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January 26, 2005

Sharla Dillon
Dockets and Record Manager
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243-0505

DOCKET NO.
05-00043

Re: Petition of Computer Network Technology Corporation, Condor Acquisition, Inc. and McDATA Corporation for Approval of Transfer of Control

Dear Ms Dillon:

On behalf of Computer Network Technology Corporation, Condor Acquisition, Inc. and McDATA Corporation, enclosed for filing are an original and thirteen (13) copies of the above-referenced Petition. Also enclosed is a check in the amount of $25.00 for the filing fee.

Please date-stamp the enclosed extra copy of this filing and return it in the self-addressed, stamped envelope provided. Should you have any questions, please do not hesitate to contact the undersigned (202) 424-7500.

Respectfully submitted,

William B. Wilhelm
Brian M. McDermott

Enclosure

Before the
Tennessee Regulatory Authority

Joint Petition of **Computer Network Technology Corporation** **Condor Acquisition, Inc.** and **McDATA Corporation** For Merger and Transfer of Control of Computer Network Technology Corporation	)	Docket No. ____________

JOINT PETITION

Computer Network Technology Corporation ("CNT"), Condor Acquisition, Inc. ("Condor") and McDATA Corporation ("McDATA") (collectively, "Petitioners"), through undersigned counsel and pursuant to Section 65.4 112 of the Tennessee Code and the rules of the Tennessee Regulatory Authority (the "Authority") hereby request authorization as may be necessary or required to permit Petitioners to consummate a series of transactions, described in greater detail below, whereby McDATA will acquire control of CNT through a merger of Condor, McDATA's wholly-owned subsidiary, and CNT ("Transaction").

Petitioners respectfully request that the Authority approve this Petition as expeditiously as possible in order to allow Petitioners to consummate the proposed Transaction prior to the anticipated closing date of April 15, 2005.

In support of this Petition, Petitioners state as follows:

I. Description of Petitioners

A. Computer Network Technology Corporation ("CNT")

CNT is a corporation organized under the laws of the state of Minnesota. CNT's address is Computer Network Technology Corporation, 6000 Nathan Lane North, Minneapolis, Minnesota 55442. CNT is publicly traded on the Nasdaq National Market System under the symbol "CMNT". In Tennessee, CNT holds a Certificate of Convenience and Necessity authorizing it to provide local exchange and interexchange telecommunications services pursuant to an Order issued in Docket 03-00612 on June 10, 2004. After the consummation of the transaction, CNT will retain its authorization and will continue to provide services to its customers. Further information concerning CNT's legal, technical, managerial and financial qualifications to provide service was submitted with its application for certification with the Authority and is, therefore, a matter of public record. CNT respectfully requests that the Authority take official notice of that information and incorporate it herein by reference. Additional information on CNT is available on the company's website at: http://www.cnt.com.

B. Condor Acquisition, Inc. ("Condor")

Condor is a newly formed Minnesota corporation established to effect the merger of CNT. Condor's principal offices are located at 380 Interlocken Crescent, Broomfield, Colorado 80021. Condor is a wholly owned subsidiary of McDATA Corporation. Condor is not authorized to provide telecommunication services in any state

C. McDATA Corporation ("McDATA")

McDATA is a Delaware corporation with principal offices located at 380 Interlocken Crescent, Bloomfield, Colorado 80021. McDATA is publicly traded on the Nasdaq National

Market System. McDATA's Class A common shares are traded under the symbol "MCDTA" and its Class B common shares are traded under the symbol "MCDT". Neither McDATA nor any of its subsidiaries have any licenses relating to the provision of telecommunications services. McDATA's revenue from the twelve months ending January 31, 2004 was $418.9 million and for the quarter ending October 31, 2005 was $98.5 million. Attached as Exhibit B is the most recent 10-Q of McDATA that demonstrates McDATA is financially qualified to acquire control of CNT. Also attached as Exhibit C are the management biographies of McDATA's key operational personnel that demonstrate McDATA's managerial qualifications to acquire control of CNT. Additional information on McDATA is available on the company's website at: http://www mcdata com.

II. Contact Information

Questions or inquiries concerning this Petition may be directed to:

William B. Wilhelm, Jr.
Brian McDermott
Swidler Berlin LLP
3000 K Street, NW, Suite 300
Washington, DC 20007-5116
(202) 424-7500 (Tel)
(202) 424-7645 (Fax)

III. Description of the Transaction

Petitioners have entered into an Agreement and Plan of Merger dated as of January 17, 2005 ("Merger Agreement")[1] through which (1) Condor will be merged with and into CNT whereupon the separate existence of Condor shall cease and CNT will be the surviving corporation ("Surviving Corporation") and (2) outstanding shares of CNT will be converted into the rights to receive 1.3

shares of McDATA Class A Common Stock plus cash in lieu of franctional shares and the Surviving Corporation will become a wholly owned subsidiary of McDATA. Upon completion of the transaction, current McDATA and CNT stockholders will own approximately 76% and 24%, respectively, of McDATA. In light of the structure of the proposed Transaction, Petitioners seek concurrent approval, to the extent required in Tennessee, for both: (1) the merger of CNT and Condor; and (2) the transfer of control of CNT to McDATA. Attached as Exhibit A is an illustrative chart describing the proposed Transaction.

Following the consummation of the Transaction, CNT's customers will continue to receive service under the same rates, terms and conditions of service as before. CNT will become a wholly owned subsidiary of McDATA, will continue to operate and provide services to CNT's customers and will retain the assets used in the provisions of those services. As a result, the proposed Transaction will not involve a change in CNT's operating authority in Tennessee and CNT's tariffs will remain in effect. As a result, the Transaction will be virtually transparent to CNT's customers in terms of the services they receive.

IV. Public Interest Considerations

Petitioners respectfully submit that the proposed Transaction serves the public interest. In particular, Petitioners submit that: (1) the Transaction will increase competition in the Tennessee telecommunications market by reinforcing the status of CNT as a viable competitor and (2) the Transaction will minimize the disruption of service and be virtually transparent to CNT's customers.

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[1] A copy of the Merger Agreement will be provided upon request

The proposed Transaction is expected to facilitate competition in Tennessee by improving the operational position of both CNT and McDATA. The combination of CNT's and McDATA's complementary products and services will provide customers with the long-term confidence that their strategic requirements for a storage networking infrastructure needed for increased productivity, business continuity and regulatory compliance will be met. Moreover, given that the Transaction will not affect CNT's rates, terms and conditions of services, the Transaction will have no negative effects on customers.

V. Conclusion

For the reasons stated above, Petitioners respectfully submit that the public interest, convenience, and necessity would be furthered by a grant of this Petition. Accordingly, Petitioners respectfully request expedited treatment to permit Petitioners to consummate the Transaction on or prior to April 15, 2005.

Respectfully submitted,

By: ______________________

William B. Wilhelm, Jr.
Brian McDermott
SWIDLER BERLIN LLP
3000 K Street, NW, Suite 300
Washington, DC 20007-5116
(202) 424-7500 (Tel)
(202) 424-7645 (Fax)

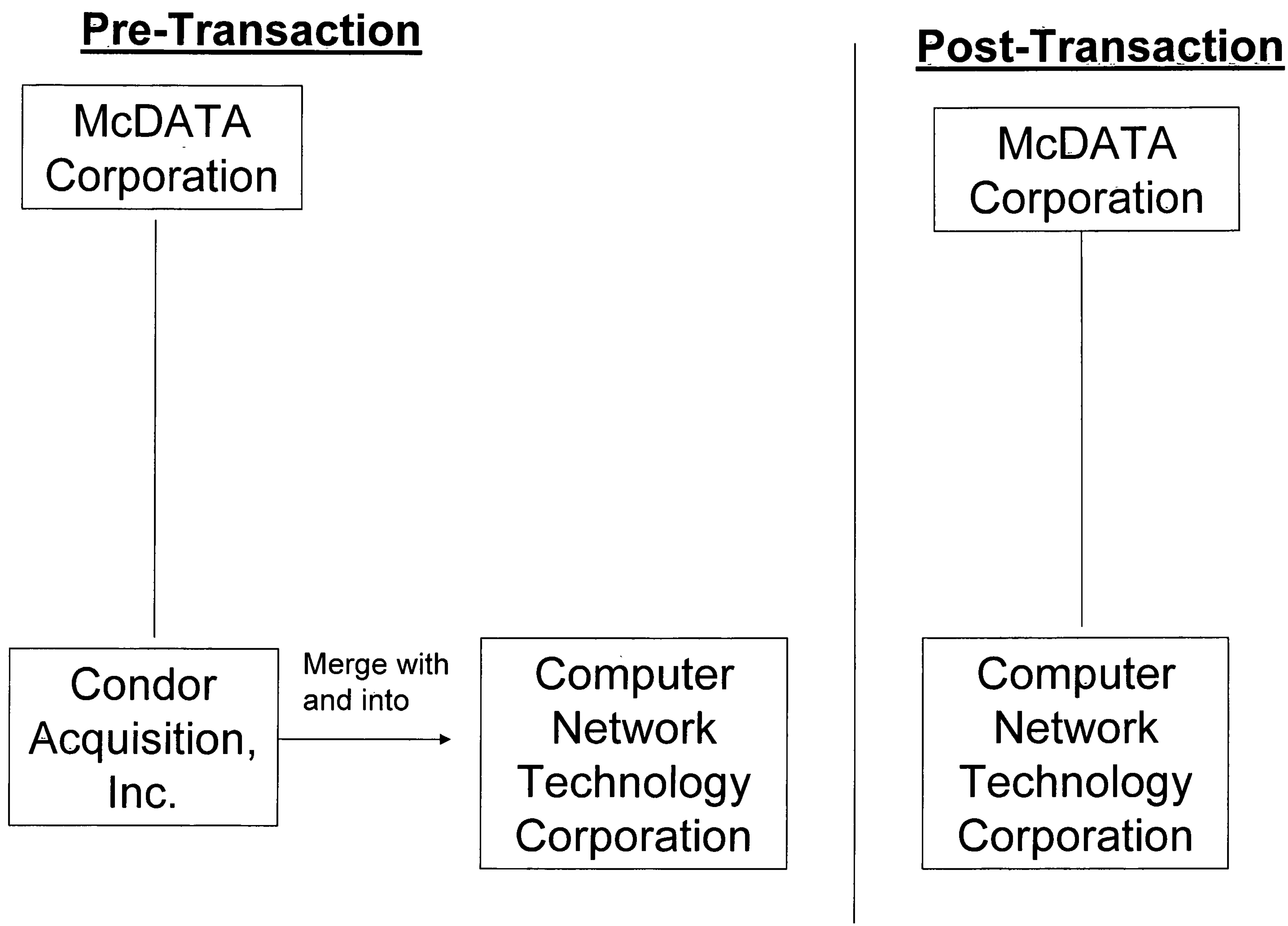
COUNSEL FOR PETITIONERS

Dated: January 26, 2005

LIST OF EXHIBITS

<u>Exhibit A</u>

Illustrative Chart


Pre-Transaction
McDATA Corporation
Condor Acquisition, Inc.
Merge with and into
Computer Network Technology Corporation
Post-Transaction
McDATA Corporation
Computer Network Technology Corporation

<u>Exhibit B</u>

Financial Information

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

FORM 10-Q

(Mark One)

☒ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended October 31, 2004

OR

☐ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from ______ to ______

Commission File Number 000-31257

McDATA CORPORATION
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation of organization)	**84-1421844** (I R.S. Employer Identification No.)

380 Interlocken Crescent, Broomfield, Colorado 80021
(Address of principal executive offices)(zip code)

(720) 558-8000
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☒ No ☐

At November 30, 2004, 81,000,000 shares of the registrant's Class A Common Stock were outstanding and 38,042,765 shares of the registrant's Class B Common Stock were outstanding

McDATA CORPORATION

FORM 10-Q
QUARTER ENDED OCTOBER 31, 2004
TABLE OF CONTENTS

Special Note Regarding Forward-Looking Statements

Some of the information presented in this Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 (the "Reform Act") Although McDATA Corporation ("McDATA" or the "Company," which may also be referred to as "we," "us" or "our") believes that its expectations are based on reasonable assumptions within the bounds of its knowledge of its businesses and operations; there can be no assurance that actual results will not differ materially from our expectations. Factors that could cause actual results to differ materially from expectations include:

- changes in our relationship with EMC Corporation, or EMC, International Business Machines Corporation, or IBM, Hitachi Data Systems, or HDS, and our other distribution partners and the level of their orders;
- our ability to successfully increase sales of McDATA's network switches and management software, including SANavigator®;
- competition in the multi-protocol (Fibre Channel and IP) network market, including competitive pricing pressures and product give-aways, by our competitors such as Brocade Communication Systems, Inc., or Brocade, QLogic Corp., or QLogic, Computer Network Technology Corporation, or CNT, Cisco Systems, Inc., or Cisco, and other IP and multi-protocol switch and software suppliers;
- our ability to expand our product offerings including our ability to successfully qualify and ramp sales of new products (including higher port density, multi-protocol and intelligent network products);
- unexpected engineering costs or delays, additional manufacturing and component costs or production delays that we may experience in connection with new product development,
- a loss of any of our key customers (and our OEMs' key customers), distributors, resellers, suppliers or our manufacturers;
- any change in business conditions, our business and sales strategy or product development plans, and our ability to attract and retain highly skilled individuals;
- any industry or technology changes that cause obsolescence of our products or components of those products;
- one-time events and other important risks and factors disclosed previously and from time to time in our filings with the U S. Securities and Exchange Commission, or SEC, including the risk factors discussed in this Quarterly Report; and
- the impact of any acquisitions by us of businesses, products, or technologies, including difficulties in integrating any acquisitions.

