have increased our reliance on third parties to develop and manufacture components for our products, some of which require custom development. The maturing process from laboratory prototype to customer trials, and subsequently to general availability, involves a

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significant number of simultaneous development efforts. These efforts often must be completed in a timely manner so that they may be introduced into the product development cycle for our systems, and include:

- completion of product development, including the completion of any associated PIC development, such as our next-generation PICs, and the completion of associated module development, including modules developed by third parties;
- the qualification and multiple sourcing of critical components;
- validation of manufacturing methods and processes;
- extensive quality assurance and reliability testing and staffing of testing infrastructure;
- validation of software; and
- establishment of systems integration and systems test validation requirements.

Each of these steps, in turn, presents risks of failure, rework or delay, any one of which could decrease the speed and scope of product introduction and marketplace acceptance of our products. New generations of our PICs, specialized ASICs and intensive software testing and validation are important to the timely introduction of new products, enhancements to our existing products and our entrance into new markets. In addition, unexpected intellectual property disputes, failure of critical design elements, and a host of other execution risks may delay, or even prevent, the introduction of new products or enhancements to our existing products. If we do not develop and successfully introduce or enhance products in a timely manner, our competitive position will suffer. In addition, if we do not develop and successfully introduce or enhance products in sufficient time so as to satisfy our customer s expectations, we may lose future business from such customers and harm our reputation and our customer relationships, either of which would harm our business and operating results.

We have a limited operating history and limited history of selling our DTN Systems and ATN Systems, both of which make it difficult to predict our future operating results.

We were incorporated in December 2000, shipped our first DTN System in November 2004 and shipped our first ATN System in August 2009. Our limited operating history gives very little basis upon which to evaluate our ability to accomplish our business objectives. In making an investment decision, you should evaluate our business in light of the risks, expenses and difficulties frequently encountered by companies in early stages of development, particularly companies in the rapidly changing optical communications market. We may not be successful in addressing these risks. It is difficult to accurately forecast our future revenue and plan expenses accordingly and, therefore, predict our future operating results.

The markets in which we compete are highly competitive and dominated by large corporations, and we may not be able to compete effectively.

Competition in the optical communications equipment market is intense, and we expect such competition to increase. A number of very large companies have historically dominated the optical communications network equipment industry. Our competitors include current wavelength division multiplexing suppliers, such as Alcatel-Lucent, Ciena Corporation, Cisco Systems, Ericsson, Fujitsu Limited, Huawei Technologies Co., NEC Corporation, Nokia-Siemens Networks, Tellabs and ZTE Corporation. Competition in these markets is based on price, commercial terms, functionality, manufacturing capability, pre-existing installation, services, existing business and customer relationships, scalability and the ability of products and breadth and quality of services to meet our customers immediate and future network requirements. Other companies have, or may in the future develop, products that are or could be competitive with our products. In particular, if a competitor develops a photonic integrated circuit with similar functionality to our PICs, our business could be harmed. Recent mergers from our competitors and any future acquisitions or combinations between or among our competitors may adversely affect our competitive position by strengthening our competitors.

Many of our competitors have substantially greater name recognition and technical, financial and marketing resources, greater manufacturing capacity and better established relationships with incumbent carriers and other potential customers than we have. Many of our competitors have more resources to develop or acquire, and more experience in developing or acquiring, new products and technologies and in creating market awareness for those products and technologies. In addition, many of our competitors have the financial resources to offer competitive products at aggressive pricing levels that could prevent us from competing effectively. Further, many of our competitors have built long-standing relationships with some of our prospective customers and have the ability to provide financing to customers and could, therefore, have an inherent advantage in selling products to those customers.

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We also compete with low-cost producers in China that can increase pricing pressure on us and a number of smaller companies that provide competition for a specific product, customer segment or geographic market. These competitors often base their products on the latest available technologies. Due to the narrower focus of their efforts, these competitors may achieve commercial availability of their products more quickly than we can and may provide attractive alternatives to our customers.

We are dependent on a small number of key customers for a significant portion of our revenue and the loss of, or a significant reduction in, orders from one or more of our key customers would reduce our revenue and harm our operating results.

A relatively small number of customers account for a large percentage of our net revenue. Our business will be harmed if we do not generate as much revenue as we expect from our key customers, if we experience a loss of any of our key customers or if we suffer a substantial reduction in orders from these customers. Our business also would be harmed if we fail to maintain our competitive advantage with our key customers.

On July 29, 2009, we were informed by Level 3 that they intend to use another DWDM vendor in their network. We believe that this vendor may ultimately be given a significant portion of Level 3 s new network deployments. This change may impact the revenue we receive from Level 3 in the future, although we cannot predict the timing of such impact.

