

RIVERSTONE NETWORKS INC  
Form 10-Q  
June 25, 2002  
Table of Contents

---

## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

---

### FORM 10-Q

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

For the Quarter Ended June 1, 2002

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

Commission File Number 0-32269

---

### RIVERSTONE NETWORKS, INC.

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

95-4596178  
(I.R.S. Employer  
Identification no.)

5200 Great America Parkway, Santa Clara, CA 95054  
(Address of principal executive offices and zip code)

(408) 878-6500  
Registrant's telephone number, including area code:

---

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

As of June 17, 2002 there were 122,704,863 shares of the Registrant's common stock outstanding.

---

---

**Table of Contents**

**INDEX**

**RIVERSTONE NETWORKS, INC.**

|   | <b><u>Page</u></b> |
|---|--------------------|
| <u>Facing Page</u>  | 1                  |
| <u>Index</u>  | 2                  |
| <br>PART I. FINANCIAL INFORMATION<br><br>   |                    |
| Item 1. Financial Statements (Unaudited)  |                    |
| <u>Condensed Consolidated Balance Sheets June 1, 2002 and March 2, 2002</u>                             | 3                  |
| <u>Condensed Consolidated Statements of Operations Three months ended June 1, 2002 and June 2, 2001</u> | 4                  |
| <u>Condensed Consolidated Statements of Cash Flows Three months ended June 1, 2002 and June 2, 2001</u> | 5                  |
| <u>Notes to Condensed Consolidated Financial Statements</u>   | 6                  |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>    | 11                 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>                               | 22                 |
| <br>PART II. OTHER INFORMATION<br><br>  |                    |
| Item 1. <u>Legal Proceedings</u>  | 22                 |
| Item 6. <u>Exhibits and Reports on Form 8-K</u>   | 23                 |
| <u>Signatures</u>   | 24                 |

**Table of Contents****PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements (unaudited)**

**RIVERSTONE NETWORKS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands)

|   | <b>June 1,<br/>2002</b> | <b>March 2,<br/>2002</b> |
|---|-------------------------|--------------------------|
|   | <b>(unaudited)</b>      | <b>(1)</b>               |
| <b>ASSETS</b>                               |                         |                          |
| Current Assets:                             |                         |                          |
| Cash and cash equivalents                   | \$ 45,531               | \$ 123,095               |
| Short-term investments                      | 199,259                 | 160,779                  |
| Accounts receivable, net                    | 50,451                  | 42,535                   |
| Inventories                                 | 17,494                  | 20,155                   |
| Prepaid expenses and other current assets   | 10,888                  | 13,173                   |
|   | <b>323,623</b>          | <b>359,737</b>           |
| Property and equipment, net                 |                         |                          |
| Intangible and other long-term assets, net  | 21,704                  | 22,508                   |
| Long-term investments                       | 24,063                  | 27,414                   |
|   | 215,117                 | 201,962                  |
|   | <b>\$ 584,507</b>       | <b>\$ 611,621</b>        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                         |                          |
| Current Liabilities:                        |                         |                          |
| Accounts payable                            | \$ 20,856               | \$ 34,873                |
| Deferred revenue                            | 9,215                   | 9,012                    |
| Accrued compensation                        | 8,130                   | 9,166                    |
| Other accrued liabilities                   | 9,884                   | 8,475                    |
|   | <b>48,085</b>           | <b>61,526</b>            |
| Long-Term Liabilities:                      |                         |                          |
| Convertible subordinated notes              | 175,000                 | 175,000                  |
| Commitments and contingencies               |                         |                          |
| Stockholders' equity:                       |                         |                          |
| Common stock                                | 1,227                   | 1,224                    |
| Additional paid in capital                  | 452,829                 | 451,645                  |
| Accumulated deficit                         | (88,124)                | (72,175)                 |
| Unearned stock-based compensation           | (5,602)                 | (6,543)                  |
| Accumulated other comprehensive income      | 1,092                   | 944                      |
|   | <b>361,422</b>          | <b>375,095</b>           |
|   | <b>\$ 584,507</b>       | <b>\$ 611,621</b>        |

- 
- (1) The balance sheet at March 2, 2002 has been derived from the audited consolidated financial statements at that date, but does not include all the information and footnotes required by generally accepted accounting principles for the complete financial statements.

See accompanying notes to the condensed consolidated financial statements

**Table of Contents****RIVERSTONE NETWORKS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(in thousands, except per share amounts)**  
**(unaudited)**

|  | <b>Three months ended</b> |                         |
|--|---------------------------|-------------------------|
|  | <b>June 1,<br/>2002</b>   | <b>June 2,<br/>2001</b> |
| Net revenues                                   | \$ 30,100                 | \$ 44,167               |
| Cost of revenues                               | 14,872                    | 19,071                  |
| Stock-based compensation                       | 84                        | 93                      |
| <b>Total cost of revenues</b>                  | <b>14,956</b>             | <b>19,164</b>           |
| Gross profit                                   | 15,144                    | 25,003                  |
| Operating expenses:                            |                           |                         |
| Research and development                       | 12,206                    | 13,286                  |
| Sales and marketing                            | 13,415                    | 13,097                  |
| General and administrative                     | 5,482                     | 5,037                   |
| Stock-based compensation                       | 568                       | 592                     |
| <b>Total operating expenses</b>                | <b>31,671</b>             | <b>32,012</b>           |
| Operating loss                                 | (16,527)                  | (7,009)                 |
| Interest and other income, net                 | 3,020                     | 2,315                   |
| Interest expense                               | (2,062)                   | (15)                    |
| <b>Loss before income taxes</b>                | <b>(15,569)</b>           | <b>(4,709)</b>          |
| Income taxes                                   | 380                       |                         |
| <b>Net loss</b>                                | <b>\$ (15,949)</b>        | <b>\$ (4,709)</b>       |
| Net loss per share:                            |                           |                         |
| Basic and diluted                              | \$ (0.13)                 | \$ (0.04)               |
| Weighted average number of shares outstanding: |                           |                         |
| Basic and diluted                              | 122,580                   | 107,490                 |

See accompanying notes to the condensed consolidated financial statements

**Table of Contents****RIVERSTONE NETWORKS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(unaudited)**

|   | <b>Three months ended</b> |                     |
|---|---------------------------|---------------------|
|   | <b>June 1, 2002</b>       | <b>June 2, 2001</b> |
| <b>Cash flows from operating activities:</b>                                |                           |                     |
| Net loss  | \$ (15,949)               | \$ (4,709)          |
| Adjustments to reconcile net loss to net cash used in operating activities: |                           |                     |
| Depreciation  | 3,089                     | 1,979               |
| Amortization  | 124                       | 388                 |
| Provision for losses on accounts receivable                                 | 2,015                     | 1,500               |
| Stock-based compensation  | 652                       | 685                 |
| Changes in assets and liabilities:  |                           |                     |
| Accounts receivable   | (9,931)                   | 1,807               |
| Inventories   | 2,661                     | (2,406)             |
| Prepaid expenses and other assets   | 2,285                     | (3,560)             |
| Accrued expenses and accounts payable                                       | (13,643)                  | (3,913)             |
| Long-term assets  | 3,226                     |                     |
| Deferred revenue  | 203                       | (3,760)             |
|   | <u>          </u>         | <u>          </u>   |
| Net cash used by operating activities                                       | (25,268)                  | (11,989)            |
|   | <u>          </u>         | <u>          </u>   |
| <b>Cash flows from investing activities:</b>                                |                           |                     |
| Capital expenditures  | (2,285)                   | (5,687)             |
| Proceeds from maturities of available-for-sale investments                  | 44,047                    |                     |
| Proceeds from sales of available-for-sale investments                       | 23,547                    |                     |
| Purchases of available-for-sale investments                                 | (110,508)                 | (84,094)            |
| Purchases of other long-term investments, net                               | (8,675)                   |                     |
|   | <u>          </u>         | <u>          </u>   |
| Net cash used in investing activities                                       | (53,874)                  | (89,781)            |
|   | <u>          </u>         | <u>          </u>   |
| <b>Cash flows from financing activities:</b>                                |                           |                     |
| Net transfers from Cabletron  |                           | 4,117               |
| Proceeds from issuance of common stock                                      | 1,476                     |                     |
|   | <u>          </u>         | <u>          </u>   |
| Net cash provided by financing activities                                   | 1,476                     | 4,117               |
|   | <u>          </u>         | <u>          </u>   |
| Effect of foreign exchange rate changes on cash                             | 102                       |                     |
|   | <u>          </u>         | <u>          </u>   |
| Net decrease in cash and cash equivalents                                   | (77,564)                  | (97,653)            |
| Cash and cash equivalents, at beginning of period                           | 123,095                   | 167,949             |
|   | <u>          </u>         | <u>          </u>   |
| Cash and cash equivalents, at end of period                                 | \$ 45,531                 | \$ 70,296           |
|   | <u>          </u>         | <u>          </u>   |

See accompanying notes to the condensed consolidated financial statements



---

**Table of Contents**

**RIVERSTONE NETWORKS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note (1) Business Operations**

Riverstone Networks designs and manufactures routers that enable service providers to convert network bandwidth into differentiated services for their customers. The Company was created by the combination of two businesses previously acquired by Cabletron: Zeitnet Inc. ( Zeitnet ), which Cabletron acquired in 1996 and Yago Systems Inc. ( Yago ), which Cabletron acquired in 1998.