You should not construe these cautionary statements as an exhaustive list or as any admission by us regarding the adequacy of the disclosures made by us. We cannot always predict or determine after the fact what factors would cause actual results to differ materially from those indicated by our forward-looking statements or other statements. In addition, you are urged to consider statements that include the terms "believes," "belief," "expects," "plans," "objectives," "anticipates," "intends," or the like to be uncertain and forward-looking All cautionary statements should be read as being applicable to all forward-looking statements wherever they appear. We do not undertake any obligation to publicly update or revise any forward-looking statements.

PART I – FINANCIAL INFORMATION

McDATA CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	October 31, 2004	January 31, 2004
	(unaudited)	
Assets		
Current assets.		
Cash and cash equivalents	$ 47,690	$ 50,301
Securities lending collateral	141,361	126,681
Short-term investments	152,307	157,740
Accounts receivable, net of allowance for bad debts of $811 and $926, respectively	64,406	62,670
Inventories, net	16,386	11,364
Prepaid expenses and other current assets	6,764	6,055
Total current assets	428,914	414,811
Property and equipment, net	98,096	99,225
Long-term investments	98,385	103,483
Restricted cash	5,029	5,130
Intangible assets, net	93,146	111,313
Goodwill	78,693	78,787
Interest rate swap	281	—
Other assets, net	27,497	18,219
Total assets	$830,041	$830,968
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 28,297	$ 16,532
Accrued liabilities	40,759	53,330
Securities lending collateral payable	141,361	126,681
Current portion of deferred revenue	20,791	19,775
Current portion of obligations under notes payable and capital leases	1,013	2,785
Total current liabilities	232,221	219,103
Obligations under notes payable and capital leases, less current portion	388	1,091
Deferred revenue, less current portion	25,049	20,632
Other long-term liabilities	2,020	—
Interest rate swap	—	349
Convertible subordinated debt	172,781	172,151
Total liabilities	432,459	413,326
Commitments and contingencies *(Note 15)*		
Stockholders' Equity:		
Preferred stock, $0 01 par value, 25,000,000 shares authorized, no shares issued or outstanding	—	—
Common stock, Class A, $0 01 par value, 250,000,000 shares authorized, 81,000,000 shares issued and outstanding	810	810
Common stock, Class B, $0 01 par value, 200,000,000 shares authorized, 37,918,492 and 36,051,473 shares issued and outstanding at October 31, 2004 and January 31, 2004, respectively	379	361
Additional paid-in-capital	481,799	476,993
Treasury stock, at cost, 2,975,730 and 975,730 shares outstanding at October 31, 2004 and January 31, 2004, respectively	(18,853)	(8,752)
Deferred compensation	(3,620)	(10,375)
Accumulated other comprehensive income (loss)	(343)	403
Accumulated deficit	(62,590)	(41,798)

Total stockholders' equity	397,582	417,642
Total liabilities and stockholders' equity	$830,041	$830,968

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

McDATA CORPORATION
CONDENSED CONSOLIDATED INCOME STATEMENTS
(in thousands, except per share data)
(unaudited)

	Three Months Ended October 31,		Nine Months Ended October, 31	
	2004	2003	2004	2003
Revenue	$ 98,525	$ 94,659	$293,975	$304,852
Cost of revenue	43,704	40,012	129,568	128,307
Gross profit	54,821	54,647	164,407	176,545
Operating expenses (recoveries):				
Research and development (excludes amortization of deferred compensation included in Amortization of deferred compensation of $811, $1,943, $3,297 and $2,811, respectively)	22,789	23,571	69,993	60,546
Selling and marketing (excludes amortization of deferred compensation included in Amortization of deferred compensation of $98, $643, $548 and $1,033, respectively)	26,755	23,531	74,477	70,452
General and administrative (excludes amortization of deferred compensation included in Amortization of deferred compensation of $141, $3,133, $952 and $4,776, respectively)	5,760	8,144	19,471	21,764
Acquired in-process research and development and other acquisition related costs	—	11,410	—	11,410
Amortization of purchased intangible assets	5,645	2,516	17,218	3,566
Amortization of deferred compensation (excludes amortization of deferred compensation included in cost of revenue of $26, $285, $162 and $555, respectively)	1,050	5,719	4,797	8,620
Restructuring charges (recoveries)	(55)	—	1,263	—
Total operating expenses	61,944	74,891	187,219	176,358
Income (loss) from operations	(7,123)	(20,244)	(22,812)	187
Interest and other income	1,639	1,860	4,302	5,508
Interest expense	(395)	(221)	(862)	(2,497)
Income (loss) before income taxes and equity in net loss of affiliated company	(5,879)	(18,605)	(19,372)	3,198
Income tax expense (benefit)	(618)	30,852	40	38,210
Loss before equity in net loss of affiliated company	(5,261)	(49,457)	(19,412)	(35,012)
Equity in net loss of affiliated company	(262)	(591)	(1,380)	(591)
Net loss	$ (5,523)	$ (50,048)	$ (20,792)	$ (35,603)
Basic net loss per share	$ (0.05)	$ (0.44)	$ (0.18)	$ (0.31)
Shares used in computing basic net loss per share	115,624	114,955	115,377	114,627
Diluted net loss per share	$ (0.05)	$ (0.44)	$ (0.18)	$ (0.31)
Shares used in computing diluted net loss per share	115,624	114,955	115,377	114,627

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

McDATA CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended October 31, 2004	Nine Months Ended October 31, 2003
Cash flows from operating activities:		
Net loss	$ (20,792)	$ (35,603)
Adjustments to reconcile net loss to cash flows from operating activities:		
Depreciation	21,127	19,538
Amortization	20,943	8,772
Equity in net loss of affiliate	1,380	591
Loss on trade-in/retirement of assets	179	482
Net realized loss (gain) on investments	652	(191)
Inventory and inventory commitment provisions	4,319	2,077
Acquired in-process research and development	—	11,410
Impairment loss	50	—
Bad debt provision	25	81
Deferred income taxes	—	38,811
Non-cash compensation expense	4,959	9,175
Tax benefit from stock options exercised	—	—
Unrealized gains on derivative transactions and cash equivalents	18	—
Changes in net assets and liabilities	(22,905)	(10,014)
Net cash provided by operating activities	9,955	45,129
Cash flows from investing activities:		
Purchases of property and equipment	(13,911)	(12,510)
Acquisitions	—	(171,174)
Equity investment	—	(6,000)
Purchases of investments	(349,582)	(591,554)
Proceeds from maturities and sales of investments	357,743	537,291
Net cash used by investing activities	(5,750)	(243,947)
Cash flows from financing activities:		
Net proceeds for issuance of convertible subordinated debt	—	166,933
Net purchase of share option transactions	—	(20,510)
Restricted cash related to interest rate swap	101	(5,130)
Purchase of treasury stock	(10,100)	—
Payments on long-term notes payable and capital leases	(2,317)	(16,747)
Proceeds from the issuance of common stock	5,500	5,624
Net cash provided (used) by financing activities	(6,816)	130,170
Net decrease in cash and cash equivalents	(2,611)	(68,648)
Cash and cash equivalents, beginning of period	50,301	108,168
Cash and cash equivalents, end of period	$ 47,690	$ 39,520
Supplemental Disclosure of Non-Cash Investing and Financing Activities		
Deferred compensation forfeitures	$ 1,795	$ —
Capital lease obligations incurred	$ 204	$ 1,658
Fixed assets exchanged for capital leases	$ —	(1,364)
Transfer of inventory to fixed assets	$ 4,337	$ 1,478

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

McDATA CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(tabular amounts in thousands, except per share data)
(unaudited)

Note 1 – Overview and Basis of Presentation

McDATA Corporation (McDATA or the Company) provides Multi-Capable Storage Network Solutions™ (integrating multiple platforms, networks, protocols and locations) that enables end-customers around the world to better utilize their storage infrastructure, easily manage the storage network and implement best-in-class business continuance solutions allowing them to be more efficient and effective McDATA solutions are an integral part of data services infrastructures sold by most major storage and system vendors, including Dell Products L P. (Dell), EMC Corporation (EMC), Hewlett-Packard (HP), Hitachi Data Systems (HDS), International Business Machines Corporation (IBM), StorageTechnology Corporation (STK) and Sun Microsystems, Inc. (Sun).

The accompanying condensed consolidated financial statements of McDATA and its subsidiaries have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission Certain information and footnote disclosures normally included in the Company's annual consolidated financial statements have been condensed or omitted. The condensed consolidated balance sheet as of January 31, 2004 has been derived from the audited consolidated financial statements as of that date, but does not include all disclosures required by generally accepted accounting principles For further information, please refer to and read these interim condensed consolidated financial statements in conjunction with the Company's audited consolidated financial statements for the year ended January 31, 2004.

The interim condensed consolidated financial statements, in the opinion of management, reflect all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows of the Company for the periods presented. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the entire fiscal year or future periods.

Recent Accounting Pronouncements

In January 2004, the Financial Accounting Standards Board (FASB) issued Emerging Issues Task Force (EITF) Issue No 03-1, The Meaning of Other-Than Temporary Impairment and Its Application to Certain Investments (EITF 03-1). EITF 03-1 provides guidance on the disclosure requirements for other-than-temporary impairments of debt and marketable equity investments that are accounted for under Statement of Financial Accounting Standards (SFAS) No 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS 115). The adoption of EITF 03-1 would require the Company to include certain quantitative and qualitative disclosures for debt and marketable equity securities classified as available-for-sale or held-to-maturity under SFAS 115 that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized. This guidance was to be effective for financial periods beginning after June 15, 2004, however, its adoption has been delayed due to proposed additional guidance concerning the impairment of debt securities The Company does not anticipate that the adoption of this issue would have a material impact on the Company's financial position or results of operations.

Note 2 – ESCON Agreement Amendment

In 1997, the Company entered into a services agreement with McDATA Holdings Corporation, a wholly-owned subsidiary of EMC, to provide manufacturing and distribution management services for proprietary mainframe protocol, or ESCON™, switching solutions manufactured for and sold to IBM. Under the terms of this agreement, McDATA agreed to manage the ESCON product manufacture, design, order and product shipment in exchange for a service fee calculated as a fixed percentage of EMC's ESCON revenues. In the second quarter ended July 31, 2004, the Company amended the service agreement to effectively assume the ESCON business operations. This comprises the acceptance of the rights, risks and costs of inventory ownership and distribution; accounts receivable billing and collections, and sales and marketing activities.

Effective July 1, 2004, the Company began to fully consolidate the operations of the ESCON product line Under this new arrangement, McDATA recorded $6 6 million of ESCON product revenue related to sales made from July 1 through October 31, 2004 In addition, the Company recorded the ESCON product inventory on the balance sheet and has included outstanding purchase commitments in the overall contract manufacturer commitments at October 31, 2004 (Note 15).

In connection with the assumption of the ESCON business, the Company renegotiated the prior service agreement with EMC to include an increased service fee percentage through June 30, 2004. As a result, during the quarter ended July 31, 2004, McDATA recognized $1 6 million of previously deferred revenue related to past service fees which were in dispute. Additionally, the Company remitted to EMC approximately $11 million of ESCON-related collections, which had been retained by the Company during the negotiations and classified in accrued liabilities in prior periods

Note 3 – Restructuring Charges

During the quarter ended January 31, 2004, the Company announced that it was taking certain cost improvement actions, which included a workforce reduction and facility consolidation Total restructuring costs of $3 5 million consist of severance and benefit charges, facility closure expenses, and other charges Severance and benefit charges of $2 3 million include severance and related employee termination costs associated with the reduction of the Company's workforce by approximately 92 employees, or 9%. Facility closure charges of $1 1 million relate to losses for a leased engineering facility in Toronto, Canada. In August 2004, the Company entered into agreements to sublease this facility to an unrelated third-party through the Company's remaining original lease term In connection with these agreements, the Company made a one-time payment of approximately $1 million to satisfy all of its outstanding lease commitments for this facility These payments were applied against the restructuring reserve accrual and approximate the original estimates made by the Company. As of October 31, 2004, all planned activities under this plan had been completed and all remaining accrued liabilities were paid or settled.