Our ability to continue to generate revenue from our key customers will depend on our ability to maintain strong relationships with these customers and introduce new products that are desirable to these customers at competitive prices, and we may not be successful doing so. Because, in most cases, our sales are made to these customers pursuant to standard purchase agreements rather than long-term purchase commitments, orders may be cancelled or reduced readily. In the event of a cancellation or reduction of an order, we may not have enough time to reduce operating expenses to minimize the effect of the lost revenue on our business. Our operating results will continue to depend on our ability to sell our products to our large customers.

Our large customers have substantial negotiating leverage, which may require that we agree to terms and conditions that result in increased cost of sales, decreased revenue and lower average selling prices and gross margins, all of which would harm our operating results.

Substantial changes in the optical communications industry have occurred over the last few years. Many potential customers have confronted static or declining revenue. Many of our customers have substantial debt burdens, many have experienced financial distress, and some have gone out of business have been acquired by other service providers or announced their withdrawal from segments of the business. Consolidation in the markets in which we compete has resulted in changes in the structure of the communications networking industry, with greater concentration of purchasing power in a small number of large service providers, cable operators and government agencies. In addition, such consolidation has resulted in a substantial reduction in the number of our potential customers. For example, service providers, such as Level 3, have acquired a number of other communications service providers, including one of our other customers. This increased concentration among our customer base may also lead to increased negotiating power for our customers and may require us to decrease our average selling prices.

Further, many of our customers are large communications service providers that have substantial purchasing power and leverage in negotiating contractual arrangements with us. Our customers have and may continue to seek advantageous pricing and other commercial terms and may require us to develop additional features in the products we sell to them. If we are required to develop additional features for our product for a customer, we may be required to defer our revenue for such a customer until we have developed and delivered such additional features. We have and may continue to be required to agree to unfavorable commercial terms with these customers, including reducing the average selling price of our products in response to these commercial requirements or competitive pricing pressures. To maintain acceptable operating results, we will need to comply with these commercial terms, develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs.

We expect the factors described above to continue to affect our business and operating results for an indeterminate period, in several ways, including:

- overall capital expenditures by many of our customers or potential customers may be flat or reduced;

we will continue to have only limited ability to forecast the volume and product mix of our sales;

managing expenditures and inventory will be difficult in light of the uncertainties surrounding our business; and

increased competition will enable customers to insist on more favorable terms and conditions for sales, including product discounts, extended payment terms or financing assistance, as a condition of procuring their business.

If we are unable to offset any reductions in our average selling prices with increased sales volumes and reduced production costs, or if we fail to develop and introduce new products and enhancements on a timely basis, or if we disagree on our interpretation and compliance with the commercial terms of our customer agreements, our relationships with our customers and our operating results would be harmed.

We are dependent on sole source and limited source suppliers for several key components, and if we fail to obtain these components on a timely basis, we will not meet our customers product delivery requirements.

We currently purchase several key components for our products from single or limited sources. In particular, we rely on our own production of certain components of our products, such as PICs, and on third parties as sole source suppliers for certain of the components of our products, including: ASICs, field-programmable gate arrays, processors, and other semiconductor and optical components. We purchase these items on a purchase order basis and have no long-term contracts with many of these sole source suppliers. Recently, we have increased our reliance on third parties to develop and manufacture components for our products, some of which require custom development. For example, for the 40G application of our DTN System, we will be purchasing a customized discrete component. If any of our sole or limited source suppliers suffer from capacity constraints, lower than expected yields, deployment delays, work stoppages or any other reduction or disruption in output, they may be unable to meet our delivery schedule which could result in lost revenue, additional product costs and deployment delays that could harm our business and customer relationships. Further, our suppliers could enter into exclusive arrangements with our competitors, refuse to sell their products or components to us at commercially reasonable prices or at all, go out of business or discontinue their relationships with us. We may be unable to develop alternative sources for these components.

The loss of a source of supply, or lack of sufficient availability of key components, could require us to redesign products that use such components, which could result in lost revenue, additional product costs and deployment delays that could harm our business and customer relationships. If we do not receive critical components for our products in a timely manner, we will be unable to deliver those components to our contract manufacturer in a timely manner and would, therefore, be unable to meet our prospective customers product delivery requirements. In addition, the sourcing from new suppliers may require us to re-design our products, which could cause delays in the manufacturing and delivery of our products. In the past, we have experienced delivery delays because of lack of availability of components or reliability issues with components that we were purchasing. In addition, some of our suppliers have gone out of business, limited their supply of components to us, or indicated that they may be going out of business. Recently, we have seen a tightening of supply with a number of our suppliers and we have experienced longer than normal lead times and supply delays. We may in the future experience a shortage of certain components as a result of our own manufacturing issues, manufacturing issues at our suppliers or contract manufacturers, capacity problem experiences by our suppliers or contract manufacturers, or strong demand in the industry for such components. A return to growth in the economy is likely to continue to create pressure on us and our suppliers to accurately project overall component demand and manufacturing capacity. These supplier disruptions may continue to occur in the future, which could limit our ability to produce our products and cause us to fail to meet a customer s delivery requirements. Such events could harm our reputation and our customer relationships, either of which would harm our business and operating results.