On February 10, 2000, Cabletron Systems, Inc. ( Cabletron ) announced its plan to create an independent publicly-traded company, Riverstone Networks, Inc. ( Riverstone or the Company ), comprised of Cabletron s Internet infrastructure solutions business for Internet service providers and other service providers. After completion of Riverstone s initial public offering on February 22, 2001, Cabletron owned 92,088,235 shares of common stock, representing approximately 86% of Riverstone s outstanding common stock. On July 24, 2001, Riverstone issued 7,117,757 shares of common stock to Cabletron in exchange for approximately \$122.2 million in cash and certain strategic investments, with a historic cost of approximately \$13.0 million. On August 6, 2001, (the Distribution Date ), Cabletron distributed all of its shares of Riverstone s common stock to its stockholders and Riverstone ceased to be a subsidiary of Cabletron. In connection with Cabletron s distribution of the Company s common stock to its stockholders, Riverstone was required to issue warrants to certain of Cabletron s investors to purchase 230,364 shares of its common stock. Additionally, Riverstone was obligated to grant supplemental options under its 2000 Equity Incentive Plan to acquire 3,146,272 shares of its common stock to those persons who held compensatory Cabletron stock options.

On the Distribution Date, Cabletron merged its subsidiary Enterasys Networks, Inc. into itself and renamed itself Enterasys Networks, Inc. The terms Cabletron and Enterasys included hereafter refer to Enterasys Networks, Inc. (formerly known as Cabletron Systems, Inc.) and Old Enterasys refers to the Enterasys Networks, Inc. that existed as a subsidiary of Cabletron prior to its merger into Cabletron.

**Note (2) Basis of Presentation**

The accompanying consolidated financial statements have been prepared by Riverstone pursuant to the rules and regulations of the Securities and Exchange Commission and include the accounts of Riverstone and its wholly-owned subsidiaries. Certain information and footnote disclosures, normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States, have been condensed or omitted pursuant to such rules and regulations. While in the opinion of the Company, the unaudited financial statements reflect all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the financial position at June 1, 2002 and the operating results and cash flows for the three months ended June 1, 2002 and June 2, 2001, these financial statements and notes should be read in conjunction with the Company s audited consolidated financial statements and notes for the year ended March 2, 2002 included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission. The condensed consolidated balance sheet at March 2, 2002 has been derived from audited financial statements as of that date.

Operating results for the three months ended June 1, 2002 are not necessarily indicative of the results that may be expected for the fiscal year ending March 1, 2003.

The consolidated financial information for the period prior to the Distribution Date includes allocations of certain Cabletron expenses, including centralized legal, accounting, treasury, real estate, information technology, and other Cabletron corporate services and infrastructure costs. All of the allocations and estimates in the financial statements are based upon assumptions that the Company s and Cabletron s management believed to be reasonable reflections of the cost of services provided or benefit received by Riverstone. However, these financial statements do not necessarily indicate the financial position or results of operations that would have occurred if the Company were a stand-alone entity during the applicable periods.

**Note (3) Reclassifications**

Certain items previously reported in specific financial captions have been reclassified to conform with the June 1, 2002 presentation.



**Table of Contents****RIVERSTONE NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note (4) Strategic Investments**

The Company has certain strategic investments in private and public debt and equity securities. These investments are accounted for using the cost method as Riverstone holds less than 20% of the equity of each of these companies and does not have the ability to exercise significant influence over their operations. As of June 1, 2002, the Company's strategic investment portfolio totaling \$48.7 million was included in long-term investments. There were no strategic investments at June 2, 2001. The Company reviews the carrying value of these investments at the end of each reporting period to determine if any investments are impaired. This review includes an evaluation of historical and projected financial performance, expected cash needs and recent funding events. Other-than-temporary impairments are recognized in earnings if the market value of the investment is below its current carrying value or the issuer has experienced significant financial declines or difficulties in raising capital to continue operations. During the three months ended June 1, 2002, sales to strategic investee companies represented approximately 7% of net revenues, with sales to no one investee company exceeding 4% of net revenues.

**Note (5) Inventories**

Inventories consist of the following at June 1, 2002 and March 2, 2002 (in thousands):

|                        | <u>June 1, 2002</u> | <u>March 2, 2002</u> |
|------------------------|---------------------|----------------------|
| Raw materials          | \$ 3,261            | \$ 1,918             |
| Finished goods         | 6,935               | 6,800                |
| Consignment            | 7,298               | 11,437               |
|                        | <u>          </u>   | <u>          </u>    |
| Total inventories, net | \$ 17,494           | \$ 20,155            |

**Note (6) Goodwill and Purchased Intangible Assets**

Effective March 3, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets. As required by SFAS No. 142, the Company discontinued amortizing the remaining balance of goodwill totaling \$6.3 million as of the beginning of fiscal 2003. All remaining and future acquired goodwill will be subject to impairment tests annually, or earlier if indicators of potential impairment exist, using a fair-value-based approach. All other intangible assets will continue to be amortized over their estimated useful lives and assessed for impairment under SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The provisions of SFAS No. 142 also require the completion of a transitional impairment test within six months of adoption, with any impairments treated as a cumulative effect of change in accounting principle. At the beginning of fiscal year 2003, the Company completed the transitional impairment test, which did not result in an impairment of recorded goodwill.

During the first quarter of fiscal year 2003, the Company adopted Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS No. 144). SFAS No. 144 was effective at the start of fiscal 2003 and supercedes Statement of Financial Accounting Standards No. 121, Accounting for the Impairment or Disposal of Long-Lived Assets and for Long-Lived Assets to be Disposed of and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30 relating to the disposal of a segment of business. The adoption of SFAS No. 144 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

A reconciliation of previously reported net loss per share to the amounts adjusted for the exclusion of goodwill amortization is as follows (in thousands, except per share data):

|                       | <u>Three months ended</u> |                     |
|-----------------------|---------------------------|---------------------|
|                       | <u>June 1, 2002</u>       | <u>June 2, 2001</u> |
| Reported net loss     | \$ (15,949)               | \$ (4,709)          |
| Goodwill amortization |                           | 388                 |

Edgar Filing: RIVERSTONE NETWORKS INC - Form 10-Q

|   |             |            |
|---|-------------|------------|
| Adjusted net loss                             | \$ (15,949) | \$ (4,321) |
| Reported basic and diluted net loss per share | \$ (0.13)   | \$ (0.04)  |
| Goodwill amortization                         |             |            |
| Adjusted basic and diluted net loss per share | \$ (0.13)   | \$ (0.04)  |

**Table of Contents****RIVERSTONE NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note (7) Customer Concentration**

During the quarter ended June 1, 2002, one reseller customer accounted for 13% of net revenues, compared with no customers individually accounting for more than 10% of net revenues in the quarter ended June 2, 2001. During the three months ended June 1, 2002, sales to strategic investee companies represented approximately 7% of net revenues, with sales to no one investee company exceeding 4% of net revenues. During the three months ended June 2, 2001, the Company did not have any strategic investments.

**Note (8) Net Loss Per Share**

The diluted net loss per share is equivalent to the basic net loss per share because the Company has experienced losses in the periods presented and thus no potential common shares from the exercise of stock options or warrants have been included in the net loss per share calculation. Common stock equivalents of 23,286,253 shares at a weighted-average price of \$3.56 and 38,317,682 shares at a weighted-average price of \$5.15 were excluded from the calculation of diluted net loss per share for the three months ended June 1, 2002 and June 2, 2001, respectively, because their effect would have been anti-dilutive. For the three months ended June 1, 2002, an additional 9,636,567 shares from the assumed conversion of the convertible subordinated notes were excluded from the computation of diluted net loss per share because their effect on earnings per share was also anti-dilutive.