The following table summarizes the Company's utilization of restructuring accruals for the nine months ended October 31, 2004:

	Employee Severance Benefits	Facility Closure	Other Costs	Totals
Remaining accrual at beginning of period	$ 2,238	$ —	$ —	$ 2,238
Expense provision	—	1,117	—	1,117
Cash payments and other	(2,297)	(985)	(219)	(3,501)
Changes in estimates	59	(132)	219	146
Accrual at end of period	$ —	$ —	$ —	$ —

Note 4 – Components of Selected Balance Sheet Accounts

	October 31, 2004	January 31, 2004
Inventories:		
Raw materials	$ 10,620	$ 7,037
Work-in-progress	436	920
Finished goods	11,001	7,883
Total inventories at cost	22,057	15,840
Less reserves	(5,671)	(4,476)
Total inventories, net	$ 16,386	$ 11,364

The Company has made significant investments in pre-production inventory related to new product introductions where technological feasibility has been established and are expected to be released in the fourth quarter of fiscal 2004 and the first half of fiscal 2005. The pre-production inventory includes both raw material component inventory to be utilized in final production as well as finished test product currently in the qualification and testing phases at OEM partner and end-user sites Upon general availability, a portion of the test product will be sold and recognized as product revenue under revenue recognition guidelines.

	October 31, 2004	January 31, 2004
Accrued liabilities:		
Wages and employee benefits	$ 17,070	$ 17,489
Purchase commitments and other supply obligations	6,628	7,829
Warranty reserves (1)	4,299	4,522
Income taxes payable	1,123	1,783
Taxes, other than income tax	2,282	2,534
Interest payable	803	1,773
Customer obligations	6,258	4,729
ESCON agency funds	—	8,373
Restructuring reserve	—	2,238
Other accrued liabilities	2,296	2,060

	$ 40,759	$ 53,330

(1) Activity in the warranty reserves is as follows:

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2004	2003	2004	2003
Balance at beginning of period	$ 4,396	$ 3,897	$ 4,522	$ 3,485
Warranty expense, net	68	181	562	844
Non-expensed warranty obligations	69	—	69	—
Warranty claims	(234)	(111)	(854)	(362)
Acquired warranty liability	—	227	—	227
Balance at end of period	$ 4,299	$ 4,194	$ 4,299	$ 4,194

From time to time the Company is indemnified by its suppliers for warranty claims related to components that are contained within its products. In these circumstances, the Company records a non-expensed warranty obligation against which future warranty claims for those components will be provided by the Company to its customers.

Note 5 – Equity Investment

On August 22, 2003, the Company purchased 13 6 million shares of preferred stock, or approximately 17.3% of the total outstanding shares, of Aarohi Communications (Aarohi) for $6 million cash. Aarohi is a privately-owned provider of next-generation intelligent storage networking technology. In addition to the equity investment, the Company has entered into a non-exclusive supply arrangement with Aarohi to purchase their Application Specific Integrated Circuit chip for inclusion in the Company's new product launches when, and if, Aarohi's product becomes generally available The Company has recorded its share of Aarohi's net loss of approximately $262,000 and $1 4 million for the three months and nine months ended October 31, 2004, respectively. Because the remaining net equity investment has been reduced to zero as of October 31, 2004, the Company will no longer recognize its share of Aarohi's net losses and will not provide for additional losses unless the Company commits to additional financial support for Aarohi, which the Company is not required to provide If Aarohi subsequently reports net income, then McDATA will resume recognizing its share of Aarohi's net income only after its share of net income equals the share of net losses not recognized.

During the nine months ended October 31, 2004, the Company purchased software development services from Aarohi at a cost of $68,000 These expenses have been classified as research and development expenditures.

Summarized unaudited financial information for Aarohi is as follows:

Nine Months Ended September 30, 2004	
Net sales	$ 122
Gross profit	$ 122
Operating loss	$ (9,044)
Net loss	$ (9,084)

As of September 30, 2004	
Current assets	$ 5,473
Noncurrent assets	$ 1,379
Current liabilities	$ 887
Noncurrent liabilities	$ 2,197
Redeemable convertible preferred stock	$ 34,471
Retained deficit	$(30,712)

Note 6 – Goodwill and Intangible assets

Changes in the carrying amounts of goodwill are as follows:

Goodwill as of January 31, 2004	$78,787
Purchase price adjustment	(94)
Goodwill as of October 31, 2004	$78,693

The Company completed its acquisitions of Nishan Systems, Inc and Sanera Systems, Inc. in the third quarter of 2003. No further material purchase adjustments are anticipated except for potential goodwill adjustments as a result of the potential future release of valuation allowance on the deferred tax assets of the acquired companies that was recorded at the time of the acquisitions.

The Company is currently amortizing its acquired intangible assets with finite lives over periods ranging from 1 to 6 years. During the quarter ended July 31, 2004, the Company identified the impairment of a customer relationship asset (the termination of Sanera's prior Original Equipment Manufacturer's Agreement with Computer Network Technology Corporation) with a net carrying value of $1.0 million. This impairment was mostly offset by the indemnification by former owners of Sanera. A net impairment charge of $50,000 was recorded in general and administrative expenses during the second quarter fiscal 2004. In connection with the cost improvement actions discussed in Note 3, the Company has retired a $2 2 million intangible asset related to the initial purchase of the Toronto operations in 1997 The asset was fully amortized and did not result in a loss. The following table summarizes the components of gross and net intangible asset balances

	October 31, 2004			January 31, 2004		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Developed technology	$116,869	$ 26,482	$ 90,387	$116,769	$ 11,133	$ 105,636
Customer relationships	1,622	604	1,018	3,021	340	2,681
Other	3,813	2,072	1,741	5,993	2,997	2,996
Total intangible assets	$122,304	$ 29,158	$ 93,146	$125,783	$ 14,470	$ 111,313

Expected annual amortization expense related to acquired intangible assets is as follows:

Fiscal Years:	
2004[(1)]	$ 5,553
2005	21,639
2006	19,494
2007	17,754
2008	17,418
Thereafter	11,288
Total expected amortization expense	$93,146

(1) Reflects the remaining three months of fiscal 2004.

Amortization expense related to acquired intangible assets was $5 6 million and $2.5 million for the quarters ended October 31, 2004 and 2003, respectively. For the nine months ended October 31, 2004 and 2003, amortization of acquired intangible assets was $17 2 million and $3.6 million, respectively.

Note 7 – Interest and Other Income, Net

Interest and other income consists of:

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2004	2003	2004	2003
Interest income	$ 1,786	$ 1,827	$ 4,970	$ 5,333
Net realized gains/(losses) on available-for-sale investments	(170)	89	(653)	210
Unrealized gain (loss) on hedged investments	23	(56)	(15)	(35)
Interest and other income, net	$ 1,639	$ 1,860	$ 4,302	$ 5,508

Note 8 – Income Tax

For the three months ended October 31, 2004 and October 31, 2003 the Company recorded an income tax benefit of $618,000 and a provision of $30 9 million, respectively. Income tax provisions of $40,000 and $38 2 million were recorded for the nine months ended October 31, 2004 and 2003, respectively. The tax provision for fiscal 2004 reflects foreign tax that McDATA will owe on the profit of its foreign branch and subsidiary activities as well as state taxes where there are insufficient tax operating losses to offset allocable taxable income. No federal tax benefit is recorded because the Company has established a valuation allowance against its entire net domestic deferred tax asset The tax benefit for the three months ended October 31, 2004 and the tax provision for the nine months ended October 31, 2004 include a benefit from the reconciliation of US, state and Canadian tax return liabilities to taxes previously accrued The tax provision for the three and nine months ended October 31, 2003 includes a non-cash charge of $38.7 million related to recording a valuation allowance against deferred tax assets.

Note 9 – Net Loss Per Share

Basic net loss per share excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period Diluted net loss per share is based on the weighted-average number of shares outstanding during each period and the assumed exercise of dilutive common stock equivalents less the number of treasury shares assumed to be purchased from the proceeds using the average market price of the Company's common stock for each of the periods presented. A dilutive effect is included for shares sold in relation to McDATA's agreement with International Business Machines Corporation (IBM) in which the Company granted IBM five-year warrants for the purchase of up to 350,000 shares of McDATA's Class B common stock The IBM warrants are fully discussed in Note 11. No dilutive effect has been included for the convertible subordinated debt issued February 7, 2003 or the share options sold in relation to the convertible subordinated debt because of their anti-dilutive impact.

Following is a reconciliation between basic and diluted loss per share:

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2004	2003	2004	2003
Net loss	$ (5,523)	$ (50,048)	$ (20,792)	$ (35,603)
Weighted average shares of common stock outstanding used in computing basic net income (loss) per share	115,624	114,955	115,377	114,627
Effect of dilutive stock options and warrants	—	—	—	—
Weighted average shares of common stock used in computing diluted net loss per share	115,624	114,955	115,377	114,627
Basic net loss per share	$ (0.05)	$ (0.44)	$ (0.18)	$ (0.31)
Diluted net loss per share	$ (0.05)	$ (0.44)	$ (0.18)	$ (0.31)
Options and warrants not included in diluted share base because of the exercise prices	11,407	5,379	10,184	6,324
Options, warrants and restricted stock not included in diluted share base because of the net loss	7,134	10,233	8,016	9,288

Note 10 – Stock-Based Compensation

The Company has stock-based employee compensation and employee stock purchase plans, which are described more fully in the Company's Annual Report on Form 10-K for the year ended January 31, 2004. In addition, the Board of Directors approved the Company's 2004 Inducement Equity Grant Plan (the 2004 Plan) in May 2004. The 2004 Plan provides for the issuance of non-qualified options, stock bonus awards, stock purchase awards, stock appreciation rights, stock unit awards and other stock awards for newly-hired employees of the Company. A maximum of 3 million shares are issuable under the 2004 Plan. As of October 31, 2004, there were approximately 6.3 million shares of common stock available for future grants under these plans.

The Company accounts for these plans according to Accounting Principles Board Opinion No. 25, Accounting for Stock Issues to Employees" (APB 25), and related interpretations and has adopted the disclosure-only alternative of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation" (SFAS No. 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123. Any deferred stock compensation calculated pursuant to APB 25 is amortized ratably over the vesting period of the individual options, generally two to four years The following table illustrates the effect on net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123.

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2004	2003	2004	2003
Net loss, as reported	$(5,523)	$(50,048)	$(20,792)	$(35,603)
Add Total stock-based employee compensation expense included in net loss as determined under the intrinsic value method, net of related tax effects	1,076	6,004	4,959	9,175
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(4,273)	(11,562)	(14,234)	(25,785)
Pro forma net loss	$(8,720)	$(55,606)	$(30,067)	$(52,213)
Loss per share:				
Basic-as reported	$ (0 05)	$ (0.44)	$ (0 18)	$ (0.31)
Basic-pro forma	$ (0.08)	$ (0.48)	$ (0.26)	$ (0.46)
Diluted-as reported	$ (0 05)	$ (0.44)	$ (0.18)	$ (0.31)
Diluted-pro forma	$ (0.08)	$ (0.48)	$ (0.26)	$ (0.46)

Note 11– Stockholders' Equity

Stock Repurchase Plan

The Company's Board of Directors has authorized a plan for the Company to repurchase its common stock (Class A, Class B or a combination thereof). During the quarter ended October 31, 2004, the Board of Directors renewed the plan and reauthorized the repurchase of up to $50 million of its common shares This repurchase plan expires on September 1, 2005 and allows the Company to repurchase shares on the open market, in negotiated transactions off the market, or pursuant to a 10b5-1 plan adopted by the Company. The Company adopted a 10b5-1 plan in September 2004, which allows the Company to repurchase its shares during a period in which the Company is in possession of material non-public information, provided the Company communicates share repurchase instructions to the broker at a time when the Company was not in possession of such material non-public information During the quarter ended October 31, 2004, the Company purchased 2 million shares of Class B common stock for $10.1 million. Since inception of the plan, approximately 3 0 million shares (approximately 679,000 shares of Class A and approximately 2.3 million shares of Class B) have been repurchased with a total cost of $18.9 million.

Warrants to Purchase Stock

In September 2004, the Company entered into an OEM agreement with IBM. In connection with this agreement, the Company granted IBM five-year warrants for the purchase of up to 350,000 shares of McDATA's Class B common stock. The warrants are structured into three substantially equal tranches at exercise prices of $4 700, $5 052 and $5.405 per share. The warrants contain customary terms and conditions, including piggy-back SEC registration rights and anti-dilution protections in favor of IBM, and are fully exercisable. The warrants have been valued at approximately $1 0 million using the Black-Scholes option pricing model with the following assumptions risk-free interest rate of 3 29%, volatility of 80%, dividend rate of 0% and an expected life of five years. The warrants are recorded as an other asset related to the OEM contract and will be amortized ratably over the 60-month term of the OEM contract as a reduction to revenue.