If our contract manufacturers do not perform as we expect, our business may be harmed.

Our future success will depend on our ability to have sufficient volumes of our products manufactured in a cost-effective and quality-controlled manner. We have engaged third parties to manufacture certain elements of our products at multiple contract manufacturing sites located around the world. There are a number of risks associated with our dependence on contract manufacturers, including:

- reduced control over delivery schedules, particularly for international contract manufacturing sites;
- reliance on the quality assurance procedures of third parties;
- potential uncertainty regarding manufacturing yields and costs;
- potential lack of adequate capacity during periods of excess demand;

potential uncertainty related to the use of international contract manufacturing sites;

limited warranties on components supplied to us;

potential misappropriation of our intellectual property; and

potential manufacturing disruptions.

Any of these risks could impair our ability to fulfill orders. Our contract manufacturers may not be able to meet the delivery requirements of our customers, which could decrease customer satisfaction and harm our product sales. We do not have long-term contracts or arrangements with our contract manufacturers that will guarantee product availability, or the continuation of particular pricing or payment terms. If our contract manufacturers are unable or unwilling to continue manufacturing our products or components of our products in required volumes or our relationship with any of our contract manufacturers is discontinued for any reason, we would be required to identify and qualify alternative manufacturers, which could cause us to be unable to meet our supply requirements to our customers and result in the breach of our customer agreements. Qualifying a new contract manufacturer and commencing volume production is expensive and time-consuming and if we are required to change or qualify a new contract manufacturer, we would likely lose sales revenue and damage our existing customer relationships.

We are dependent on a single product, and the lack of continued market acceptance of our DTN System would harm our business.

Although in 2009 we added the ATN System as part of our product offering, our DTN System accounts for substantially all of our revenue and will continue to do so for the foreseeable future. As a result, our business could be harmed by:

- any decline in demand for our DTN System;
- the failure of our existing DTN System to achieve continued market acceptance;
- the introduction of products and technologies that serve as a replacement or substitute for, or represent an improvement over, our DTN System;
- technological innovations or new communications standards that our DTN System does not address; and
- our inability to release enhanced versions of our DTN System on a timely basis.

If we fail to expand sales of our products into international markets or to sell our products to new types of customers, such as U.S. regional Bell operating companies and international postal, telephone and telegraph companies, our revenue will be harmed.

We believe that, in order to grow our revenue and business and to build a large and diverse customer base, we must successfully sell our products in international markets and to new types of customers, such as U.S. regional Bell operating companies and international postal, telephone and telegraph companies. We have limited experience selling our products internationally and to U.S. regional Bell operating companies and international postal, telephone and telegraph companies. Sales cycles for these customers are often very lengthy and competition for these customers is intense. To succeed in these sales efforts, we believe we must hire additional sales personnel to develop our relationships with these potential customers and develop and manage new sales channels through resellers, distributors and systems integrators. If we do not succeed in our efforts to sell to these customers, the size of our total addressable market will be limited. This, in turn, would harm our ability to grow our customer base and revenue.

If we fail to protect our intellectual property rights, our competitive position could be harmed or we could incur significant expense to enforce our rights.

We depend on our ability to protect our proprietary technology. We rely on a combination of methods to protect our intellectual property, including limiting access to certain information, and utilizing trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. The steps we have taken to protect our proprietary rights may be inadequate to preclude misappropriation or unauthorized disclosure of our proprietary information or infringement of our intellectual property rights, and our ability to police such misappropriation, unauthorized disclosure or infringement is uncertain, particularly in countries outside of the United States. This is likely to become an increasingly important issue as we expand our operations and product development into countries that provide a lower level of intellectual property protection. We do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, the rights granted under any issued patents may not provide us with a competitive advantage, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future.

Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult, time consuming and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity or scope of the proprietary rights of others. Such litigation could result in substantial cost and diversion of management resources, either of which could harm our business, financial condition and operating results. Furthermore, many of our current and potential competitors have the ability to dedicate substantially greater resources to enforce their intellectual property rights than we do. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property.

Claims by others that we infringe their intellectual property could harm our business.

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In particular, many leading companies in the optical communications industry, including our competitors, have extensive patent portfolios with respect to optical communications technology. We expect that infringement claims may increase as the number of products and competitors in our market increases and overlaps occur. From time to time, third parties may assert exclusive patent, copyright, trademark and other intellectual property rights to technologies and related standards that are important to our business or seek to invalidate the proprietary rights that we hold. Competitors or other third parties have, and may continue to assert claims or initiate litigation or other proceedings against us or our manufacturers, suppliers or customers alleging infringement of their proprietary rights, or seeking to invalidate our proprietary rights, with respect to our products and technology. In the event that we are unsuccessful in defending against any such claims, or any resulting lawsuit or proceedings, we could incur liability for damages and/or have valuable proprietary rights invalidated.