**Note (9) Segment Reporting**

Revenues based on product shipment destination from unaffiliated customers by geographic region are as follows (in thousands):

|  | <b>Three months ended</b> |                         |
|--|---------------------------|-------------------------|
|  | <b>June 1,<br/>2002</b>   | <b>June 2,<br/>2001</b> |
| Sales to unaffiliated customers (trade): |                           |                         |
| United States                            | \$ 13,641                 | \$ 26,899               |
| Korea                                    | 7,631                     |                         |
| China                                    | 6,742                     | 5,587                   |
| Japan                                    | 1,897                     | 4,930                   |
| Other                                    | 189                       | 6,354                   |
|  | <b>30,100</b>             | <b>43,770</b>           |
| Total trade sales                        |                           |                         |
| Sales to related parties                 |                           | 397                     |
|  | <b>30,100</b>             | <b>44,167</b>           |
| Total sales                              | <b>\$ 30,100</b>          | <b>\$ 44,167</b>        |

Substantially all of the Company's assets are located in the United States.

**Note (10) Other Comprehensive Income**

The components of comprehensive income (loss), net of tax, were as follows (in thousands):

|                             | <b>Three months ended</b> |                         |
|-----------------------------|---------------------------|-------------------------|
|                             | <b>June 1,<br/>2002</b>   | <b>June 2,<br/>2001</b> |
| Net loss                    | \$ (15,949)               | \$ (4,709)              |
| Other comprehensive income: |                           |                         |

Edgar Filing: RIVERSTONE NETWORKS INC - Form 10-Q

|   |                   |                   |
|---|-------------------|-------------------|
| Change in net unrealized gain on available-for-sale investments, net of tax | 46                | 202               |
| Foreign currency translation adjustment                                     | 102               | 297               |
|   | <u>          </u> | <u>          </u> |
| Total comprehensive loss  | \$ (15,801)       | \$ (4,210)        |
|   | <u>          </u> | <u>          </u> |

**Table of Contents****RIVERSTONE NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The components of accumulated comprehensive income (loss), net of tax, were as follows (in thousands):

|   | <b>June 1,<br/>2002</b> | <b>March 2,<br/>2002</b> |
|---|-------------------------|--------------------------|
|   | <u>          </u>       | <u>          </u>        |
| Other comprehensive income:   |                         |                          |
| Accumulated net unrealized gain on available-for-sale investments, net of tax | \$ 1,094                | \$ 1,048                 |
| Accumulated foreign currency translation adjustment                           | (2)                     | (104)                    |
|   | <u>          </u>       | <u>          </u>        |
| Total accumulated other comprehensive income                                  | \$ 1,092                | \$ 944                   |
|   | <u>          </u>       | <u>          </u>        |

**Note (11) Restructuring Charges**

In the fourth quarter of fiscal year 2002, the Company announced a restructuring in an effort to better align the Company's business operations with the current market as well as service provider and carrier industry conditions. The restructuring charge totaled \$3.3 million and included a worldwide workforce reduction, discontinuance of certain product lines and an asset write-off related to the workforce reduction and discontinued product line. The restructuring program resulted in the reduction of approximately 50 employees across all business functions.

The following table sets forth the restructuring activities during the first quarter of fiscal 2003 (in thousands).

|                     | <b>Balance<br/>at<br/>March 2,<br/>2002</b> | <b>Additions</b>  | <b>Charges<br/>Utilized</b> | <b>Balance<br/>at<br/>June 1,<br/>2002</b> |
|---------------------|---|-------------------|-----------------------------|--|
|                     | <u>          </u>                           | <u>          </u> | <u>          </u>           | <u>          </u>                          |
| Workforce reduction | \$ 457                                      | \$                | \$ (457)                    | \$   |
|                     | <u>          </u>                           | <u>          </u> | <u>          </u>           | <u>          </u>                          |

**Note (12) Contingencies**

A consolidated class action lawsuit raising claims against Cabletron and some officers and directors of Cabletron was filed in the United States District Court for the District of New Hampshire and, following transfer, is pending in the District of Rhode Island. The complaint alleges that Cabletron and several of its officers and directors made materially false and misleading statements about Cabletron's operations and acted in violation of Section 10(b) of and Rule 10b-5 under the Securities Exchange Act of 1934 during the period between March 3, 1997 and December 2, 1997. The complaint also alleges that Cabletron's accounting practices resulted in the disclosure of materially misleading financial results during the same period. More specifically, the complaint challenged Cabletron's revenue recognition policies, accounting for product returns, and the validity of some sales. The complaint does not specify the amount of damages sought on behalf of the class. The plaintiffs served a second consolidated class action complaint and Cabletron filed a motion to dismiss this complaint. In a ruling dated May 23, 2001, the district court dismissed this complaint with prejudice. The plaintiffs have appealed this ruling to the First Circuit Court of Appeals. If the plaintiffs were to prevail on appeal, and ultimately prevail on the merits of the case, Enterasys (formerly known as Cabletron) could be required to pay substantial damages.

Riverstone has not assumed any liability from Enterasys for this litigation. Riverstone has not been named as a defendant in this litigation and none of our officers or directors is named as a defendant to this litigation. However, the plaintiffs might attempt to involve Riverstone in this litigation or might seek to have us pay damages if Enterasys has insufficient assets to cover any resulting damages. Any involvement in this litigation could be protracted and may result in a diversion of management and other resources. The payment of substantial legal costs or damages, or the diversion of the Company's management and other resources, could have a material adverse effect on Riverstone's business, financial condition or results of operations.

On August 28, 2001, Tellabs Operations, Inc. filed an action against Riverstone in the Chancery Division of the Circuit Court of Cook County, Illinois alleging that Riverstone breached the Strategic Alliance Agreement dated as of November 17, 2000 between Riverstone and Tellabs and committed various torts by (i) failing to provide Tellabs with CMTS products that met the technical specifications in the agreement; (ii)

## Edgar Filing: RIVERSTONE NETWORKS INC - Form 10-Q

misrepresenting to Tellabs the technical capabilities of Riverstone's CMTS products; and (iii) improperly selling Riverstone products to Tellabs customers. Tellabs' complaint seeks compensatory damages in excess of \$15 million, plus punitive damages and costs in unspecified amounts. On that same date, Tellabs terminated the agreement and is seeking a declaratory judgment that it has no further obligations under the agreement. The Company intends to vigorously defend this proceeding. On August 29, 2001, Riverstone filed suit against Tellabs in the Superior Court for Santa Clara

**Table of Contents**

**RIVERSTONE NETWORKS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

County, California seeking compensatory damages in excess of \$60 million, including over \$56 million in unfulfilled minimum purchase obligations Tellabs was required to make under the agreement. On December 7, 2001, the Company withdrew its suit without prejudice to re-file at a later time. On January 9, 2002, the Company asserted numerous affirmative defenses and counterclaims against Tellabs in the Illinois case. Through Riverstone's counterclaims, the Company seeks \$57 million in compensatory damages, in addition to punitive damages, attorneys' fees and costs.

The Company has granted options to purchase shares of its common stock under its 2000 Equity Incentive Plan to its employees and employees of Cabletron and Cabletron's affiliates and to the Company's advisors and consultants. As a result of the nature of the persons who received these options and the vesting provisions of these options granted prior to February 22, 2001, the Company may have violated the California state securities laws. Because these option grants may not have been qualified or exempt from qualification under California state securities laws, certain persons residing in California who received these options may have a claim against the Company. Accordingly, the Company may offer to repurchase, from persons who resided in California at the time of grant, outstanding options to purchase shares of its common stock granted under its 2000 Equity Incentive Plan prior to February 22, 2001 and shares acquired upon exercise of options granted prior to February 22, 2001. The Company has not yet determined whether or when to make the offer to repurchase. If an offer to repurchase is actually made and if all of the holders of these options (and shares acquired upon exercise of these options) accept the offer, the Company's cash position could be adversely impacted. As of the date hereof, the Company is not aware of any claims for rescission against it.

On January 31, 2002, the Securities and Exchange Commission notified Enterasys that it had commenced an Order of Investigation into Enterasys and certain of its affiliates' accounting practices. This SEC investigation may cover periods during which Riverstone was an affiliate of Enterasys. The Company has not been notified that it is part of the SEC investigation, nor has the Company received any inquiry with respect to the investigation. On August 6, 2001, when Cabletron distributed all of its shares of Riverstone common stock to its stockholders, Riverstone ceased to be a subsidiary of Cabletron and an affiliate of Enterasys. Riverstone has been operating with its own management and board of directors since its IPO in February 2001.