Note 12 – Comprehensive Loss

Comprehensive loss consisted of the following

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2004	2003	2004	2003
Net loss	$(5,523)	$(50,048)	$(20,792)	$(35,603)
Unrealized loss on investments, net of tax	418	139	(746)	(304)
Comprehensive loss	$(5,105)	$(49,909)	$(21,538)	$(35,907)

Note 13 – Segment Information

The Company has one reporting segment relating to the design, development, manufacture and sale of open storage networking solutions that provide highly available, scalable and centrally managed storage area networks (SANs). The Company's Chief Operating Decision Makers, as defined by SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," allocate resources and assess the performance of the Company based on revenue and overall profitability.

A significant portion of revenue is concentrated with the largest storage OEMs. For the three months ended October 31, 2004, approximately 49% of total revenue came from EMC as compared to 54% for the three months ended October 31, 2003; IBM contributed approximately 23% of revenue compared to 21% for the three months ended October 31, 2003; and HDS contributed less than 10% for the three months ended October 31 2004, and approximately 10% for the three months ended October 31, 2003. For the nine months ended October 31, 2004, approximately 47% of total revenue came from EMC as compared to 59% for the nine months ended October 31, 2003, IBM contributed approximately 25% of total revenue compared to 19% for the nine months ended October 31, 2003; and HDS contributed approximately 10% of total revenue for the nine months ended October 31, 2004 and 2003. Other major storage and system vendors, including Dell, HP, STK and Sun, offer McDATA solutions to their customers. In addition to storage and system vendors, the Company has relationships with many resellers, distributors and systems integrators. Sales to these other channels represented 19% and 15% of total revenue, respectively for the three months ended October 31, 2004 and 2003 and 18% and 12% of total revenue, respectively for the nine months ended October 31, 2004 and 2003.

Revenues are attributed to geographic areas based on the location of the customers to which products are shipped. International revenues primarily consist of sales to customers in Western Europe and the greater Asia Pacific region. Included in domestic revenues are sales to certain OEM customers who take possession of products domestically and then distribute these products to their international customers In addition, included in revenues from Western Europe are sales to certain OEM customers who take possession of products in distribution centers designated for international-bound product and then distribute these products among various international regions The mix of international and domestic revenue can, therefore, vary depending on the relative mix of sales to certain OEM customers. Domestic and international revenue was approximately 66% and 34% of total revenue, respectively, for the three months ended October 31, 2004 For the three months ended October 31, 2003, domestic and international revenue was approximately 66% and 34% of total revenue, respectively. For the nine months ended October 31, 2004, domestic and international revenue was approximately 64% and 36% of total revenue as compared to 69% and 31%, respectively for the nine months ended October 31, 2003.

Note 14 – Related Party Transaction

In June 2004, the Company entered into a Software OEM Agreement (OEM Agreement) with Crosswalk, Inc. (Crosswalk). John F. McDonnell, a Class B shareholder of the Company and its former Chairman is the founder and sole director of Crosswalk Pursuant to the OEM Agreement, the Company granted Crosswalk a license to develop and integrate the Company's SANavigator® software into Crosswalk's software platform, create certain enhancements for use with such integrated software product, and re-brand such integrated software product with Crosswalk's trademarks The Company also granted Crosswalk a limited license to distribute the integrated software product furnished by the Company. The Company has deferred a $250,000 license fee and is recognizing license fee revenue over the license period of twelve months. Since entering into the agreement, the Company has recorded approximately $82,000 of revenue Upon release and distribution of the Crosswalk proprietary software, software royalties will be recognized in accordance with the terms of the OEM Agreement and the Company's revenue recognition policies.

As of October 31, 2004, Mr. McDonnell is no longer a significant holder of the Company's common stock and, therefore, is no longer considered a related party

Note 15 – Commitment and Contingencies

From time to time, the Company is subject to claims arising in the ordinary course of business In the opinion of management and, except as set forth below, no such matter, individually or in the aggregate, exists which is expected to have a material adverse effect on the Company's consolidated results of operations, financial position or cash flows.

On September 9, 2004, the Company entered into a triple net office lease for the future lease of approximately 168,127 square feet of office space in Broomfield, Colorado (the "New Premises"). The Company intends to begin moving its current world headquarters location to the New Premises early in 2006 with lease payments commencing in February of 2006. The Company's current headquarter office lease expires at the end of April 2006. The term of the new lease is for 11 years (with two 5 year renewal options) and is at market lease rates that are substantially lower than the current lease rate paid by the Company. The base annual lease rates per rentable square foot for the New Premises range from $0 in the first year to $14 15 in the last year of the lease, plus normal operating expenses. In addition, the Company has an option to purchase the New Premises at varying amounts until December 31, 2005. The lease and option to purchase have customary terms and conditions.

Manufacturing and Purchase Commitments

The Company has contracted with Sanmina SCI Systems, Inc (SSCI), Solectron Corporation (Solectron) and others (collectively, Contract Manufacturers) for the manufacture of printed circuit boards and box build assembly and configuration for specific multi-protocol directors and switches. The agreements require the Company to submit purchasing forecasts and place orders sixty calendar days in advance of delivery. At October 31, 2004, the Company's commitment with the Contract Manufacturers for purchases over the next sixty days totaled $62.7 million. The Company may be liable for materials that the Contract Manufacturers purchase on McDATA's behalf if the Company's actual requirements do not meet or exceed its forecasts and those materials cannot be redirected to other uses. At October 31, 2004, the Company had recorded obligations of approximately $6.6 million (See Note 4) primarily related to materials purchased by the Contract Manufacturers for certain end-of-life and obsolete material. Management does not expect the remaining commitments under these agreements to have a material adverse effect on the Company's business, results of operations, financial position or cash flows.

The Company has various other commitments for sales and purchases in the ordinary course of business. In the aggregate, such commitments do not differ significantly from current market prices or anticipated usage requirements.

Litigation

Class Action Laddering Lawsuits

The Company, John F McDonnell, the former Chairman of the board of directors, Dee J Perry, a former officer and Thomas O. McGimpsey a current officer were named as defendants in purported securities class-action lawsuits filed in the United States District Court, Southern District of New York. The first of these lawsuits, filed on July 20, 2001, is captioned Gutner v. McDATA Corporation, Credit Suisse First Boston (CSFB), Merrill Lynch, Pierce Fenner & Smith Incorporated, Bear, Stearns & Co., Inc., FleetBoston Robertson Stephens et al., No 01 CIV. 6627 Three other similar suits were filed against the Company and the individuals. The complaints are substantially identical to numerous other complaints filed against other companies that went public in 1999 and 2000. These lawsuits generally allege, among other things, that the registration statements and prospectus filed with the SEC by such companies were materially false and misleading because they failed to disclose (a) that certain underwriters had allegedly solicited and received excessive and undisclosed commissions from certain investors in exchange for which the underwriters allocated to those investors material portions of shares in connection with the initial public offerings, or IPOs, and (b) that certain of the underwriters had allegedly entered into agreements with customers whereby the underwriters agreed to allocate IPO shares in exchange for which the customers agreed to purchase additional company shares in the aftermarket at pre-determined prices. The complaints allege claims against the Company, the named individuals, and CSFB, the lead underwriter of the Company's August 9, 2000 initial public offering, under Sections 11 and 15 of the Securities Act of 1933. The complaints also allege claims solely against CSFB and the other underwriter defendants under Section 12(a)(2) of the Securities Act of 1933, and claims against the individual defendants under Section 10(b) of the Securities Exchange Act of 1934. Although management believes that all of the lawsuits are without legal merit and they intend to defend against them vigorously, there is no assurance that the Company will prevail.

In September 2002, plaintiffs' counsel in the above-mentioned lawsuits offered to individual defendants of many of the public companies being sued, including the Company, the opportunity to enter into a Reservation of Rights and Tolling Agreement that would dismiss without prejudice and without costs all claims against such persons if the company itself had entity coverage insurance. This agreement was signed by Mr McDonnell, the former Company Chairman, Mrs Perry, the former chief financial officer, and Mr. McGimpsey, the current Vice President of Business Development and General Counsel and the plaintiffs' executive committee. Under the Reservation of Rights and Tolling Agreement, the plaintiffs dismissed the claims against such individuals.

On February 19, 2003, the court in the above-mentioned lawsuits entered a ruling on the pending motions to dismiss, which dismissed some, but not all, of the plaintiffs' claims against the Company. These lawsuits have been consolidated as part of In Re Initial Public Offering Securities Litigation (SDNY). The Company has considered and agreed to enter into a proposed settlement offer with representatives of the plaintiffs in the consolidated proceeding, and we believe that any liability on behalf of the Company that may accrue under that settlement offer would be covered by our insurance policies Until that settlement is fully effective, management intends to vigorously defend against the consolidated proceeding.

Nishan Acquisition Related Lawsuit

In connection with the Company's acquisition of Nishan, the Company was named along with Nishan, various investors of Nishan, CSFB and certain of the former board members and officers of Nishan in a lawsuit brought by Aamer Latif, a former board member and ex-CEO of Nishan, in the Superior Court of California, County of Santa Clara on September 11, 2003 (as amended on October 10, 2003 and March 24, 2004) entitled *Aamer Latif v. Nishan Systems, Inc. et al (103 CV 004 939)*. The Complaint makes various allegations against the other defendants such as fraud, directors' breach of the duty of care, shareholders' breach of fiduciary duty, unjust enrichment, and conspiracy to commit unjust enrichment The allegations made against the Company are vote buying, unjust enrichment, and conspiracy to commit unjust enrichment The allegation made against Nishan is breach of Section 1602 of the California Corporations Code (a provision dealing with books and records inspection) The complaint primarily seeks compensatory damages of approximately $11.5 million and other relief The defendants have agreed that lawsuit expenses are covered by indemnification under the merger agreement from the selling shareholders of Nishan. The defendants filed a demurrer to dismiss this action, which was denied by the Court in January 2004 In May 2004, the defendants filed another demurrer to dismiss this action On August 6, 2004, the defendants received a favorable ruling from the Judge The Judge ruled against Mr. Latif and dismissed his claims since they were barred by California's appraisal rights statute (Corporations Code Section 1312(a)). The Judge also gave Mr. Latif 20 days leave to attempt to amend his complaint since it failed to state facts sufficient to constitute a legal cause of action. Mr. Latif subsequently amended his complaint and a demurrer hearing occurred on November 16, 2004. In late November, the Judge again ruled against Mr. Latif but gave Mr Latif until December 10, 2004 to amend his complaint again After significant review of the allegations made by the plaintiff, management strongly believes that the lawsuit is wholly without legal merit and the Company intends to vigorously defend against this action.

Indemnifications and Guarantees

During its normal course of business, the Company may enter into agreements with, among others, customers, resellers, OEMs, systems integrators and distributors. These agreements typically require the Company to indemnify the other party against product defects, third party claims or product infringements on patents or copyrights The Company provides indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products.

In addition, the majority of these indemnities, commitments and guarantees do not provide for any limitation of the maximum potential future payments the Company could be obligated to make The Company evaluates and estimates losses from such indemnification under SFAS No. 5, Accounting for Contingencies, as interpreted by FASB Interpretation No. 45. To date, the Company has not incurred any material costs as a result of such obligations and has not accrued any liabilities related to such indemnification and guarantees in our financial statements.

Note 16 – Subsequent Event

On November 22, 2004, the Company entered into a five year Master Joint Development and Marketing Agreement with QLogic Corporation, a Delaware corporation (QLogic). Pursuant to this agreement, the parties will jointly develop, market and distribute to select OEMs and other distribution channel partners certain joint embedded fabric switch and software offerings that consist of a QLogic embedded switch blade product for the server environment that is interoperable in McDATA fabrics and with McDATA's storage management and security software. QLogic will pay McDATA an initial fee of $4.0 million which will be deferred initially and recognized as revenue in accordance with SAB 104 at the expiration of the agreement. QLogic will also pay a unit royalty on sales of the joint product offering.