Any claim of infringement from a third party, even one without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from running our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all. Alternatively, we may be required to develop non-infringing technology, which would require significant effort and expense and may ultimately not be successful. Any of these events could harm our business, financial condition and operating results. Competitors and other third parties have and may continue to assert infringement claims against our customers and sales partners. Any of these claims would require us to initiate or defend potentially protracted and costly litigation on their behalf, regardless of the merits of these claims, because we generally indemnify our customers and sales partners from claims of infringement of proprietary rights of third parties. If any of these claims succeed, we may be forced to pay damages on behalf of our customers or sales partners, which could have an adverse effect on our business, financial condition and operating results.

We incorporate open source software into our products. Although we monitor our use of open source software closely, the terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. In such event, we could be required to seek licenses from third parties in order to continue offering our products, to re-engineer our products or to discontinue the sale of our products in the event re-engineering cannot be accomplished on a timely basis, any of which could adversely affect our business, operating results and financial condition.

We are currently involved in litigation with Cheetah and Level 3 in the United States District Court for the Eastern District of Texas Texarkana Division whereby Cheetah alleges that Infinera and Level 3 infringe on two Cheetah patents. We are also currently involved in litigation with Aloft in the United States District Court for the Eastern District of Texas Tyler Division whereby Aloft alleges that Infinera infringes on two Aloft patents. Information regarding the Company s lawsuits with Cheetah and Aloft is set forth above under Part II, Item 1. Legal Proceedings and is incorporated herein by reference. We believe these lawsuits are without merit and intend to defend ourselves vigorously, but are unable to predict the likelihood of an unfavorable outcome. In the event that Cheetah or Aloft is successful in obtaining a judgment requiring us to pay damages or obtains an injunction preventing the sale of our products, our business and operating results could be harmed.

Our manufacturing process is very complex and the partial or complete loss of our manufacturing facility, or a reduction in yields or an inability to scale capacity to meet customer demands could harm our business.

The manufacturing process for certain components of our products, including our PICs, is technically challenging. In the event that any of these manufacturing facilities was fully or partially destroyed, as a result of fire, water damage, or otherwise, it would limit our ability to produce our products. Because of the complex nature of our manufacturing facilities, such loss would take a considerable amount of time to repair or rebuild. The partial or complete loss of any of our manufacturing facilities, or an event causing the interruption in our use of such facility for any extended period of time would cause our business, financial condition and operating results to be harmed.

Minor deviations in the PIC manufacturing process can cause substantial decreases in yields and, in some cases, cause production to be suspended. In the past, we have had significant variances in our PIC yields, including production interruptions and suspensions and may have continued yield variances, including additional interruptions or suspensions in the future. We expect our manufacturing yield

for our next generation PICs to be lower initially and increase as we achieve full production. Poor yields from our PIC manufacturing process or defects, integration issues or other performance problems in our products could limit our ability to satisfy customer demand requirements, and could cause us customer relations and business reputation problems, harming our business and operating results.

In addition, our manufacturing facilities may not have adequate capacity to meet the demand for our products or we may not be able to increase our capacity to meet potential increases in demand for our products. Our inability to obtain sufficient manufacturing capacity to meet demand, either in our own facilities or through foundry or similar arrangements with third parties, could harm our relationships with customers, our business and our operating results.

Our leadership transitions may not go smoothly and could adversely impact our future operations.

On January 1, 2010, Jagdeep Singh stepped down as our President and Chief Executive Officer and became our Executive Chairman. On October 14, 2010, Mr. Singh subsequently resigned from this position. On January 1, 2010, Thomas Fallon, our then Chief Operating Officer became our President and Chief Executive Officer. On June 26, 2010, Duston Williams stepped down as our Chief Financial Officer and was replaced by Ita Brennan, our former Vice President of Finance and Corporate Controller. A significant leadership change is inherently risky and we may be unable to manage these transitions smoothly which could adversely impact our future strategy and ability to function or execute and could materially and adversely affect our business, financial condition and results of operations.

Recent turmoil in the financial markets and the global recession has adversely affected and may continue to adversely affect our industry, business and gross margins.

Our business depends on the overall demand for additional bandwidth capacity and on the economic health and willingness of our customers and potential customers to make capital commitments to purchase our products and services. As a result of the recent economic slowdown, and related market uncertainty, we may face new risks that we have not yet identified. In addition, a number of the risks associated with our business, which are disclosed in these risk factors, may increase in likelihood, magnitude or duration.