Riverstone is not aware of any other legal proceedings against it that, individually or in the aggregate, would have a material adverse effect on Riverstone's business, operating results or financial condition. Riverstone may in the future be party to litigation arising in the course of its business, including claims that Riverstone allegedly infringe third-party trademarks and other intellectual property rights. These claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

## **Table of Contents**

### **Item 2. *Management's Discussion And Analysis Of Financial Condition And Results Of Operations***

The following discussion and analysis of our financial condition and results of operations should be read together with our condensed consolidated financial statements and related notes appearing elsewhere in this Form 10-Q, and our Annual Report on Form 10-K filed on May 31, 2002 with the Securities and Exchange Commission.

When used in the discussion below, the words expect, anticipate, estimate, plan, believe, intend and similar expressions are intended to identify forward-looking statements. These statements, which include statements as to our expectations regarding net income or losses, trends in average selling prices, gross margins and revenues, expected cost of revenues and sources of revenues, changes in product mix, inventory levels, the adequacy of allowances for doubtful accounts, expectations regarding expenses, including investments in product development, expected stock-based compensation expenses, expected cost structure reductions as a result of restructuring, statements regarding our critical accounting policies, the adequacy of capital resources and expected variations in capital requirements, expectations regarding capital expenditures and growth of operations and infrastructure, strategic investments, plans to expand sales organizations, the features and benefits of our current and future products, expectations regarding the development and maintenance of strategic distribution relationships and our foreign currency risk management strategy, are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, those risks discussed below, as well as our ability to successfully bring future products to market, gain market share and compete against established companies in our market, the impact of alternative technological advances and competitive products, our ability to develop and maintain strategic relationships, and the matters discussed in Factors That May Affect Future Results and Market Price of Our Stock. These forward-looking statements speak only as of the date thereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

#### **Overview**

We are a leading provider of metropolitan area networking solutions that enable service providers to convert raw bandwidth into profitable services over legacy and next-generation infrastructures. Our products consist of advanced routers that enable service providers to offer a wide range of products and services that increase revenue and maintain customer loyalty.

Riverstone was created by the combination of two businesses previously acquired by Cabletron. These businesses are Zeitnet, which Cabletron acquired in 1996, and Yago Systems, which Cabletron acquired in 1998. The majority of our net revenues come from sales of our routers. We began shipping products outside the United States in fiscal year 2000, and these shipments accounted for 55% of our net revenues during the first quarter of fiscal 2003 compared to 38% during the comparable quarter of fiscal 2002.

Our industry has experienced an erosion of average selling prices. We anticipate that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, which may reduce our gross margins or revenues. We expect our quarterly gross margins to fluctuate with changes in our product mix. Most of our sales within the United States have been through direct sales channels. We intend to add and maintain a limited number of strategic distribution relationships that complement our direct sales efforts. International sales are made through a combination of direct and indirect sale efforts. In fiscal 2002, we initiated sales and marketing efforts internationally, focusing initially on Europe and Asia. As part of this effort, we have negotiated separate reseller agreements with various network integrators in Europe and Asia.

#### **Critical Accounting Policies and Estimates**

There have been no material changes to our critical accounting policies and estimates as disclosed in our Report on Form 10-K for the fiscal year ended March 2, 2002.



**Table of Contents****Results of Operations**

The following table sets forth for the period indicated certain financial data as a percentage of net revenues:

|                                 | Three months ended |                 |
|---------------------------------|--------------------|-----------------|
|                                 | June 1,<br>2002    | June 2,<br>2001 |
| Net revenues                    | 100 %              | 100 %           |
| Cost of revenues                | 50                 | 43              |
| Stock-based compensation        |                    |                 |
| <b>Total cost of revenues</b>   | <b>50</b>          | <b>43</b>       |
| Gross profit                    | 50                 | 57              |
| Operating expenses:             |                    |                 |
| Research and development        | 40                 | 30              |
| Sales and marketing             | 45                 | 30              |
| General and administrative      | 18                 | 11              |
| Stock-based compensation        | 2                  | 1               |
| <b>Total operating expenses</b> | <b>105</b>         | <b>72</b>       |
| Operating loss                  | (55)               | (15)            |
| Interest and other income, net  | 10                 | (5)             |
| Interest expense                | (7)                |                 |
| <b>Loss before income taxes</b> | <b>(52)</b>        | <b>(10)</b>     |
| Income taxes                    | (1)                |                 |
| <b>Net loss</b>                 | <b>(53) %</b>      | <b>(10) %</b>   |

*Net Revenues.* Net revenues were \$30.1 million for the three months ended June 1, 2002, a \$14.1 million or 32% decrease as compared with net revenues of \$44.2 million for the three months ended June 2, 2001. The decrease in net revenues was primarily due to lower unit sales of our routers due to unfavorable economic conditions and weaker capital spending compared to the same period in the prior year. During the first three months of fiscal year 2003, revenues from international regions decreased at a lower rate than United States revenues. International revenues for the first quarter of fiscal year 2003 were 55% of revenues compared with 38% of revenues in the same period of fiscal year 2002. During the fourth quarter of fiscal year 2002 and the first quarter of fiscal year 2003, the economic downturn and the reduction of capital spending by our existing and potential customers adversely impacted our product demand and made it increasingly difficult to accurately forecast our future revenues, as evidenced by declining quarterly revenues during these periods. The current economic conditions may cause future revenues and operating results to vary significantly and unexpectedly from quarter to quarter.

In order to establish relationships with companies in markets consistent with our long-term strategic direction, we have invested in equity and convertible debt of private and public companies. During the three months ended June 1, 2002, sales to these strategic investee companies represented 7% of net revenues, with sales to no one investee company exceeding 4% of net revenues.

*Cost of Revenues.* Cost of revenues includes costs of raw materials, direct labor, manufacturing overhead and amounts paid to third-party contract manufacturers, and other costs related to warranty, contractual obligations, customer service and support. Cost of revenues for the three months ended June 1, 2002 were \$15.0 million with a gross margin of 50%, compared with cost of revenues of \$19.2 million for the three months ended June 2, 2001 and a gross margin of 57%. The decrease in cost of revenues is primarily related to the decrease in sales volume. The decrease in gross margin is primarily attributable to lower shipment volumes and the impact of certain fixed costs as well as a change in product mix. Our gross margins are highly variable due to many factors such as our and our competitors' pricing policies and new product introductions by us or by our competitors.

## Edgar Filing: RIVERSTONE NETWORKS INC - Form 10-Q

*Research and Development.* Research and development expenses consist primarily of salaries and related personnel expenses, consultants and outside service provider fees, non-recurring engineering charges and prototype costs related to the development, testing and enhancement of our ASICs and software, and the depreciation of property and equipment related to

---

**Table of Contents**

these activities. Our research and development efforts can require significant expenditures, the timing of which can cause quarterly variability in our expenses.

Research and development expenses excluding stock-based compensation were \$12.2 million for the three months ended June 1, 2002, a decrease of approximately \$1.1 million over the comparable quarter in fiscal year 2002. Research and development expenses, excluding stock-based compensation, as a percentage of net revenues were 40% and 30% of net revenues in the three months ended June 1, 2002 and June 2, 2001, respectively. The increase in research and development expenses as a percentage of revenues for the three months ended June 1, 2002 compared with the three months ended June 2, 2001, was primarily due to the decrease in revenues. The decrease in absolute dollars was primarily due to cost cutting measures including the restructuring program that was initiated in the fourth quarter of fiscal year 2002. Research and development is essential to our future success and we expect our research and development expenses to slightly increase in absolute dollars and vary as a percent of revenues as we continue to devote significant resources to research and development in the foreseeable future.

*Sales and Marketing.* Sales and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales and customer support functions, and trade shows, advertising and promotional expenses. Sales and marketing expenses excluding stock-based compensation were \$13.4 million for the three months ended June 1, 2002, an increase of \$318,000 over the comparable quarter in fiscal year 2002. Sales and marketing expenses, excluding stock-based compensation, as a percentage of net revenues were 45% and 30% of net revenues in the three months ended June 1, 2002 and June 2, 2001, respectively. The increase in sales and marketing expenses as a percentage of revenues for the three months ended June 1, 2002 compared with the three months ended June 2, 2001 was primarily attributable to the decrease in revenues. The increase in absolute dollars in sales and marketing expenses was primarily due to the addition of international sales offices. We expect that quarterly sales and marketing expenses will not vary significantly in the near term as we continue to support our products and market segments.