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

You should read the following discussion and analysis in conjunction with the condensed consolidated financial statements and notes thereto included in Item 1 of this Quarterly Report and with Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report filed on Form 10-K, with the Securities and Exchange Commission on April 15, 2004, and as amended on April 30, 2004 and August 23, 2004

Overview

Competitive and Industry Environment

The market for our multi-protocol SAN switching hardware and software products is highly competitive. Our competitors are providing or plan to provide SAN switching and routing hardware and software that is multi-protocol capable such as Fibre Channel over IP (FCIP), SCSI over Internet (iSCSI), Internet Fibre Channel (iFCP) and InfiniBand (IB) A number of our current and potential competitors have longer operating histories, greater name recognition, access to larger customer bases, more established distribution channels and substantially greater financial and managerial resources. To remain competitive, we will need to build on the new products and technologies developed and acquired through our 2003 acquisitions of Nishan and Sanera as well as our investment in Aarohi Communications. In addition, we continue to expand our distribution channels for our product lines, including our Eclipse switch product line, which is based upon the technology acquired from Nishan The financial results discussed below reflect our efforts to expand our channels and to develop our new hardware and software products for release in the last half of fiscal 2004 and first half of fiscal 2005. Our recent port sales of hardware products, reflect increases from the third quarter of fiscal 2003 and sequentially from the second quarter of fiscal 2004. Additionally, our Eclipse SAN routing switch saw a growth in year to date sales since its release in the fourth quarter of fiscal 2003. In addition, our software revenue has steadily increased from prior years to represent almost 15% of total revenue, up from 11% in the third quarter of 2003. Our operating expense results reflect our continued product development efforts and, in the last half of 2004, will reflect development and launch-related expenditures as we introduce new products.

We believe that we are well positioned in the industry with a full complement of hardware and software products that customers require for the next phase of their infrastructure development. Management believes the trend of revenue, control of operating expense and the related competitive environment define the overall performance of the Company and provide a specific context to further analyze the financial results of the company.

Revenue Reclassification

Beginning second quarter ended July 31, 2004, we have presented a reformatted classification of revenue to provide further visibility into our product lines and to emphasize our software growth strategy. All prior periods have been reclassified to reflect the new classification. Our revenue comprises the following product categories:

- Product Revenue – revenue from the sales of our director and switch products (including Eclipse SAN routers)
- Software and Related Maintenance Revenue – revenue from the sales of our software licenses and related maintenance agreements. Our software maintenance agreements consist of our standard post-contract services (PCS) that are sold in conjunction with the initial sales of the software licenses. These services include customer support that provides bug fixes, upgrades and telephone support.
- Other Service Revenue – revenue from our professional service offerings as well as services provided under extended maintenance and upgraded warranty contracts for our hardware products.
- ESCON Revenue – historical revenue earned from the ESCON service agreement and, beginning July 1, 2004, revenue from our ESCON product sales.

ESCON Agreement Amendment

In 1997, we entered into a services agreement with McDATA Holdings Corporation, a wholly-owned subsidiary of EMC, to provide manufacturing and distribution management services for proprietary mainframe protocol, or ESCON™, switching solutions manufactured for and sold to IBM. Under the terms of this agreement, we agreed to manage the ESCON product manufacture, design, order and product shipment in exchange for a service fee calculated as a fixed percentage of EMC's ESCON revenues. In the second quarter ended July 31, 2004, we amended the service agreement to effectively assume the ESCON business operations. This comprises the acceptance of the rights, risks and costs of inventory ownership and distribution, accounts receivable billing and collections; and sales and marketing activities. We elected to amend the service agreement and effectively assume the ESCON business operations for two primary reasons. First, we believe that the gross margin dollars that we will earn by managing the business in its entirety will exceed the service fees we would have earned under the prior arrangement. Second, as a result of our amendment of the service agreement, we obtained a retroactive increase in the prior service fee.

Therefore, effective July 1, 2004, we began to fully consolidate the operations of the ESCON product line. Under this new arrangement, we have recorded $6.6 million of ESCON product revenue related to sales made from July 1 through October 31, 2004. In addition, we recorded the ESCON product inventory on our balance sheet and have included outstanding purchase commitments in our overall contract manufacturer commitments at October 31, 2004. The ESCON technology is a mature technology, and therefore, we anticipate revenues from this product line will decline over time. In the Results of Operations discussion, we classify the ESCON revenue results as "ESCON revenue" in an effort to segregate this business from our current product sales, including our next-generation products, which will be introduced in the fourth quarter of fiscal 2004.

In addition to the assumption of the ESCON business, the Company renegotiated the prior service agreement with EMC to include an increased service fee percentage through June 30, 2004. As a result, in the second quarter ended July 31, 2004, we recognized $1.6 million of previously deferred revenue related to past service fees which were in dispute. Additionally, we remitted to EMC approximately $11 million of ESCON-related collections, which were retained by us during the negotiations and classified in accrued liabilities in prior periods.

Results of Operations

The following table sets forth certain financial data for the periods indicated as a percentage of total revenues.

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2004	2003	2004	2003
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	44.4	42.3	44.1	42.1
Gross profit	55.6	57.7	55.9	57.9
Operating expenses:				
Research and development	23.1	24.9	23.8	19.9
Selling and marketing	27.2	24.8	25.3	23.1
General and administrative	5.8	8.6	6.6	7.1
Acquired in-process research and development	—	12.1	—	3.7
Amortization of purchased intangible assets	5.7	2.7	5.9	1.2
Amortization of deferred compensation	1.1	6.0	1.6	2.8
Restructuring charges	(0.1)	—	0.4	—
Total operating expenses	62.8	79.1	63.6	57.8
Income (loss) from operations	(7.2)	(21.4)	(7.7)	0.1
Interest and other income, net	1.3	1.7	1.2	0.9
Income (loss) before income taxes and equity in loss of affiliated company	(5.9)	(19.7)	(6.5)	1.0
Income tax expense (benefit)	(0.6)	32.6	—	12.5
Loss before equity in net loss of affiliated company	(5.3)	(52.3)	(6.5)	(11.5)
Equity in net loss of affiliated company	(0.3)	(0.6)	(0.5)	(0.2)
Net loss	(5.6)%	(52.9)%	(7.0)%	(11.7)%

Revenues

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2004	2003	2004	2003
Product revenue	$73,210	$80,082	$227,367	$265,327
Software and related maintenance revenue	14,563	10,832	42,428	29,702
Other service revenue	5,720	3,122	14,593	8,180
ESCON revenue	5,032	623	9,587	1,643
Total Revenue	$98,525	$94,659	$293,975	$304,852

Product revenue of $73 2 million for the three months ended October 31, 2004 decreased 9% from $80.1 million for the three months ended October 31, 2003 This decline in product revenue reflects a 16% increase in estimated director and switch ports sold offset by a 24% decrease in estimated average sales prices Product revenue of $227.4 million for the nine months ended October 31, 2004 decreased 14% from $265 3 million for the nine months ended October 31, 2003. This decline in product revenue reflects a 2% increase in estimated ports sold which partially offsets a 17% decrease in estimated average sales prices from the nine months ended October 31, 2003. The increase in sales of hardware ports reflects the market strength of our flex ports as well as our mid-range switch products despite the economic and competitive environment which has lengthened the decision making process of our end-users and lengthened our sales cycles. We expect the number of ports shipped to fluctuate depending on the demand for our existing and newly introduced products including the timing of product introductions by our OEM customers. Average sales price declines during the third quarter were greater than the historical pricing declines typical with our technology products. During the third quarter ended October 31, 2004, we lowered pricing on director chassis to take advantage of the ongoing competitive environment in the high-end director product category These price declines were enabled by the lowered costs of our director components. We anticipate the gross margin impact from these pricing actions will be mitigated by the growth in higher margin software sales. Ongoing competition and macroeconomic factors could continue to provide downward pricing pressures that could impact our revenue growth and related margins. Product revenue for the third quarter ended October 31, 2004, includes approximately $1 3 million of product revenue recorded as a result of previously deferred revenue recognized upon our change in estimates for distributor sales See further discussion under the Revenue Recognition section of the Critical Accounting Policies.

For the three months ended October 31, 2004, software revenue of $14 6 million was a 34% increase from $10 8 million for the three months ended October 31, 2003 Software revenue of $42 4 million for the nine months ended October 31, 2004 increased 43% from $29.7 million for the nine months ended October 31, 2003 This revenue growth is due to continued revenue growth from our software products, including our SANavigator®, SANtegrity® and SAN routing software

Other service revenue includes professional service revenue and revenue earned from our upgraded warranty and extended maintenance contracts on our hardware products For the three months ended October 31, 2004, other service revenue increased 83% to $5.7 million as compared to $3 1 million for the three months ended October 31, 2003 For the nine months ended October 31, 2004, other service revenue increased 78% to $14 6 million as compared to $8 2 million for the nine months ended October 31, 2003. These increases are due primarily to the activation of extended maintenance and upgraded warranty contracts sold in conjunction with our hardware products In prior periods, we experienced a significant growth in deferred revenue as the attach rates for extended maintenance contracts increased significantly (primarily through IBM sales) As the standard product warranties on these products expire, we will continue to see a growth in maintenance revenue as the extended contracts are activated and deferred revenue is recognized. As part of our recently announced OEM agreement with IBM, we will no longer provide the end-user support services through these extended maintenance contracts Therefore, revenue from deferred extended maintenance contracts is expected to decline in fiscal 2006

ESCON revenues of $5 0 million for the three months ended October 31, 2004 increased $4 4 million from $0.6 million for the three months ended October 31, 2003. ESCON revenues of $9 6 million for the nine months ended October 31, 2004 increased $7.9 million from the $1 6 million for the same period in fiscal 2003 The increase reflects McDATA's assumption of the ESCON business operations from EMC during the second quarter of fiscal 2004 as explained above As of July 1, 2004, ESCON revenue included product revenue from sales of these products In addition, ESCON revenue for the nine months ended October 31, 2004 includes $1.6 million of previously deferred service fees discussed in the Overview above These fees were deferred in prior periods in accordance with revenue recognition policies and the contract negotiations at that time

A significant portion of our revenue is concentrated with the largest storage OEMs. For the three months ended October 31, 2004, approximately 49% of our total revenue came from EMC as compared to 54% for the three months ended October 31, 2003; IBM contributed approximately 23% of our revenue compared to 21% for the three months ended October 31, 2003; and HDS contributed less than 10% for the three months ended October 31 2004, and contributed 10% of total revenue for the three months ended October 31, 2003 For the nine months ended October 31, 2004, approximately 47% of our total revenue came from EMC as compared to 59% for the nine months ended October 31, 2003, IBM contributed approximately 25% of total revenue compared to 19% for the nine months ended October 31, 2003, and HDS contributed approximately 10% of total revenue for the nine months ended October 31, 2004 and 2003 Other major storage and system vendors, including Dell, HP, STK and Sun, offer McDATA solutions In addition to our storage and system vendors, we have relationships with many resellers, distributors and systems integrators. Sales to these other channels represented 19% and 15%, respectively for the three months ended October 31, 2004 and 2003 and 18% and 12%, respectively for the nine months ended October 31, 2004 and 2003 The decline in the revenue from EMC as a percentage of our sales is the result of the entrance of new competitors into the storage market and the lengthened sales cycle in the high-end director market, as well as the overall growth in revenue dollars from our other OEMs and non-OEM channels, particularly IBM with whom we have a strengthened relationship Expanding our reseller, distributor and system integrator channels into Small Medium Enterprise (SME) and vertical markets will be a strategic focus for us as we continue to grow our business. However, the level of sales to any single customer may vary and the loss of any one significant customer, or a decrease in the level of sales to any significant or group of significant customers, could harm our financial condition and results of operations. Given the dependencies on our limited number of OEM resellers combined with an increasingly competitive environment, we may experience continued adverse price pressures at critical times near the end of the fiscal quarters In addition, the fiscal quarters for many of our largest OEM and reseller partners begin during the last month of our fiscal quarter While we do not have complete insight into the purchasing processes of our OEM and reseller partners, we believe that such partners may purchase some amount of our non-configured product in anticipation of end-user customer demand that will be realized in the later portion of their fiscal quarter. Large end-of-quarter purchases by our partners could result in lower future revenues or earnings if market demand as forecasted by our partners is not met.

Domestic and international revenue was approximately 66% and 34% of our total revenue, respectively, for the three months ended October 31, 2004 For the three months ended October 31, 2003, domestic and international revenue was approximately 66% and 34% of our total revenue, respectively For the nine months ended October 31, 2004, domestic and international revenue was 64% and 36% of total revenue as compared to 69% and 31%, respectively for the nine months ended October 31, 2003. Revenues are attributed to geographic areas based on the location of the customers to which our products are shipped. International revenues primarily consist of sales to customers in Western Europe and the greater Asia Pacific region Included in domestic revenues are sales to certain OEM customers who take possession of our products domestically and then distribute these products to their international customers. In addition, included in revenues from Western Europe are sales to certain OEM customers who take possession of our products in distribution centers designated for international-bound product and then distribute these products among various international regions. Our mix of international and domestic revenue can, therefore, vary depending on the relative mix of sales to certain OEM customers

Gross Profit

Gross profit margin of 56% for the three months ended October 31, 2004 reflects a 210 basis point decline from the gross profit margin of 58% for the three months ended October 31, 2003 Costs of goods sold consists of product costs, which are generally variable, and manufacturing operating cost, which include both variable and fixed expenses. Product costs as a percentage of revenue increased approximately 1.0% due to lower product revenue and revenue growth in lower margin service products, which were partially offset by higher margin software sales and lowered component costs Manufacturing operating costs as a percentage of revenue increased 1.1% due to the release of inventory-related reserves during the third quarter of fiscal 2003 and higher product royalty charges during the third quarter of fiscal 2004.