As a result of the tightening of credit markets, our customers may be delayed in obtaining, or may not be able to obtain, necessary financing for their purchases of our products. A lack of liquidity in the capital markets or the continued uncertainty in the global economic environment may cause our customers to delay or cancel their purchases, increase the time they take to pay or default on their payment obligations, each of which would negatively affect our business and operating results. Continued weakness and uncertainty in the global economy could cause some of our customers to become illiquid, delay payments or adversely affect our collection of their accounts, which could result in a higher level of bad debt expense. In addition, currency fluctuations could negatively affect our international customers ability or desire to purchase our products.

Challenging economic conditions have from time to time contributed to slowdowns in the telecommunications industry in which we operate. This slowdown may result in:

- reduced demand for our products as a result of constraints on capital spending by our customers, particularly service providers;
- increased price competition for our products, not only from our competitors, but also as a result of our customer s or potential customer s utilization of inventoried or underutilized products, which could put additional pressure on our near term gross profits;
- risk of excess or obsolete inventories;
- excess manufacturing capacity and higher associated overhead costs as a percentage of revenue; and
- more limited ability to accurately forecast our business and future financial performance.

The lack of liquidity and economic slowdown may adversely affect our suppliers or the terms on which we purchase products from these suppliers. It may also cause some of our suppliers to become illiquid. Any of these impacts could limit our ability to obtain components for our products from these suppliers and could adversely impact our supply chain or the delivery schedule to our customers. This also could require us to purchase more expensive components, or re-design our products, which could cause increases in the cost of our products and delays in the manufacturing and delivery of our products. Such events could harm our gross margins and harm our reputation and our customer relationships, either of which could harm our business and operating results.

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If we fail to accurately forecast demand for our products, we may have excess or insufficient inventory, which may increase our operating costs, decrease our revenue and harm our business.

We are required to generate forecasts of future demands for our products several months prior to the scheduled delivery to our prospective customers, which requires us to make significant investments before we know if corresponding revenue will be recognized. Lead times for materials and components, including ASICs, that we need to order for the manufacture of our products vary significantly and depend on factors such as the specific supplier, contract terms and demand for each component at a given time. In the past, we have experienced the lengthening in lead times for certain components. If the lead times for components are lengthened, we may be required to purchase increased levels of such components to satisfy our delivery commitments to our customers.

If we overestimate demand for our products or particular elements of our products and increase our inventory in anticipation of customer orders that do not materialize, we will have excess inventory, we will face a risk of obsolescence and significant inventory write-downs and our fixed costs will be spread across fewer units raising our per unit costs. If we underestimate demand for our products, we will have inadequate inventory, which could slow down or interrupt the manufacturing of our products and result in delays in shipments and our ability to recognize revenue. If actual market conditions are less favorable than our internal projections, additional inventory write-offs may be required. In addition, we may be unable to meet our supply commitments to customers which could result in a breach of our customer agreements and require us to pay damages.

Product performance problems, including undetected errors in our hardware or software, or deployment delays could harm our business and reputation.

The development and production of new products with high technology content is complicated and often involves problems with software, components and manufacturing methods. Complex hardware and software systems, such as our products, can often contain undetected errors when first introduced or as new versions are released. In addition, errors associated with components we purchase from third parties, including customized components, may be difficult to resolve. We have experienced errors in the past in connection with our DTN System, including failures due to the receipt of faulty components from our suppliers. We suspect that errors, including potentially serious errors, will be found from time to time in our products. We have been shipping our DTN System since November 2004 and our ATN System since August 2009, which provides us with limited information on which to judge their reliability. Our products may suffer degradation of performance and reliability over time.

If reliability, quality or network monitoring problems develop, a number of negative effects on our business could result, including:

- delays in our ability to recognize revenue;
- costs associated with fixing software or hardware defects or replacing products;
- high service and warranty expenses;
- delays in shipments;
- high inventory excess and obsolescence expense;
- high levels of product returns;

- diversion of our engineering personnel from our product development efforts;
- delays in collecting accounts receivable;
- payment of damages for performance failures;
- reduced orders from existing customers; and
- declining interest from potential customers.

Because we outsource the manufacturing of certain components of our products, we may also be subject to product performance problems as a result of the acts or omissions of third parties.

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From time to time, we encounter interruptions or delays in the activation of our products at a customer s site. These interruptions or delays may result from product performance problems or from issues with installation and activation, some of which are outside our control. If we experience significant interruptions or delays that we cannot promptly resolve, the associated revenue for these installations may be delayed or confidence in our products could be undermined, which could cause us to lose customers and fail to add new customers.

We must respond to rapid technological change and comply with evolving industry standards and requirements for our products to be successful.

The optical communications equipment market is characterized by rapid technological change, changes in customer requirements and evolving industry standards. The introduction of new communications technologies and the emergence of new industry standards or requirements could render our products obsolete. Further, in developing our products, we have made, and will continue to make, assumptions with respect to which standards or requirements will be adopted by our customers and competitors. If the standards or requirements adopted by our prospective customers are different from those on which we have focused our efforts, market acceptance of our products would be reduced or delayed and our business would be harmed.