*General and Administrative.* General and administrative expenses consist primarily of employee compensation and related expenses, professional and contractor fees, finance, legal, facilities, human resources, amortization of goodwill and intangibles and provisions for doubtful accounts. Through August 6, 2001, included in general and administrative expenses are expenses for services provided by Cabletron under our services agreement with them.

General and administrative expenses excluding stock-based compensation were \$5.5 million for the three months ended June 1, 2002, an increase of \$445,000 over the comparable quarter in fiscal year 2002. General and administrative expenses, excluding stock-based compensation, as a percentage of net revenues were 18% and 11% in the three months ended June 1, 2002 and June 2, 2001, respectively. The increase from fiscal year 2002 to 2003 was due to an increase in our provision for doubtful accounts as a result of the impact of the weakening economy on our customer base. We expect that quarterly general and administrative expenses will not change significantly in the near term.

In conjunction with the implementation of the new accounting rules for goodwill, as of the beginning of fiscal 2003, we completed a goodwill impairment review and found no impairment. According to our accounting policy under the new rules, we will perform a similar review annually, or earlier if indicators of potential impairment exist. Our impairment review is based on a discounted cash flow approach that uses our estimates of future market share and revenues as well as appropriate discount rates. The estimates we have used are consistent with the plans and estimates that we are using to manage the underlying business. If we fail to deliver new products, if the products fail to gain expected market acceptance, or if market conditions in the business fail to improve, our revenue and cost forecasts may not be achieved and we may incur charges for impairment of goodwill.

*Interest and Other Income, Net.* Interest and other income primarily consist of income on available-for-sale investments. Interest income was \$3.0 million for the three months ended June 1, 2002, compared with \$2.3 million for the three months ended June 2, 2001. The increase in interest income is a direct result of increased cash and investment balances, resulting from the proceeds from the issuance of common stock to Cabletron in July 2001, stock option exercises, and net proceeds from the issuance of convertible subordinated notes in November 2001.

*Interest expense.* Interest expense was \$2.1 million for the three months ended June 1, 2002. Interest expense consisted of accrued interest and amortization of debt issuance costs, both attributable to the issuance of the 3.75% convertible subordinated notes in November 2001, as well as interest on trade accounts receivable that were sold to an unrelated financial institution.

*Income taxes.* We recorded a \$380,000 provision for income taxes for the three months ended June 1, 2002. The provision for income taxes results primarily from certain foreign and minimum tax liabilities arising in jurisdictions in which we operate. Due to our history of cumulative operating losses, we recorded a valuation allowance for deferred tax assets for the three months ended June 1, 2002 that eliminated the income tax benefit derived by applying the U.S. federal statutory rate to the net loss before income taxes we sustained during the period.

---

## **Table of Contents**

### **Liquidity and Capital Resources**

At June 1, 2002, we had cash and cash equivalents of approximately \$45.5 million, short-term investments of \$199.3 million and marketable long-term investments of \$166.4 million. We regularly invest excess funds in money market funds, commercial paper and government and non-government debt securities.

The Company also has a \$15.0 million credit facility available under a revolving line of credit. This borrowing facility does not require compliance with any financial covenants and can be withdrawn by the financial institution at anytime. At June 1, 2002 there was no indebtedness outstanding under this credit facility.

Net cash used in operating activities for the three months ended June 1, 2002 and June 2, 2001 was \$25.3 million and \$12.0 million, respectively. Cash used by operating activities in the first quarter of fiscal 2003 was primarily attributable to general operating expenses, an increase in accounts receivable and a decrease in accounts payable offset by decreased inventories and prepaid assets. Cash used by operating activities in the first quarter of fiscal 2002 was primarily due to general operating expenses, an increase in inventories and prepaid assets offset by decreased accrued expenses, deferred revenue and accounts receivable.

Net cash used in investing activities of \$53.9 million and \$89.8 million for the three months ended June 1, 2002 and June 2, 2001 consisted of capital expenditures, and purchases of short-term and long-term investments, partially offset by proceeds from maturities and sales of investments. Capital expenditures during both periods were for the procurement of production equipment, research and development equipment, computers, enterprise resource planning software applications and facility-related improvements.

Cash provided by financing activities was \$1.5 million for the three months ended June 1, 2002, as compared to \$4.1 million for the three months ended June 2, 2001. The net cash provided for the three months ended June 1, 2002 consisted of net proceeds from the issuance of common stock pursuant to option exercises and our employee stock purchase plan. The net cash provided for the three months ended June 2, 2001 consisted of net transfers of cash from Cabletron.

Beginning in fiscal 2002, we initiated a program to sell, from time to time, trade accounts receivables to an unrelated finance entity, with limited recourse. We account for the transfer of accounts receivable in accordance with SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - A Replacement of FASB Statement No. 125*. According to the accounts receivable sale agreements, we maintain the servicing of these receivables. During the three months ended June 1, 2002, we sold approximately \$4.2 million in receivables, compared to none in the same period a year ago. The difference between the receivables face amount and net cash flow from the sale of receivables in any given period represents the discount on sales and is recorded as interest expense. The discount was approximately \$188,000 in the first quarter of fiscal year 2003. At June 1, 2002, \$7.1 million in sold trade accounts receivable remained outstanding. In conjunction with the accounts receivable sale agreements, we provide deposits to the finance entity. At June 1, 2002, we had a deposit of \$495,000 with the finance entity.

We currently have operating lease commitments of \$15.7 million, convertible subordinated notes of \$175.0 million due December 2006 and standby letters of credit relating to lease guarantees of \$8.3 million. Our future capital requirements will depend on a number of factors, including the timing and rate of the expansion of our business, resources we devote to developing our products and market acceptance of our products. We anticipate devoting substantial capital resources to continue our research and development efforts, to maintain our sales, support, marketing and product development organizations, and for other general corporate activities and infrastructure. Although we do not have any current plans or commitments to do so, from time to time, we may also consider the acquisition of products and businesses complementary to our business. Any acquisition or investments may require additional capital. Although it is difficult for us to predict future liquidity requirements with certainty, we believe that our existing cash, cash equivalents and marketable short-and long-term investments together with our existing credit facility will be sufficient to meet our anticipated cash needs for working capital and capital expenditures over the next 12 months.

### **Risk Factors that May Affect Our Future Results and the Market Price of Our Stock**

#### *Factors Related to Our Business*

***We have a general history of losses and cannot assure you that we will operate profitably in the future.***

We have not yet achieved profitability on an annual basis, and we cannot be certain that we will realize sufficient revenue to achieve profitability in the future. We incurred net losses of \$30.7 million, \$65.8 million and \$37.4 million during fiscal years 2002, 2001 and 2000, respectively and \$15.9 million during the three months ended June 1, 2002. Portions of our financial data

---

## **Table of Contents**

are based on Cabletron's financial statements. We anticipate incurring significant sales and marketing, product development and general and administrative expenses, requiring us to realize significantly higher revenue to achieve and sustain profitability.

Because the United States, Europe and Asia-Pacific are experiencing an economic slowdown, our ability to increase or sustain our revenues may be limited. The events on September 11, 2001 and other terrorist attacks, as well as concerns regarding any related conflicts or similar events worldwide, have increased uncertainty in the U.S. These events have decreased our ability to project our revenue in future quarters and may decrease the amount of funds our customers commit to information technology infrastructure spending. Any reduction in or delay of capital spending by our customers due to the events of September 11, 2001 and recent economic, political and social turmoil will reduce our future revenue and profitability.

***Our focus on sales to service provider customers subjects us to risks that may be greater than those for providers with a more diverse customer base.***

Our customers consist of local exchange carriers, long distance carriers, Internet service providers, metropolitan service providers, content hosting providers and cable operators whose businesses depend on the continuing demand for differentiated services by their customers. Service provider companies generally have been adversely impacted by the current global economic slowdown. The developing service provider market has become very competitive and price sensitive. Poor conditions in the service provider market have reduced capital expenditures on technology infrastructure. We have experienced reductions and order delays from our service provider customers. Our exposure to these risks is greater than it is for other vendors who sell to a more diversified customer base. We believe that there are risks arising from doing business with service providers in these markets that may not be faced by our competitors in their relationships with corporate and other customers, including:

service providers that are heavily dependent upon financing, particularly from the high yield debt market, may decrease their infrastructure purchases as a result of limited financing availability or interest rates increases;

weak economic conditions may cause service providers to postpone or reduce capital expenditures;

the introduction, or the planned introduction, of new products and product enhancements, which could cause service providers to cancel, reduce or delay existing orders;

any failure of a service provider's service to its customers that it attributes to our products, whether or not our products actually failed, which could lead to substantial negative publicity and undermine our sales; and

the low level of brand loyalty demonstrated by service providers, which may cause them to switch to another supplier that provides, or that they believe provides, superior performance or cost-effectiveness.