For the nine months ended October 31, 2004 and 2003, gross profit margin was 56% and 58%, respectively, reflecting a decrease of 200 basis points. Product costs as a percentage of revenue increased 0 5% due to lower product revenues and growth in lower margin service products, which were partially offset by increases in higher margin software sales, lower component costs and the one-time increase in revenue due to retroactive ESCON service fees Manufacturing operating costs as a percentage of revenue increased 1.5% due primarily to the release of inventory-related reserves and obligations of approximately $2 7 million or 0.9% of the nine-month 2003 gross margins reported above.

In anticipation of the competitive-driven and natural decline in selling prices, we continue to drive cost advantages through our engineering and manufacturing processes In April 2004, we announced the availability of the lower cost versions of our second-generation switch technology and began shipping the lower cost versions of our director components. Through these actions, we anticipate gross profit margin will remain in the mid-50 percent range through the fourth quarter of fiscal 2004.

Operating Expenses

Research and Development Expenses. Research and development expenses consist primarily of salaries and related expenses for personnel engaged in engineering and R&D activities, fees paid to consultants and outside service providers; nonrecurring engineering charges; prototyping expenses related to the design, development, testing and enhancement of our products; depreciation related to engineering and other test equipment, and IT and facilities expenses

For the three months ended October 31, 2004, research and development expenses decreased $0.8 million to $22 8 million compared with $23 6 million for the three months ended October 31, 2003 Research and development expenses reflect the net impact of capitalized software development costs which reduce research and development expenses when recorded on the balance sheet and amortized against cost of goods sold upon introduction of the software product In the third quarter ended October 31, 2004, capitalized software costs were $6.0 million compared to $2.2 million for the three months ended October 31, 2003 These costs vary in conjunction with stages of development of our application software, our new director and switch products and related firmware software. The decrease caused by the capitalization of software development expenses was partially offset by a $1 0 million increase in personnel related expenses attributable to our third quarter 2003 acquisitions and a $1.5 million increase in spending related to product development and testing of our new products scheduled for general availability in the fourth quarter of fiscal 2004 and the first quarter of fiscal 2005.

For the nine months ended October 31, 2004, research and development increased by $9.4 million to $70 0 million as compared with $60 5 million for the nine months ended October 31, 2003. This increase was primarily due to a $8.2 million increase in personnel related expenses attributable to fiscal 2003 acquisitions and a $8.7 million increase in spending related to new product development and testing This increased spending was partially offset by increases in the capitalization of software development costs during fiscal 2004 Capitalized software costs for the nine months ended October 31, 2004, increased to $12.9 million as compared to $4.8 million for the nine months ended October 31, 2003.

Selling and Marketing Expenses Sales and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing and sales, costs associated with promotional and travel expenses, and IT and facilities expenses.

For the three months ended October 31, 2004, selling and marketing expenses increased $3.2 million to $26.8 million as compared to $23 5 million for the three months ended October 31, 2003. This increase was primarily due to a $1 8 million increase for personnel expenses as well as increases in equipment costs, and tradeshow and marketing activities totaling $1 4 million

For the nine months ended October 31, 2004, selling and marketing expenses increased by $4 0 million to $74 5 million as compared to $70 5 million for the nine months ended October 31, 2003 Increases in personnel, travel and equipment costs of $4 8 million in fiscal 2004 were offset by a $1 0 million decrease in customer acquisition costs from the nine months ended October 31, 2003 attributable to two new OEM contracts signed during that period.

General and Administrative Expenses General and administrative expenses consist primarily of salaries and related expenses for corporate executives, finance, human resources and investor relations, as well as accounting and professional fees, corporate legal expenses, other corporate expenses, and IT and facilities expenses.

For the three months ended October 31, 2004 and 2003, respective, general and administrative expenses were $5.8 million and $8 1 million. For the nine months ended October 31, 2004 and 2003, respectively, general and administrative expenses were $19.5 million and $21 8 million. These decreases over prior year are attributable to several litigation matters the Company was involved in during fiscal 2003 which were subsequently settled.

Amortization Of Purchased Intangible Assets Amortization of purchased intangible assets was $5.6 million and $2.5 million for the three months ended October 31, 2004 and 2003, respectively, and $17 2 million and $3 6 million for the nine months ended October 31, 2003, respectively The increases were the result of our fiscal 2003 acquisitions through which we recorded approximately $113 million of amortizable intangible assets. These assets are being amortized on a straight-line basis over a period of one to nine years

Amortization of Deferred Compensation Amortization of deferred compensation was $1 0 million for the three months ended October 31, 2004, and $5.7 million for the three months ended October 31, 2003 (of which approximately $26,000 and $285,000 was included in cost of revenue, respectively). Deferred amortization expense of $4 8 million was recorded for the nine months ended October 31, 2004 and $8.6 million for the same period October 31, 2003 (of which approximately $162,000 and $555,000 was included in cost of revenue, respectively) We have recorded deferred compensation in connection with Class B common stock options granted prior to our August 9, 2000 initial public offering (IPO) and restricted Class B stock grants granted through our equity incentive plans In addition, we issued approximately 1 0 million shares of Class B restricted common stock with vesting periods ranging from 12 to 24 months in connection with our acquisitions during fiscal 2003. We are amortizing all deferred compensation on a straight-line basis over the vesting period of the applicable options and stock awards. Deferred compensation expense related to these awards will decrease as the awards become fully vested over the following two to five years

Restructuring Charges In the fourth quarter of fiscal 2003, we announced that we were taking certain cost improvement actions, which included a workforce reduction and facility consolidation. During the nine months ended October 31, 2004, we completed our planned closure of our Toronto engineering facility and recorded an approximate $1 1 million restructuring charge related to this closure In addition, we incurred an additional $279,000 restructuring charge in fiscal 2004 for additional severance-related and other costs as we finalized the reduction in workforce that was initiated in the fourth quarter of 2003 As of October 31, 2004, all planned activities under this plan had been completed and all remaining accrued liabilities were paid or settled.

Interest and Other Income Interest and other income consisted primarily of interest earnings on our cash, cash equivalents and various investment holdings Interest and other income decreased to $1 6 million for the three months ended October 31, 2004 as compared with $1.9 million for the three months ended October 31, 2003 Interest and other income decreased to $4.3 million for the nine months ended October 31, 2004 as compared with $5 5 million for the nine months ended October 31, 2003. This decrease in income reflects the use of a portion of our investment portfolio to fund our third quarter 2003 acquisitions. Fluctuations in our investment balances as well as fluctuations in interest rates could cause our investment income to vary between periods.

Interest Expense For the three months ended October 31, 2004, interest expense increased slightly to $0.4 million compared with $0 2 million for the three months ended October 31, 2003 For the nine months ended October 31, 2004, interest expense decreased $1 6 million to $0 9 million compared to $2.5 million for the nine months ended October 31, 2003 The decrease in interest expense from the nine months ended October 31, 2003 to 2004 was attributable to the interest rate swap which was established during the third quarter fiscal 2003 This interest-rate swap agreement has the economic effect of modifying the fixed interest obligations associated with our convertible debt so that the interest payable on the majority of the debt effectively becomes variable based on the six-month London Interbank Offered Rate (LIBOR) minus 152 basis points The reset dates of the swap are February 15 and August 15 of each year until maturity on February 15, 2010 On August 16, 2004, the six-month LIBOR setting was reset to 1.92%, resulting in a rate of approximately 0 4%, which is effective until February 15, 2005. Significant increases in interest rates in future periods could significantly increase interest expense.

Provision for Income Taxes. The Company has recorded tax expense for the nine months ended October 31, 2004 even though the pre-tax result on the books is a loss. This is due primarily to taxes payable in foreign jurisdictions where the net taxable income will be positive No tax benefit is realized currently for the book loss or available tax credits as the Company has established a valuation allowance against its entire domestic net deferred tax assets The tax provision for the three and nine months ended October 31, 2003 includes a non-cash charge of $38.7 million related to recording a valuation allowance against deferred tax assets.

We are subject to audit by federal, state and foreign tax authorities. These audits may result in additional tax liabilities We account for such contingent liabilities in accordance with SFAS No 5, Accounting for Contingencies, and believe that we have appropriately provided for taxes for all years Several factors drive the calculation of our tax reserves including (i) the expiration of statutes of limitations, (ii) changes in tax law and regulations, and (iii) settlements with tax authorities. The occurrence of any of these events may result in adjustments to our reserves that could impact our reported financial results.

The Internal Revenue Service is currently conducting an audit of the Company's US income tax returns for 2000, 2001 and 2002 An audit of these years is mandated by the procedures for Joint Committee cases due to the carry back of tax losses from the 2001 and 2002 tax years to 2000 In addition, the state of Colorado has completed a review of income tax returns filed by the Company with the state for 2001 and 2002. We received notification from the state auditor on November 4, 2004 that no changes would be proposed with respect to those returns.

Liquidity and Capital Resources

Our financial condition remains solid At October 31, 2004, cash, short- and long-term investments were $303 million compared to approximately $317 million as of January 31, 2004 These balances include approximately $5 million of restricted cash that we are required to maintain in relation to the interest rate swap we have executed in connection with our convertible debt. We invest excess cash predominantly in debt and equity instruments that are highly liquid, of high-quality investment grade, and predominantly have maturities of less than three years with the intent to make such funds readily available for operating purposes, including expansion of operations and potential acquisitions or other transactions.

We believe our existing cash, short-term and long-term investment balances, and cash expected to be generated from future operations will be sufficient to meet our capital and operating requirements at least through the next twelve months, although we could be required, or could elect, to seek additional funding prior to that time. Our future capital requirements will depend on many factors, including our rate of revenue growth, the timing and extent of spending to support development of new products and expansion of sales and marketing, the timing of new product introductions and enhancements to existing products, and market acceptance of our products

In summary, our cash flows were:

	Nine Months Ended October 31,	
Source/(use) (in thousands)	**2004**	**2003**
Net cash provided by operating activities	$ 9,955	$ 45,129
Net cash used by investing activities	(5,750)	(243,947)
Net cash provided (used) by financing activities	(6,816)	130,170

The decrease in cash provided by operating activities reflects the net loss for the nine months ended October 31, 2004 adjusted for non-cash charges including depreciation, amortization, deferred compensation and changes in working capital items. Working capital items include accounts receivable, inventories, other current and non-current assets, accounts payable, accrued liabilities and deferred revenue Accounts receivable was a use of $1.5 million in the first nine months of fiscal year 2004 compared to a use of $23 5 million in the first nine months of 2003 Days sales outstanding (DSO) was 60 days and 58 days for the nine months ended October 31, 2004 and 2003, respectively The change between years is the result of the timing and collections compared to the linearity of billings within the quarter The use of cash of $13 6 million during the first nine months of fiscal 2004 for the net purchase of inventories compares to the $5 5 million use of cash during the same period of fiscal 2003 The increased purchasing reflects the build of inventories surrounding the next generation of products that are currently in the pre-production phase. For the nine months ended October 31, 2004, cash provided from accounts payable and accrued liabilities was $20,000 compared to the $17.7 million source of cash for the nine months ended October 31, 2003 This change reflects the timing of payments of vendor invoices as well as an $11 million payment made during the second quarter of fiscal 2004 to EMC in connection with the ESCON service agreement amendment.

The decrease in net cash used by investing activities reflects the fiscal 2003 use of cash proceeds for the acquisitions of Nishan and Sanera and our equity investment in Aarohi In addition, the use of cash also reflects the use of cash proceeds from the issuance of convertible subordinated notes to purchase investments in the nine months ended October 31, 2003.

Net cash used by financing activities during the nine months ended October 31, 2004 reflects the Company's purchase of treasury stock for $10 1 million This use of cash is partially offset by proceeds from the issuance of common stock from stock option exercises and purchases under the Company's employee stock purchase plan In February 2003, we issued convertible subordinated notes of $172 5 million in principal amount, with proceeds of $167 million The 2.25% convertible subordinated notes mature in February 2010, unless converted into McDATA common stock at a conversion price of $10.71 per share, subject to certain conversion price adjustments Offsetting these net proceeds in fiscal 2003 were the use of $20.5 million of those proceeds to enter into share option transactions and $5 million of cash being classified as restricted related to our interest rate swap agreement.

Off-Balance Sheet Arrangements

Other than facility and equipment leasing arrangements, the Company does not engage in off-balance sheet financing activities.

During its normal course of business, we may enter into agreements with, among others, customers, resellers, OEMs, systems integrators and distributors. These agreements typically require us to indemnify the other party against third party claims or product infringements on patents or copyrights We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising for the use of our products We have also indemnified our former parent, EMC, for any income taxes arising out of the distribution of our Class A common stock in February 2001 In addition, the majority of these indemnities, commitments and guarantees do not provide for any limitation of the maximum potential future payments we could be obligated to make We evaluate and estimate losses from such indemnification under SFAS No. 5, Accounting for Contingencies, as interpreted by FASB Interpretation No 45 To date, we have not incurred any material costs as a result of such obligations and have not accrued any liabilities related to such indemnification and guarantees in our financial statements.