We expect our competitors to continue to improve the performance of their existing products and to introduce new products and technologies and to influence customers buying criteria so as to emphasize product capabilities that we may not possess, such as capacity greater than 1.6 Terabits per second. To be competitive, we must continue to invest significant resources in research and development, sales and marketing and customer support. We may not have sufficient resources to make these investments, we may not be able to make the technological advances necessary to be competitive and we may not be able to effectively sell our products to customers who have prior relationships with our competitors.

If we fail to maintain effective internal control over financial reporting in the future, the accuracy and timing of our financial reporting may be adversely affected.

We are required to comply with Section 404 of the Sarbanes-Oxley Act of 2002. The provisions of the act require, among other things, that we maintain effective internal control over financial reporting and disclosure controls and procedures. Preparing our financial statements involves a number of complex processes, many of which are done manually and are dependent upon individual data input or review. These processes include, but are not limited to, calculating revenue, deferred revenue and inventory costs. While we continue to automate our processes and enhance our review and put in place controls to reduce the likelihood for errors, we expect that for the foreseeable future many of our processes will remain manually intensive and thus subject to human error.

In the past, we have identified several material weaknesses in our internal control over financial reporting. We have remediated these identified material weaknesses, but we cannot give any assurances that all material weaknesses have been identified or that additional material weaknesses will not be identified in the future in connection with our compliance with the provisions of Section 404 of the Sarbanes-Oxley Act of 2002. The existence of one or more material weaknesses could preclude a conclusion by management that we maintained effective internal control over financial reporting. The existence or disclosure of any such material weakness could adversely affect our stock price.

If we lose key personnel or fail to attract and retain additional qualified personnel when needed, our business may be harmed.

Our success depends to a significant degree upon the continued contributions of our key management, engineering, sales and marketing, and finance personnel, many of whom would be difficult to replace. For example, senior members of our engineering team have unique technical experience that would be difficult to replace. We do not have long-term employment contracts or key person life insurance covering any of our key personnel. Because our products are complex, we must hire and retain a large number of highly trained customer service and support personnel to ensure that the deployment of our products do not result in network disruption for our customers. We believe our future success will depend in large part upon our ability to identify, attract and retain highly skilled managerial, engineering, sales, marketing, finance and customer service and support personnel. Competition for these individuals is intense in our industry, especially in the San Francisco Bay Area. We may not succeed in identifying, attracting and retaining appropriate personnel. The loss of the services of any of our key personnel, the inability to identify, attract or retain qualified personnel in the future or delays in hiring qualified personnel, particularly engineers and sales personnel, could make it difficult for us to manage our business and meet key objectives, such as timely product introductions.

Our sales cycle can be long and unpredictable, which could result in an unexpected revenue shortfall in any given quarter.

Our products have a lengthy sales cycle, which can extend from six to twelve months and may take even longer for larger prospective customers such as U.S. regional Bell operating companies, international postal, telephone and telegraph companies and U.S. competitive local exchange carriers. Our prospective customers conduct significant evaluation, testing, implementation and acceptance

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procedures before they purchase our products. We incur substantial sales and marketing expenses and expend significant management effort during this time, regardless of whether we make a sale.

Because the purchase of our equipment involves substantial cost, most of our customers wait to purchase our equipment until they are ready to deploy it in their network. As a result, it is difficult for us to accurately predict the timing of future purchases by our customers. In addition, product purchases are often subject to budget constraints, multiple approvals and unplanned administrative processing and other delays. If sales expected from customers for a particular quarter are not realized in that quarter or at all, our revenue will be negatively impacted.

Our international sales and operations subject us to additional risks that may harm our operating results.

We market, sell and service our products globally. In 2009, 2008 and 2007, we derived approximately 31%, 21% and 19%, respectively, of our revenue from customers outside of the United States. We have sales and support personnel in numerous countries worldwide. In addition, we have a large group of development personnel located in Bangalore, India, Beijing, China and Kanata, Canada. We expect that significant management attention and financial resources will be required for our international activities over the foreseeable future as we continue to expand our international presence. In some countries, our successes in selling our products will depend in part on our ability to form relationships with local partners. Our inability to identify appropriate partners or reach mutually satisfactory arrangements for international sales of our products could impact our ability to maintain or increase international market demand for our products.