The occurrence of these events may lead to our customers delaying orders, delivery times or payments for our products, or require us to increase the time and cost associated with our sales efforts.

***Our quarterly revenue and operating results are likely to fluctuate which could cause us to miss quarterly revenue targets and result in a decline in our stock price.***

We base our operating expenses on anticipated revenue trends. A high percentage of our expenses remain relatively fixed despite changes in revenue, including marketing, research and development and general administrative expenses and expenses for employee compensation other than sales commissions. This means that any failure to achieve anticipated revenues could cause our quarterly operating results to fall below the expectations of public market analysts or investors, which could cause the price of our common stock to fall.

Our quarterly revenue and operating results may vary significantly in the future due to a number of factors, including:

fluctuations in demand for our products and services;

unexpected product returns or the cancellation or rescheduling of significant orders;

our ability to develop, introduce, ship and support new products and product enhancements and manage product transitions;

the timing and amount of non-cash stock-based compensation charges;

our ability and our suppliers' abilities to attain and maintain production volumes and quality levels for our products; and

write-downs resulting from other-than-temporary declines in value of our investments in equity and convertible debt



---

**Table of Contents**

investees.

Due to these factors, we believe that you should not rely on period-to-period comparisons of our operating results as an indicator of our future performance.

***We generally do not have binding commitments from our customers and if significant customers cancel, reduce or delay a large purchase, our revenues may decline and the price of our stock may fall.***

Historically, a limited number of customers have accounted for a significant portion of our revenues. Customers making large purchases from us are likely to vary over time, due to changes in our product cycles, customer needs, competition or economic circumstances. Two of our former significant customers, Vits Networks and Metricom, have filed for bankruptcy and ceased operations and Tellabs has terminated its agreement with us. Although our largest customers may vary from period to period, we anticipate that our operating results for any given period will continue to depend significantly on large orders from a small number of customers. We generally do not have binding commitments from our customers. If any of our large customers cancels, reduces or delays purchases, our revenues and profitability would be harmed because of our dependence on large customers.

***Because the purchase of our products often represents a significant decision on the part of potential customers, we may expend significant resources on potential customers without achieving actual sales.***

Purchases of our products often represent a significant strategic decision and capital investment by our customers related to their communications infrastructure and typically involve significant internal procedures involving the evaluation, testing, implementation and acceptance of new technologies. This evaluation process frequently results in a lengthy sales process, often ranging from one month to longer than a year, and purchases of our products are subject to a number of significant risks, including customer budgetary constraints and internal acceptance reviews. During this time we may incur substantial sales and marketing expenses and expend significant management effort. The length of the sales cycle, and the magnitude of our investment in the sales process, is more substantial for our service provider customers than it would typically be with corporate customers. If sales forecasts from a specific customer for a particular quarter are not realized in that quarter, we may be unable to compensate for the shortfall, which could harm our operating results.

***We may be unable to expand our sales and direct and indirect distribution channels, which may hinder our ability to target multiple levels of a prospective customer's organization as well as our ability to increase sales and revenues.***

Our products and services require a sophisticated sales and marketing effort targeted at several levels within a prospective customer's organization. Unless we expand our sales force and maintain high levels of marketing activity, we will be unable to increase revenues. Although we plan to continue to hire additional sales personnel, competition for qualified sales personnel is intense, and we may be unable to hire the sales personnel we require.

Our sales and distribution strategy relies on value-added resellers, original equipment manufacturers, or OEMs, our direct and indirect international sales efforts and our ability to package our products into a complete network infrastructure solution by working with other technology vendors. If we are unable to establish new value-added reseller or OEM relationships, or if our OEMs and value-added resellers are unsuccessful in distributing our products, our sales could suffer. Because we are not a vertically integrated network infrastructure provider, if we fail to maintain existing technology vendor relationships or to establish new ones, we will be unable to satisfy our customers' need for complete, fully-integrated solutions and our business could suffer.

***Certain of our customers rely on us to arrange financing for our products, which subjects us to credit and market risks.***

Certain of our customers do not have or do not wish to commit the financial resources necessary to purchase our products without financing, and these customers expect us to arrange their financing. These financing arrangements can expose us to our customers' credit risks and in the past we have experienced customer defaults. Due to continuing public market volatility, a number of our current or prospective customers may be unable to raise funding through the issuance of their equity securities. This difficulty could result in an increased need for financing provided either by us or with our assistance and an increased risk of customer default. At June 1, 2002, our guaranteed lease payments amounted to \$8.3 million. In the past, we benefited from Cabletron's resources and credit in arranging financing for our customers. As a result of our separation from Cabletron, we are a much smaller, stand-alone company, which could impair our ability to provide or arrange and support customer financing. If third party financing were to become less available due to credit market factors, our ability to arrange third party financing for our customers could be significantly limited, potentially resulting in reduced revenues.

---

**Table of Contents**

*We purchase several key components for our products from single or limited sources and could lose sales if these sources fail to fulfill our needs.*

We purchase several key components used in the manufacturing of our products from single or limited sources and are dependent upon supply from these sources to meet our needs. We have worked with NEC, Agere and LSI Logic to develop several of our key proprietary application specific integrated circuits, or ASICs. These proprietary ASICs are very complex, and NEC, Agere and LSI Logic are our sole source suppliers for the specific types of ASICs that they supply to us. We do not have a long-term fixed price or minimum volume agreement with any of these suppliers. Should we encounter problems with NEC, Agere or LSI Logic, we may not be able to develop an alternate source in a timely manner, which could hurt our ability to deliver our routers.

*We base our purchasing decisions on a forecast of anticipated orders of our products, and if we miscalculate our needs or are not able to obtain necessary components, our business could be harmed.*

We use a forward-looking forecast of anticipated product orders to determine our material requirements, and if customer orders do not match forecasts, we may have excess or inadequate inventory of materials and components. In the past, we have experienced shortages of some components, resulting in delays in filling orders. We have also experienced delays in the prototyping of our ASICs during initial product development, which in turn has led to delays in product introductions. If we cannot obtain necessary components, we may not be able to meet customer orders and our business and results of operations could suffer.

*We depend on a single contract manufacturer for all of our manufacturing requirements, and a failure by this contract manufacturer would impair our ability to deliver products.*

We outsource all of our manufacturing to one company, Flextronics International, Ltd., which manufactures our products in San Jose, California. If the demand for our products grows, we will need to increase our material purchases and our contract manufacturing capacity with Flextronics or add additional contract manufacturers. Our existing and future contract manufacturers may not meet our future requirements. We have experienced a delay in product shipments from our contract manufacturer in the past, which in turn delayed product shipments to our customers. We may in the future experience similar and other problems, such as insufficient quantity of product, which could materially harm our business and operating results. The inability of our contract manufacturer to provide us with adequate supplies of high-quality products or the loss of our contract manufacturer would cause a delay in our ability to fulfill orders while we obtain a replacement manufacturer and would have a significant negative effect on our business, operating results and financial condition.

*Substantially all of our revenues come from sales of our RS router family, making us dependent on widespread market acceptance of these products.*

Substantially all of our revenues result from sales of our RS router family. Continuing market acceptance of our products is critical to our future success, and we are more dependent on the market acceptance of an individual product family than competitors with broader product offerings. Factors that may affect the market acceptance of our products include:

- adoption of advanced routing and switching products and technologies;
- the performance, price and total cost of ownership of our products;
- the availability and price of competing products and technologies;
- brand recognition of the Riverstone name; and
- the success and development of our sales and marketing organizations and resellers.

If we fail to achieve and maintain market acceptance for our RS router family, our revenues may be harmed.

*The market for network equipment is subject to rapid technological change, and if we fail to accurately predict and respond to market developments or demands, we will be unable to compete successfully.*



---

**Table of Contents**

The market for network equipment is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Our future performance will depend on our successful development and introduction and the market acceptance of new and enhanced products that address customer requirements in a cost-effective manner. We may be unsuccessful in completing the development or introduction of these product enhancements or new products on a timely basis or at all. The failure of these enhancements or new products to operate as expected could delay or prevent future sales. Developments in routers and routing software could also significantly reduce demand for our product. Alternative technologies and customer requirements could achieve widespread market acceptance and displace the technologies, protocols and service requirements on which our product lines are based. Our technological approach may not achieve broad market acceptance, and other technologies or devices may supplant our approach.