Commitments

The Company has contracted with Sanmina SCI Systems, Inc (SSCI), Solectron Corporation (Solectron) and others (collectively, Contract Manufacturers) for the manufacture of printed circuit boards and box build assembly and configuration for specific multi-protocol directors and switches The agreements require the Company to submit purchasing forecasts and place orders sixty calendar days in advance of delivery. At October 31, 2004, the Company's commitment with the Contract Manufacturers for purchases over the next sixty days totaled $62.7 million The Company may be liable for materials that the Contract Manufacturers purchase on McDATA's behalf if the Company's actual requirements do not meet or exceed its forecasts and those materials cannot be redirected to other uses At October 31, 2004, the Company had recorded obligations of approximately $6 6 million (See Note 4) primarily related to materials purchased by the Contract Manufacturers for certain end-of-life and obsolete material. Management does not expect the remaining commitments under these agreements to have a material adverse effect on the Company's business, results of operations, financial position or cash flows

In February 2003, the Company sold $172.5 million of 2 25% convertible subordinated notes due February 15, 2010 (the Notes) The Notes are convertible into our Class A common stock at conversion rate of 93 3986 shares per $1,000 principal amount of notes (aggregate of approximately 16 1 million shares) or $10 71 per share, subject to certain conversion adjustments. Upon a conversion, the Company may choose to deliver shares of our Class A common stock, or, in lieu of shares of our Class A common stock, cash or a combination of cash and shares of Class A common stock We are required to pay interest on February 15 and August 15 of each year, beginning August 15, 2003. Debt issuance costs of $5.6 million are being amortized over the term of the Notes The amortization of debt issuance costs will accelerate upon early redemption or conversion of the Notes The net proceeds remain available for general corporate purposes, including working capital requirements and capital expenditures.

Concurrent with the issuance of the Notes, the Company entered into share option transactions using approximately $20.5 million of proceeds. As part of these share option transactions, the Company purchased options that cover approximately 16 1 million shares of Class A common stock, at a strike price of $10 71. The Company also sold options that cover approximately 16.9 million shares of Class A common stock, at a strike price of $15 08. The net cost of the share option transactions was recorded against additional paid in capital These share option transactions are intended to give the Company the option to mitigate dilution as a result of the Notes being converted to common shares up to the $15 08 price per common share and mitigate dilution if the share price exceeds $15 08 at that time. Should there be an early unwind of either of the share option transactions, the amount of cash or net shares potentially received or paid by the Company will be dependent on then existing overall market conditions, the stock price, the volatility of the stock, and the amount of time remaining until expiration of the options.

In July 2003, we entered into an interest-rate swap agreement with a notional amount of $155 3 million that has the economic effect of modifying the fixed interest obligations associated with the Notes so that the interest payable on the majority of the Notes effectively becomes variable based on the six-month LIBOR minus 152 basis points. The reset dates of the swap are February 15 and August 15 of each year until maturity on February 15, 2010 On February 15, 2004, the six-month LIBOR setting was reset to 1 175%, resulting in a rate of approximately minus 0 345%, which was effective until August 15, 2004 On August 16, 2004, the six-month LIBOR setting was reset to 1 92%, resulting in a rate of approximately 0 4%, which is effective until February 15, 2005. Increases in interest rates could significantly increase the interest expense we are obligated to pay under the interest-rate swap agreement in future periods. The swap was designated as a fair value hedge and, as such, the gain or loss on the derivative instrument, as well as the fully offsetting gain or loss on the Notes attributable to the swap, were recognized in earnings. We are also required to post collateral based on changes in the fair value of the interest rate swap. This collateral, in the form of restricted cash, was $5.0 million at October 31, 2004.

On September 9, 2004, McDATA entered into a triple net office lease with Ridge Parkway Associates, LLC, a Delaware limited liability company for the future lease office space at 11802 Ridge Parkway, Building 2, Broomfield, Colorado (the "New Premises"). The Company intends to begin moving its current world headquarters location at 380 Interlocken Crescent, Broomfield, Colorado 80021 to the New Premises early in 2006 with lease payments commencing in February of 2006. The Company's current headquarter office lease expires at the end of April 2006 The term of the new lease is for 11 years (with two 5 year renewal options) and is at market lease rates that are substantially lower than the current lease rate paid by the Company The base annual lease rates per rentable square foot for the New Premises range from $0 in the first year to $14 15 in the last year of the lease, plus normal operating expenses In addition, the Company has an option to purchase the New Premises at varying amounts until December 31, 2005. The lease and option to purchase have customary terms and conditions

The following table summarizes our contractual obligations (including interest expense) and commitments as of October 31, 2004 (in thousands):

	Total	Less Than 1 Year	1-3 Years	More than 5 years
Convertible subordinated debt, at fair value	$172,781	$ —	$ —	$172,781
Non-cancelable operating leases	53,841	10,266	12,002	31,573
Non-cancelable purchase agreements	62,662	62,662	—	—
Capital leases, including interest	1,087	699	388	—
Total contractual obligations	$290,371	$73,627	$12,390	$204,354

Critical Accounting Policies

General

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, revenue and expenses, and the related disclosure of contingent assets and liabilities as of the date of the financial statements. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources Senior management has discussed the development, selection and disclosure of these estimates with the Audit Committee of McDATA's Board of Directors Actual results may differ materially from these estimates under different assumptions or conditions. Management believes the following critical accounting policies reflect its more significant estimates and assumptions used in the preparation of its consolidated financial statements.

Revenue Recognition

We recognize revenue, in accordance with SEC Staff Accounting Bulletin No. 104, Revenue Recognition (SAB 104) and the American Institute of Certified Public Accountants' Statement of Position 97-2 (SOP 97-2), as amended, when persuasive evidence of an arrangement exists, products are delivered or services rendered, the sales price is fixed or determinable and collectibility is assured. In instances when any one of these four criteria is not met, we will defer recognition of revenue until all the criteria have been met.

With respect to revenue from our configured products, we request evidence of sell-through from our OEM and distributor partners prior to recognizing revenue In situations where our OEM and distributor partners refuse to provide sell-through information when requested, but all the criteria under SAB 104 (as discussed above) have been met, we recognize revenue for such configured products These configured products represent high value, customized solutions of directors, cabinets and various combinations of port cards ordered by our OEM and distributor partners as required by the end user Non-configured products and components, such as our switch products, port cards, and FlexPort upgrades, are recognized as revenue when the criteria for SAB 104 (as discussed above) have been met, generally at time of shipment Revenue for both configured and non-configured products and components is reduced for estimated customer returns, price protection rebates, and other contract terms that are provided to the Company's OEMs, distributors and resellers These estimates are calculated in accordance with SFAS No. 48, Revenue Recognition When Rights of Return Exist (SFAS 48) and rely on historical experience for all customer returns We have not experienced credits in excess of 1% of annual revenues If actual credit experience varies from our historical experience due to changes in product technology, the pricing environment or other unforeseen factors, our revenue could be adversely affected. Through the second quarter of fiscal 2004 McDATA had recognized revenue on distributor sales of non-configured products when proof of sell-through was obtained This was due to insufficient historical experience regarding returns or credits under price protection or inventory rotation rights McDATA has been monitoring and tracking distributor returns and purchasing patterns since 2001 We believe we have obtained sufficient historical experience as of the end of the second quarter of fiscal 2004. Therefore, during the third quarter of fiscal 2004 we began recognizing distributor revenue at the time of shipment We estimate the potential for returns in accordance with SFAS 48 and record revenues upon shipment if all SAB 104 revenue recognition criteria have been met. As disclosed in the second quarter 2004 Form 10-Q, in connection with this change in estimate, we recognized approximately $1 3 million of distributor revenue which had previously been deferred. If actual credits received by our partners for returns or price protection and inventory rotation actions were to deviate significantly from our estimates, which are based on historical experience, our revenue could be adversely affected.

Inventory Reserves

We value our inventory at the lower of cost or net realizable values We regularly review inventory on hand and record a provision for excess and obsolete inventory based upon assumptions about current and future demand for our products, the current market conditions, new product introductions, new technologies and the current life cycle of our products. Adverse changes in these factors and our assumptions could result in an increase in the amount of excess and obsolete inventory on hand and increase our cost of revenue.

Additionally, we have certain purchase commitments with our Contract Manufacturers that are non-cancelable. We may be liable for materials that our third-party manufacturers purchase on our behalf if our actual requirements do not meet or exceed our forecasts and those materials cannot be redirected to other uses by the Contract Manufacturers. We evaluate these open purchase orders in light of our current inventory on hand, expected demand, market conditions and new product introductions. Based on this information, we record purchase obligations for inventory we believe is excess or obsolete and cannot be redirected to other uses by our contract manufacturers. At October 31, 2004, the Company's commitment with our Contract Manufacturers for purchases over the next sixty days totaled $62.7 million, of which we had recorded reserves of $6 6 million. Adverse changes in our and our contract manufacturers' calculations and assumptions concerning these purchase commitments may result in an increase to our vendor obligations and increase our cost of revenue

Warranty Provision

We also provide for estimated expenses for warranty obligations as revenue is recognized These estimates are based primarily on our historical experience with product failures, cost to repair and known identified product quality issues. Our historical warranty claims has been immaterial with actual warranty claims representing less than 1% of our annual cost of sales Future material changes in our product and component quality or significant increases in our warranty repair and replacement cost could require revisions to the estimated warranty liability and could significantly increase our product costs, cause significant customer relations problems and reduce revenue. Where possible, we recover any warranty costs related to component quality through warranties we receive from our contract manufacturers and component suppliers.

Income Taxes

Significant management judgment is required in determining the provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against deferred tax assets We are required to estimate our income taxes in each jurisdiction where we operate This process involves estimating our actual current income tax expense together with assessing temporary differences resulting from the different treatment of items for income tax and accounting purposes such as the timing of revenue recognition and accrued expenses, depreciation methods, reserve accounts, and research and development costs.

These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet net of any valuation allowance. In evaluating the need for a valuation allowance, we assessed the likelihood that our net deferred tax assets will be recovered from future taxable income We have considered past tax return and financial statement operating losses, cumulative losses for financial accounting in recent years, estimated future taxable income and our ongoing prudent and feasible tax planning strategies as factors that affect the need for a valuation allowance After considering all available evidence, both positive and negative, management concluded, after applying the provisions of SFAS 109, that it is more likely than not that we will not be able to realize our deferred tax assets in the future. Therefore, a full valuation allowance has been provided against those deferred tax assets. The portion relating to the acquisitions of Nishan and Sanera in 2003, was applied as an increase to the basis of other assets from the acquired companies.

We are subject to audit by federal, state and foreign tax authorities. These audits may result in additional tax liabilities We account for such contingent liabilities in accordance with SFAS No 5, Accounting for Contingencies, and believe that we have appropriately provided for taxes for all years. Several factors drive the calculation of our tax reserves including (i) the expiration of statutes of limitations, (ii) changes in tax law and regulations, and (iii) settlements with tax authorities. The occurrence of any of these events may result in adjustments to our reserves that could impact our reported financial results.

Valuation of Long-Lived Assets Including Goodwill and Purchased Intangible Assets

We have performed and will perform an annual impairment test for goodwill in accordance with Statement of Financial Accounting Standards (SFAS) No 142, Goodwill and Other Intangible Assets, (SFAS 142). This review is based on a comparison of the carrying value of our net assets including goodwill balances to the fair value of our net assets using the quoted market price of our common stock We performed the 2004 impairment test during our first fiscal quarter and determined that no impairment loss should be recognized. In the event that business conditions change and our market value were to drop significantly below year-end levels, future tests may result in a need to record a loss due to write down of the value of goodwill At October 31, 2004, goodwill recorded in the consolidated balance sheet totaled $78.7 million.

We currently operate our business as a single solutions business and do not maintain separate cash flows or operating margins on a segmented level Future operating losses, deterioration of our business or segmentation of our operations in the future could also lead to impairment adjustments as such issues are identified.

Capitalized Software Development Costs

We capitalize certain software development costs in accordance with SFAS No 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed (SFAS 86). Under SFAS 86, costs incurred to develop a computer software product are charged to research and development expenses as incurred until technological feasibility has been established. We establish technological feasibility upon completion of a detailed program design or working model from which point all research and development costs for that project are capitalized until the product is available for general release to customers. The establishment of technological feasibility and the ongoing assessment of recoverability of capitalized software development costs require considerable judgment by management with respect to certain external factors, including, but not limited to, anticipated future revenues, estimated economic life of the products, or both

Sales Commission Estimates

Our sales approach is focused on an indirect model executed primarily through OEMs and resellers. Our field sales and service personnel support these distribution channels using a direct-assist model and are commissioned based on sales results achieved during the reporting period. Because specific sales data used to calculate these commissions is not always available at the time our financial results are released, we routinely make certain estimates based on known revenue achievement, historical experience and assumptions regarding individual sales contributions Changes to these assumptions and estimates could cause revisions to our sales commission liabilities and result in variations between estimated liabilities and actual payments.