Our international operations are subject to inherent risks, and our future results could be adversely affected by a variety of factors, many of which are outside of our control, including:

- greater difficulty in collecting accounts receivable and longer collection periods;
- difficulties of managing and staffing international offices, and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- the impact of recessions in economies outside the United States;
- tariff and trade barriers and other regulatory requirements or contractual limitations on our ability to sell or develop our products in certain foreign markets;
- certification requirements;
- greater difficulty documenting and testing our internal controls;
- reduced protection for intellectual property rights in some countries;
- potentially adverse tax consequences;
- political and economic instability;
- effects of changes in currency exchange rates which could negatively affect our financial results and cash flows; and

service provider and government spending patterns.

International customers may also require that we comply with certain testing or customization of our products to conform to local standards. The product development costs to test or customize our products could be extensive and a material expense for us.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks could harm our international operations and reduce our international sales.

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We may be adversely affected by fluctuations in currency exchange rates.

A portion of our sales are from countries outside of the United States, and are in currencies other than U.S. dollars, particularly the Euro. Accordingly, fluctuations in foreign currency rates, most notably the strengthening of the dollar against the Euro, could have a material impact on our revenue in future periods. We enter into foreign currency forward exchange contracts to hedge against the short-term impact of currency fluctuations related to certain forecasted sales transactions denominated in Euro and into foreign currency exchange forward contracts to reduce the impact of foreign currency fluctuations on accounts receivable denominated in Euro. These hedging programs reduce the impact of currency exchange rate movements on certain transactions, but do not cover all foreign-denominated transactions and therefore do not entirely eliminate the impact of fluctuations in exchange rates which could negatively affect our results of operations and financial condition.

Any acquisitions we make could disrupt our business and harm our financial condition and operations.

We have made strategic acquisitions of businesses, technologies and other assets in the past. While we have no current agreements or commitments, we may in the future acquire businesses, product lines or technologies. In the event of any future acquisitions, we may not ultimately strengthen our competitive position or achieve our goals, or they may be viewed negatively by customers, financial markets or investors and we could:

- issue stock that would dilute our current stockholders percentage ownership;
- incur debt and assume other liabilities; or
- incur amortization expenses related to goodwill and other intangible assets and/or incur large and immediate write-offs.

Acquisitions also involve numerous risks, including:

- problems integrating the acquired operations, technologies or products with our own;
- diversion of management s attention from our core business;
- assumption of unknown liabilities;
- adverse effects on existing business relationships with suppliers and customers;
- increased accounting compliance risk;
- risks associated with entering new markets; and
- potential loss of key employees.

We may not be able to successfully integrate any businesses, products, technologies or personnel that we might acquire in the future. Our failure to do so could have an adverse effect on our business, financial condition and operating results.

Our use and reliance upon development resources in India, China and Canada may expose us to unanticipated costs or liabilities.

We have established development centers in India, China and Canada and expect to continue to increase hiring of personnel for these facilities. There is no assurance that our reliance upon development resources in India, China or Canada will enable us to achieve meaningful cost reductions or greater resource efficiency. Further, our development efforts and other operations in these countries involve significant risks, including:

- difficulty hiring and retaining appropriate engineering resources due to intense competition for such resources and resulting wage inflation;
- the knowledge transfer related to our technology and exposure to misappropriation of intellectual property or confidential information, including information that is proprietary to us, our customers and other third parties;

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- heightened exposure to changes in the economic, security and political conditions of India, China and Canada;
- fluctuation in currency exchange rates and tax risks associated with international operations; and
- development efforts that do not meet our requirements because of language, cultural or other differences associated with international operations, resulting in errors or delays.

Difficulties resulting from the factors above and other risks related to our operations in these countries could expose us to increased expense, impair our development efforts, harm our competitive position and damage our reputation.

Unforeseen health, safety and environmental costs could harm our business.

Our manufacturing operations use substances that are regulated by various federal, state and international laws governing health, safety and the environment, including the Waste Electrical and Electronic Equipment and Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment regulations adopted by the European Union. If we experience a problem with these substances, it could cause an interruption or delay in our manufacturing operations or could cause us to incur liabilities for any costs related to health, safety or environmental remediation. We could also be subject to liability if we do not handle these substances in compliance with safety standards for storage and transportation and applicable laws. If we experience a problem or fail to comply with such safety standards, our business, financial condition and operating results may be harmed.

We are subject to governmental export and import controls that could subject us to liability or impair our ability to compete in international markets.

We are subject to export control laws that limit which products we sell and where and to whom we sell our products. U.S. export control laws also limit our ability to conduct product development activities in certain countries. In addition, various countries regulate the import of certain technologies and have enacted laws that could limit our ability to distribute our products or could limit our customers ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products throughout their global systems or, in some cases, prevent the export or import of our products to certain countries altogether. Any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. Failure to comply with these and similar laws on a timely basis, or at all, decreased use of our products or any limitation on our ability to export or sell our products would adversely affect our business, financial condition and operating results.

If we need additional capital in the future, it may not be available to us on favorable terms, or at all.