***If we are unable to deliver the high level of customer service and support demanded by our customers, we may lose customers and our operating results will suffer.***

Our customers demand a high level of customer service and support. Our customer service and support functions are provided by our internal product support groups. We have transitioned all of these functions from a combination of internal and external support to our internal customer service group, RTAC group, and field technical support group. If we are unable to manage these functions internally and satisfy our customers with a high level of service and support, any resulting customer dissatisfaction could impair our ability to retain customers and make future sales. We have also considered, and could consider in the future, using other third parties to provide certain customer support services. We may be unable to manage effectively those third parties who may provide support services for us and they may provide inadequate levels of customer support.

***We continue to expand our international sales effort, and marketing and distributing our products outside of the United States may require increased expenses and greater exposure to risks that we may not be able to successfully address.***

Our growth strategy depends in part on the expansion of our international sales and operations. International sales increased to 55% during the three months ended June 1, 2002 from 38% during the three months ended June 2, 2001. The international market for our products is less mature than the market in the United States, and our strategy of selling to service providers that operate in the metropolitan area network may be unsuccessful on an international basis. Operating internationally exposes us to risks such as longer accounts receivable collection cycles, difficulties in staffing and managing operations across disparate geographic areas and tariffs, export controls and other trade barriers. We conduct our international sales in either U.S. dollars or local currencies and a change in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets. We are also subject to fluctuations in exchange rates between the U.S. dollar and the particular local currency. We may determine to engage in hedging transactions to minimize the risk of fluctuations, and if we are not successful in managing hedging transactions, we could incur losses.

***Our products are very complex and undetected defects may increase our costs and harm our reputation with our customers.***

Networking products are extremely complex and must operate successfully with equally complex products of other vendors. These products frequently contain undetected software or hardware errors when first introduced or as new upgrades are released. Additionally, the pressures we face to be the first to market new products increases the possibility that we will offer products in which we or our customers later discover errors. We have experienced new product and product upgrade errors in the past and may experience similar problems in the future. These problems could result in our incurring significant warranty and repair costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems and our stock price to fall.

***We face risks associated with our strategic investments and may not realize the anticipated benefits of such investments.***

We plan to continue to make strategic investments in the future. However, we may not realize in full the anticipated benefits of our current and future strategic investments. The companies in which we invest may not make, may reduce or may terminate product purchases from us. We may lose all or a portion of the amount invested. We assess the fair value of our strategic investments quarterly and may be required to record impairment charges against our strategic investments. During the fourth quarter of the fiscal year ended March 2, 2002, certain private companies in which we held investments were experiencing financial declines and were not likely to be able to raise capital to continue operations. As a result, we determined that investments in these investees had declined in fair market value on an other-than-temporary basis and accordingly recorded an impairment charge of \$22.1 million against strategic investments. We incurred no investment write-downs during the three months ended June 1, 2002. Factors we consider important that could trigger an impairment charge include the likelihood that the

---

**Table of Contents**

related company would have insufficient cash flows to operate for the next twelve months, significant changes in the operating performance or operating model, and/or changes in market conditions. If we determine to reduce the carrying value of one of our investments, such a reduction could adversely affect our financial condition and results of operations.

***We have limited ability to engage in acquisitions and other strategic transactions using our equity because of the federal income tax requirements for a tax-free distribution.***

For the distribution of our stock by Cabletron (now known as Enterasys) to qualify as tax-free to Enterasys there must not be a change in ownership of 50% or greater in either the voting power or value of either our stock or Cabletron's stock that is considered to be part of a plan or series of transactions related to the distribution. If there is a direct or indirect acquisition of our or Enterasys' stock by one or more persons during the four-year period beginning two years before and ending two years after the distribution, it will be presumed to be part of a plan or series of related transactions related to Enterasys' intended distribution of our stock. Unless this presumption is successfully rebutted, the distribution will be taxable to Enterasys.

We have entered into a tax sharing agreement with Enterasys and Aprisma. This agreement requires us to indemnify the other parties if the distribution by Cabletron of its Riverstone shares does not qualify as tax-free due to actions we take or that otherwise relate to us, including any change of ownership of us. The process for determining whether a change of ownership has occurred under the tax rules is complex. If we do not carefully monitor our compliance with these rules, we might inadvertently cause a change of ownership to occur, triggering our obligation to indemnify Enterasys and the other parties to the tax sharing agreement. Our obligation to indemnify these parties if a change of ownership causes the distribution not to be tax-free could discourage or prevent a third party from making a proposal to acquire us. The amount of any such indemnification would be substantial.

For the reasons described above, our ability to use our stock for acquisitions and other similar strategic transactions or for compensation for employees and others is restricted. Many of our competitors use their equity to complete acquisitions, to expand their product offerings and speed the development of new technology and to attract and retain employees and other key personnel, giving them a potentially significant competitive advantage over us.

***We jointly own with Enterasys some of our intellectual property, and our business could be harmed if Enterasys uses this intellectual property to compete with us.***

Intellectual property that relates to a family of ASICs used in both our RS router family and Enterasys' Smart Switch Router product family is owned jointly by Enterasys and us. Enterasys is primarily a provider of local area network products for the enterprise market. There are no contractual provisions that prohibit Enterasys from developing products that are competitive with our products, including products based upon the jointly owned intellectual property. If Enterasys is acquired by one of our competitors, there are no contractual provisions that would prohibit the combined company from developing products competitive with our products.

***Our limited ability to protect our intellectual property may hinder our ability to compete.***

We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure of confidential information to protect our intellectual property rights. We cannot assure you that any patents that we hold will protect our intellectual property or will not be challenged by third parties. Other parties may also independently develop similar or competing products that do not infringe upon our patents. Although we attempt to protect our intellectual property rights, we may be unable to prevent the misappropriation of our intellectual property, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

***We may be subject to claims that our intellectual property infringes upon the proprietary rights of others, and a successful claim could harm our ability to sell and develop our products.***

If other parties claim that our products infringe upon their intellectual property we would be forced to defend ourselves or our customers, manufacturers or suppliers against those claims. We could incur substantial costs to prosecute or defend those claims. A successful claim of infringement against us and our failure or inability to develop non-infringing technology or license the infringed technology on acceptable terms and on a timely basis could harm our business, results of operations and financial condition.

---

## **Table of Contents**

***If we are unable to attract, integrate, manage and retain qualified personnel, we may not be able to achieve our objectives and our business could be harmed.***

Our success depends to a significant degree upon the continued contributions of our key management, engineering, sales and marketing, customer support and manufacturing personnel, many of whom would be difficult to replace. In particular, we believe that our future success is highly dependent on Romulus Pereira, our president and chief executive officer.

We believe our future success also depends on our ability to attract, integrate, manage and retain highly skilled managerial, engineering, sales and marketing, finance, customer support and manufacturing personnel. Competition for these personnel is intense, and in the past, we have had difficulty hiring employees in our desired time frame, particularly software and hardware engineers. We may be unsuccessful in attracting and retaining personnel. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel in the future or delays in hiring required 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.

***We rely on independent service providers to supply certain of our back-office functions, and if they fail to deliver adequate services, our business will suffer.***

We rely on service providers to supply us with many of our operational and back-office functions, including human resources applications, enterprise resource management applications and customer relationship management applications. Although these functions are critical to our business, we neither own the software that performs these functions nor, in some cases, the hardware on which these programs and our data reside. If there is a significant degradation or failure in service, we may be unable to quickly and cost-effectively transition to other service providers or provide the necessary functionality ourselves and our business could be disrupted.

### *Factors Related to Our Industry*

***Intense competition in the market for network equipment could prevent us from increasing revenues and sustaining profitability.***

The market for network equipment is very competitive and has historically been dominated by Cisco Systems. Other principal competitors include established companies such as Extreme Networks, Inc., Foundry Networks, Inc., Juniper Networks, Inc., Nortel Networks Corporation and other smaller public and private companies. These competitors may have developed or could in the future develop new technologies that compete with our products or even make our products obsolete. Consolidation in our industry is occurring and is likely to continue. Future acquisitions by, and mergers among, our competitors and potential competitors could expand their product offerings and accelerate their development of new technologies, providing them with a competitive advantage.

Many of our competitors have significantly more established customer support and professional services organizations and substantially greater financial resources than we do. Many of our competitors also have much greater name recognition and have a more extensive customer base and broader customer relationships and product offerings than we do. These companies can rely on their customer bases and broader product offerings and adopt aggressive pricing policies to gain market share. We expect that competitive pressures may result in price reductions, reduced margins and loss of market share, which would materially harm our business, results of operations and financial condition.

***We expect the average selling prices of our products to decrease rapidly, which may reduce our gross margins or revenues.***

Our industry has experienced rapid erosion of average selling prices. We anticipate that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, increased sales discounts, new product introductions by us or our competitors and increasing availability of relatively inexpensive standard microprocessors that can perform some of our products' functionality. If we are unable to achieve sufficient cost reductions and increases in sales volumes, this decline in average selling prices will reduce our revenues and gross margins.

***If our products do not comply with complex governmental regulations and evolving industry standards, our products may not be widely accepted, which may prevent us from sustaining our revenues or achieving profitability.***

The market for network equipment products is characterized by the need to support industry standards as different standards emerge, evolve and achieve acceptance. To be competitive, we must continually introduce new products and product enhancements that meet these emerging standards. We have had to delay the introduction of new products to comply with third

**Table of Contents**

party standards testing. We may be unable to address compatibility and interoperability issues that arise from technological changes and evolving industry standards. In the United States, our products must comply with various governmental regulations and industry regulations and standards, including those defined by the Federal Communications Commission, Underwriters Laboratories and NEBS. Internationally, products that we develop may be required to comply with standards or obtain certifications established by telecommunications authorities in various countries and with recommendations of the International Telecommunications Union. If we do not comply with existing or evolving industry standards or fail to obtain timely domestic or foreign regulatory approvals or certificates, we will be unable to sell our products where these standards or regulations apply, which may prevent us from sustaining our revenues or achieving or maintaining profitability.

*Factors Related to Our Separation from Cabletron*

***We cannot rely on Cabletron to fund our future capital requirements, and financing from other sources may not be available on favorable terms or at all.***

In the past, our capital needs were satisfied by Cabletron. However, following our separation, Cabletron is no longer a source of funds to finance our working capital or other cash requirements. Financing or financial support from other sources, if needed, may not be available on favorable terms or at all.

We believe our capital requirements will vary greatly from quarter to quarter. Capital expenditures, fluctuations in our operating results, financing activities, acquisitions, investments and inventory and receivables management may contribute to these fluctuations. We believe that the proceeds from our initial public offering, our sale of common stock to Cabletron in July 2001, our issuance of convertible subordinated notes in November 2001 and our future cash flow from operations, will be sufficient to satisfy our working capital, capital expenditure and research and development requirements for at least the next twelve months. However, we may require or choose to obtain additional debt or equity financing to finance acquisitions or other investments in our business. Future equity financings may be dilutive to the existing holders of our common stock. Future debt financings could involve restrictive covenants. We will likely not be able to obtain debt financing with interest rates and other terms as favorable as those that Cabletron could obtain.

***The plaintiffs in Cabletron's outstanding class action suit might seek to add us to this litigation or seek payment of any related damages.***

Since December 1997, Cabletron has been party to an outstanding class action suit alleging that during the period from March 3, 1997 through December 2, 1997, Cabletron released false and misleading information about its operations and that Cabletron's accounting practices resulted in the disclosure of materially misleading financial results. The plaintiffs' complaint does not specify the amount of damages, but if the plaintiffs prevail Enterasys (formerly Cabletron) could be required to pay substantial damages. The plaintiffs in this matter might seek to involve us in this litigation or, if they prevail in this litigation, might seek to recover damages from us, particularly if Enterasys has insufficient assets.

***We face risks related to the pending formal SEC Investigation of Enterasys and certain of its affiliates.***

On January 31, 2002, the Securities and Exchange Commission notified Enterasys that it had commenced an Order of Investigation into Enterasys and certain of its affiliates' accounting practices. This SEC investigation may cover periods during which Riverstone was an affiliate of Enterasys. We have not been notified that we are part of the SEC investigation, nor have we received any inquiry with respect to the investigation. On August 6, 2001, when Cabletron distributed all of its shares of our common stock to its stockholders, we ceased to be a subsidiary of Cabletron and an affiliate of Enterasys. We have been operating with our management and board of directors since our IPO in February 2001. At this point we are unable to predict what, if any, impact the SEC inquiry into Enterasys' prior accounting practices may have on us. We could be required to take actions not presently contemplated, which could be expensive, divert management's attention from other business concerns and harm our business. In addition, the ongoing SEC inquiry into Enterasys may contribute to volatility in the price of our common stock.

***Conflicts of interest may arise because our directors and executive officers have ownership interests in Enterasys and Aprisma.***

Many of our directors and executive officers have a substantial amount of their personal financial portfolios in Enterasys common stock and options to purchase Enterasys common stock. Our directors also hold options to purchase stock of Aprisma. Conflicts of interest may arise between Enterasys and us in a number of areas relating to our past and ongoing relationships, including tax, indemnification, intellectual property and other matters arising from our separation from Cabletron, which is now Enterasys. These factors could create, or appear to create, potential conflicts of interest when directors and officers are faced with

**Table of Contents**

decisions that could have different implications for Enterasys, Aprisma and us. In our certificate of incorporation we have renounced any interest in business opportunities that are presented to Cabletron (now known as Enterasys), its subsidiaries, or our officers or directors who are employees of Enterasys or its subsidiaries at the time the opportunity is presented.

*We could incur significant tax liability if the distribution does not qualify for tax-free treatment, which could require us to pay Enterasys a substantial amount of money.*

In addition to our liability under the tax sharing agreement with Enterasys and Aprisma under United States Federal income tax laws, we would be jointly and severally liable for the Federal income taxes of Cabletron resulting from the distribution being taxable. This means that even if we do not have to indemnify Enterasys under the tax sharing agreement because we did not take any specific action to cause the distribution to fail as a tax-free event, we may still be liable for any part of, including the whole amount of, these liabilities and expenses if Enterasys fails to pay them.

*Factors Related to Our Stock*

*Our stock price has been and may continue to be volatile, which could result in substantial losses for individual stockholders.*

The stock markets in general, and the markets for high technology stocks in particular, have experienced extreme volatility that has often been unrelated to the operating performance of particular companies. The market price of our common stock has been volatile, and we expect that it will continue to be volatile. This volatility could result in substantial losses to individual stockholders and holders of our convertible subordinated notes.

*Anti-takeover provisions could make it more difficult for a third party to acquire us.*

We have adopted a stockholder rights plan and declared a dividend distribution of one right for each outstanding share of common stock to stockholders of record as of July 26, 2001. Each right entitles the holder to purchase upon certain events one one-thousandth of a share of our Series A Preferred Stock for \$115. Under certain circumstances, if a person or group acquire 15% or more of our outstanding common stock, holders of the rights (other than the person or group triggering their exercise) will be able to purchase, in exchange for the exercise price, shares of our common stock, and in certain cases, shares of stock of a company into which we are merged, having a value of double the exercise price. Because the rights may substantially dilute the stock ownership of a person or group attempting to take us over without the approval of our board of directors, our rights plan could make it more difficult for a third party to acquire us, or a significant percentage of our outstanding capital stock, without first negotiating with our board of directors regarding such acquisition.

In addition, our board of directors has the authority to issue up to 2,000,000 shares of preferred stock (of which 200,000 shares have been designated as Series A Preferred Stock) and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the stockholders. The rights of the holders of common stock may be subject to, and may be adversely affected by, the rights of holders of any preferred stock that may be issued in the future. The issuance of preferred stock may have the effect of delaying, deferring or preventing a change of control of us without further action by the stockholders and may adversely affect the voting and other rights of the holders of common stock. Further, certain provisions of our charter documents may have the effect of delaying or preventing changes in control or management of Riverstone.

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

We have no material changes to the disclosure on this matter made in our report on Form 10-K for the fiscal year ended March 2, 2002.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

Information with respect to this item is incorporated by reference to Note (12) of the Notes to the Condensed Consolidated Financial Statements included herein on page 9 of this Report on Form 10-Q.

**Table of Contents**

**Item 6. *Exhibits and Reports on Form 8-K***

(a) List of Exhibits: None

(b) Reports on Form 8-K: None

**Table of Contents**

**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.

RIVERSTONE NETWORKS, INC.  
(Registrant)

/s/ ROMULUS S. PEREIRA

---

**Romulus S. Pereira**  
**President, Chief Executive Officer**  
**and Director**  
**(Duly Authorized Officer)**

Dated: June 25, 2002

/s/ ROBERT STANTON

---

**Robert Stanton**  
**Executive Vice President of Finance**  
**and Chief Financial Officer**  
**(Principal Financial Officer)**

Dated: June 25, 2002