Our business requires significant capital. We have historically relied on significant outside debt and equity financing as well as cash flow from operations to fund our operations, capital expenditures and expansion. We may require additional capital from equity or debt financings in the future to fund our operations or respond to competitive pressures or strategic opportunities. We have a history of significant operating losses. For 2009, we had a net loss of $86.6 million and for the nine months ended September 25, 2010, we had a net loss of $25.2 million. In the event that we require additional capital, we may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock. If we are unable to obtain adequate financing or financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be limited and our business will be harmed.

We are subject to government regulations that could adversely impact our business.

The Federal Communications Commission, or FCC, has jurisdiction over the entire U.S. communications industry and, as a result, our products and our U.S. customers are subject to FCC rules and regulations. Current and future FCC regulations affecting communications services, our products or our customers businesses could negatively affect our business. In addition, international regulatory standards could impair our ability to develop products for international customers in the future. Delays caused by our compliance with regulatory requirements could result in postponements or cancellations of product orders. Further, we may not be

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successful in obtaining or maintaining any regulatory approvals that may, in the future, be required to operate our business. Any failure to obtain such approvals could harm our business and operating results.

Natural disasters, terrorist attacks or other catastrophic events could harm our operations.

Our headquarters and the majority of our infrastructure, including our PIC manufacturing facility, are located in Northern California, an area that is susceptible to earthquakes and other natural disasters. Further, a terrorist attack aimed at Northern California or at our nation s energy or telecommunications infrastructure could hinder or delay the development and sale of our products. In the event that an earthquake, terrorist attack or other catastrophe were to destroy any part of our facilities, or certain of our contract manufacturers facilities, destroy or disrupt vital infrastructure systems or interrupt our operations for any extended period of time, our business, financial condition and operating results would be harmed.

The trading price of our common stock has been volatile and is likely to be volatile in the future.

The trading prices of our common stock and the securities of other technology companies have been and may continue to be highly volatile. Further, our common stock has limited prior trading history. Factors affecting the trading price of our common stock include:

- variations in our operating results;
- announcements of technological innovations, new services or service enhancements, strategic alliances or agreements by us or by our competitors;
- the gain or loss of customers;
- recruitment or departure of key personnel;
- changes in the estimates of our future operating results or external guidance on those results or changes in recommendations by any securities analysts that elect to follow our common stock;
- market conditions in our industry, the industries of our customers and the economy as a whole; and
- adoption or modification of regulations, policies, procedures or programs applicable to our business.

In addition, if the market for technology stocks or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, financial condition or operating results. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. Each of these factors, among others, could harm the value of your investment in our common stock. Some companies that have had volatile market prices for their securities have had securities class action lawsuits filed against them. If a suit were filed against us, regardless of its merits or outcome, it could result in substantial costs and divert management s attention and resources.

Anti-takeover provisions in our charter documents and Delaware law could discourage delay or prevent a change in control of our company and may affect the trading price of our common stock.

We are a Delaware corporation and the anti-takeover provisions of the Delaware General Corporation Law, which apply to us, may discourage, delay or prevent a change in control by prohibiting us from engaging in a business combination with an interested stockholder for a period of three years after the person becomes an interested stockholder, even if a change of control would be beneficial to our existing stockholders. In addition, our amended and restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a change in our management or control over us that stockholders may consider favorable. Our amended and restated certificate of incorporation and amended and restated bylaws:

- authorize the issuance of blank check convertible preferred stock that could be issued by our board of directors to thwart a takeover attempt;

- establish a classified board of directors, as a result of which the successors to the directors whose terms have expired will be elected to serve from the time of election and qualification until the third annual meeting following their election;

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- require that directors only be removed from office for cause and only upon a supermajority stockholder vote;

- provide that vacancies on the board of directors, including newly-created directorships, may be filled only by a majority vote of directors then in office rather than by stockholders;

- prevent stockholders from calling special meetings; and

- prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders.

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Item 6. ***Exhibits***

Exhibit No.	Description
10.1	Form of Section 16 Officer Restricted Stock Unit Agreement under the 2007 Equity Incentive Plan.
10.2	Form of Section 16 Officer Performance Share Agreement under the 2007 Equity Incentive Plan.
10.3(1)	Form of CEO Amended and Restated Change of Control Severance Agreement
10.4(1)	Form of Section 16 Officer Amended and Restated Change of Control Severance Agreement
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to exhibit filed with Registrant s Current Report on Form 8-K (No. 001-33486) filed with the SEC on September 13, 2010.

The certification attached as Exhibit 32.1 that accompanies this Quarterly Report on Form 10-Q is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Infinera Corporation under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date of this Quarterly Report on Form 10-Q, irrespective of any general incorporation language contained in such filing.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Infinera Corporation

By: /s/ Ita M. Brennan

Ita M. Brennan
Chief Financial Officer
(Duly Authorized Officer and Principal Financial Officer)

Date: November 2, 2010