Restructuring Charges

We monitor and regularly evaluate our organization structure and associated operating expenses Depending on events and circumstances, we may decide to restructure our operations to reduce future operating costs In determining the restructuring charges, we analyze our future operating requirements, including the required headcount by functions and facility space requirements Our restructuring costs, and any resulting accruals, involve significant estimates made by management using the best information available at the time the estimates are made, some of which may be provided by third parties. In recording facilities lease loss reserves, we make various assumptions, including the time period over which the facilities will be vacant, expected sublease terms, expected sublease rates, anticipated future operating expenses, and expected future use of the facilities. Our estimates involve a number of risks and uncertainties, some of which are beyond our control, including future real estate market conditions and our ability to successfully enter into subleases or lease termination agreements with terms as favorable as those assumed when arriving at our estimates. We regularly evaluate a number of factors to determine the appropriateness and reasonableness of our restructuring and lease commitment accruals including the various assumptions noted above. If actual results differ significantly from our estimates, we may be required to adjust our restructuring accruals in the future

Risk Factors

Risks Relating to Our Business

Changing market conditions and increased competitive risks.

The market for our multi-protocol storage area networking (SAN) products and solutions has grown and will continue to become more competitive with (a) the entrance of new competitors from the IP based switching market into our market, (b) pricing pressures resulting from this increase in competitive SAN networking products and solutions, (c) challenges to our direct-assist sales model with distribution through channels when our competitors engage end-user customers directly or otherwise have the ability to drive end-user customer preference for SAN equipment through their traditional IP networking presence and relationships, and (d) anticipated competition from our own storage OEM partners through their recent acquisitions of, or alliances with, competitive software management products and/or application providers that would utilize the intelligence in the network. As a result of these market changes, we anticipate continued lengthened sales cycles and price erosion in an environment where storage OEM certification of our products may still be required for end-user customer acceptance Given our direct-assist sales model with distribution through our channel partners, we are highly dependent upon our channel partners' relationships with end-user customers to promote the value of our products. If our channel partners do not promote the value of our products or competitors begin to control end-user customer preference, we may lose sales in key enterprise accounts that would materially adversely affect our revenues.

New competitors have entered this market and we may not be able to successfully compete against existing or potential competitors.

The market for our multi-protocol SAN switching and routing hardware and software products is highly competitive, especially with the entrance of competitors from the IP based switch market Our competitors are providing or plan to provide SAN switching hardware and software that is multi-protocol capable (such as Fibre Channel over IP (FCIP), SCSI over Internet (iSCSI), Internet Fibre Channel (iFCP) and InfiniBand) Our competitors in the this market include Brocade, CNT, Cisco, QLogic Corp., Emulex Corporation (which acquired Vixel Corporation), Broadcom Corporation (which acquired the assets of Gadzoox Networks), Veritas Software Corporation, Fujitsu Softech and others, including storage hardware device providers Given Cisco's entrance into the SAN switching and routing market, other IP based switching companies such as Juniper, Extreme, Foundry and others may enter the market for multi-protocol SAN products Many of our competitors and potential competitors have longer operating histories, greater name recognition, access to larger customer bases, more established distribution channels and substantially greater financial and managerial resources than McDATA Given the highly competitive market, we anticipate continued lengthened sales cycles and continued downward pricing pressures. To be competitive, we may have to substantially increase headcount in our direct-assist sales model and migrate to a direct end-user customer touch and possibly to direct sales, which we may not be able to do successfully and which, in any case, will increase expenses Continued or increased competition could result in pricing pressures, reduced sales, reduced margins, reduced profits, reduced market share, further elongating of sales cycles, or the failure of our products to achieve or maintain market acceptance.

We incurred a substantial loss for the nine months ended October 31, 2004 and for the fiscal years ended January 31, 2004 and December 31, 2002, and may not be profitable in the future.

Our future operating results will depend on many factors, including the growth of the multi-protocol (Fibre Channel and IP) market, market acceptance of new products we introduce, demand for our products, levels of product and price competition and our reaching and maintaining targeted costs for our products In addition, we expect to incur continued significant product development, sales and marketing, and general and administrative expenses We cannot provide assurance that we will generate sufficient revenue to achieve or sustain profitability.

The prices and gross margins of our products may decline, which would reduce our revenues and profitability.

In response to changes in product mix, competitive pricing pressures, increased sales discounts, introductions of new competitive products, product enhancements by our competitors, increases in manufacturing or labor costs or other operating expenses, we may experience declines in prices, gross margins and profitability. To maintain our gross margins we must maintain or increase current shipment volumes, develop and introduce new products and product enhancements and reduce the costs to produce our products. Moreover, most of our expenses are fixed in the short-term or incurred in advance of receipt of corresponding revenue. As a result, we may not be able to decrease our spending to offset any unexpected shortfall in revenues If this occurs, we could incur losses, and our revenue, gross margins and operating results may be below our expectations and those of investors and stock market analysts.

We depend on two key distribution relationships for most of our revenue and the loss of either of them could significantly reduce our revenues.

We depend on EMC and IBM, for a significant portion of our total revenue Sales to EMC and IBM represented approximately 49% and 23%, respectively, of our revenue for the three months ended October 31, 2004 and 47% and 25% respectively, for the nine months ended October 31, 2004. We anticipate that our future operating results will continue to depend heavily on sales to EMC and IBM. EMC and IBM resell products offered by our competitors, and nothing restricts EMC and IBM from expanding those relationships in a manner that could be adverse to us. Therefore, the loss of either EMC or IBM as a customer, or a significant reduction in sales to either EMC or IBM could significantly reduce our revenue While we are aware that Dell sources some of our switch product through EMC, it is unclear whether this mitigates our dependency on EMC Our product sales agreements with sales partners do not provide for the purchase of a guaranteed minimum amount of product.

Our business may be subject to seasonal fluctuations and uneven sales patterns in the future.

Many of our OEM partners experience seasonality and uneven sales patterns in their businesses For example, some of our partners close a disproportionate percentage of their sales transactions in the last month, weeks and days of each quarter; and other partners experience increased sales during the fourth calendar quarter of each year.

Our uneven sales pattern makes it difficult for our management to predict near-term demand and adjust manufacturing capacity. Further, our OEM and reseller partners may purchase certain of our products ahead of end-user customer demand, which could reduce subsequent purchases by those partners Accordingly, if orders for our products vary substantially from the predicted demand, our ability to assemble, test and ship orders received in the last weeks and days of each quarter may be limited, which could seriously harm quarterly revenue or earnings Moreover, an unexpected decline in revenue without a corresponding and timely reduction in expenses could intensify the impact of these factors on our business, financial condition and results of operations.

Factors that affect us and which could cause our revenue and operating results to vary in future periods include:

- the size, timing, terms and fluctuations of customer orders, particularly large orders from EMC, IBM or HDS;
- pricing discussions late in a quarter and a limited capability to ramp shipments near the end of that quarter;
- our ability to attain and maintain market acceptance of our products;
- seasonal fluctuations in customer buying patterns;
- the timing of the introduction of or enhancement to, products by us, our significant OEM or reseller customers or our competitors (e g , transition to higher speed, higher port density and multi-protocol products);
- our ability to obtain sufficient supplies of single- or limited-source components of our products; and
- increased operating expenses, particularly in connection with our strategies to increase customer touch and purchase preference for our products or to invest in research and development.

We currently have limited product offerings and must successfully introduce new products and product enhancements that respond to rapid technological changes and evolving industry standards.

For the three months ended October 31, 2004, we derived a significant portion of our revenue from sales of our director-class Intrepid™ switch products. We expect that revenue from our director-class Intrepid™ switch products will continue to account for a substantial portion of our revenue for the foreseeable future Factors such as performance, market positioning, the availability and price of competing products, the introduction of new technologies and the success of our OEM, reseller and systems integrator customers will affect the market acceptance of our products Therefore, continued market acceptance of these products and their successor products, along with our Sphereon™ switches and Eclipse® routers, are critical to our future success.

In addition, our future success depends upon our ability to address the changing needs of customers and to transition to new technologies and industry standards The introduction of competing products embodying new technologies or the emergence of new industry standards could render our products non-competitive, obsolete or unmarketable and seriously harm our market share, revenue and gross margin. Risks inherent in transitions to new technology, industry standards and new protocols include the inability to expand production capacity to meet demand for new products, write-downs of our existing inventory due to obsolescence, the impact of customer demand for new products or products being replaced, and delays in the introduction or initial shipment of new products. There can be no assurance that we will successfully manage these transitions.

We are currently developing products that contain untested devices and subassemblies. As with any development, there are inherent risks should such devices or subassemblies require redesign or rework In particular, in conjunction with the transition of our products from fibre channel to multi-protocol, 2 Gb to 4Gb to 10 Gb transmission speed technology, higher port densities, and advanced management capabilities, we will be introducing products with new features and functionality, such as our next generation director-class switch product, the Intrepid™ 10000 Director We face risks relating to this product transition, including risks relating to the qualification of such products by our storage and system OEMs, forecasting of demand, as well as possible product and software defects and a potentially different sales and support environment due to the complexity of these new systems. Finally, if we fail to introduce new products timely, or to add new features and functions to existing products to compete against new entrants in the market, or if there is no demand for these or our current products, our business could be seriously harmed.

Risks related to recent acquisitions.

In September 2003, we closed our acquisitions of Nishan Systems, Inc (Nishan) and Sanera Systems, Inc. (Sanera) While management believes that such acquisitions are an integral part of their long-term strategy, there are risks and uncertainties related to acquiring companies that have limited or no product sales to date. Our success depends upon integrating Nishan and Sanera with McDATA, finalizing the development of such products, retaining critical employees from the acquired companies, qualifying such products with our OEM and reseller partners and ramping sales of those products with such partners.

Our business is subject to risks from global operations.

We conduct significant marketing, pre-sales assistance and customer support operations in countries outside of the United States and also depend on non-U.S operations of our contract manufacturers, and our distribution partners. Further, we utilize an India-based firm to provide certain software engineering services, and our virtualization chip supplier, Aarohi Communications, is also reliant on offshore engineering We derived approximately 34% of our revenue for the three months ended October 31, 2004, from customers located outside of the United States We believe that our continued growth and profitability will require us to continue to expand marketing and selling efforts internationally We have limited experience in marketing, distributing and supporting our products internationally and may not be able to maintain or increase international market demand for our products. In addition, our international operations are generally subject to inherent risks and challenges that could harm our operating results, including:

- expenses associated with developing and customizing our products for foreign countries;
- difficulties in staffing and managing international operations, including reliance on third parties to manage certain aspects of our foreign operations, including hub inventory locations;
- multiple, conflicting and changing governmental laws and regulations,
- tariffs, quotas and other import or export restrictions, trade protection measures and other regulatory requirements on computer peripheral equipment,
- longer sales cycles for our products,
- reduced or limited protections of intellectual property rights,
- adverse tax consequences, including imposition of withholding or other taxes on payments by subsidiaries and customers;
- compliance with international standards that differ from domestic standards,
- risks surrounding any product and software outsourcing activities in foreign countries, and
- political, social and economic instability in a specific country or region

Any negative effects on our international business could harm our business, operating results and financial condition as a whole. To date, substantially all of our international revenue or costs have been denominated in U S dollars. As a result, an increase in the value of the U.S dollar relative to foreign currencies could make our products more expensive and thus less competitive in foreign markets A portion of our international revenue may be denominated in foreign currencies in the future, which will subject us to risks associated with fluctuations in those foreign currencies.

Unforeseen environmental costs could impact our future net earnings.

Some of our operations use substances regulated under various federal, state and international laws governing the environment, including those governing the discharge of pollutants into the air and water, the management and disposal of hazardous substances and wastes and the cleanup of contaminated sites Certain of our products are subject to various federal, state and international laws governing chemical substances in electronic products We could incur costs, fines and civil or criminal sanctions, third-party property damage or personal injury claims if we were to violate or become liable under environmental laws The ultimate costs under environmental laws and the timing of these costs are difficult to predict.

The European Union has finalized the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. This directive must now be enacted and implemented by individual European Union governments (such legislation together with the directive, the "WEEE Legislation"), and certain producers are to be financially responsible under the WEEE Legislation beginning in August 2005. In addition, the European Parliament has enacted a requirement for the elimination or reduction of hazardous substances (RoHS). This legislation governs the recovery of such substances as mercury, lead, cadmium, and hexavalent cadmium. We are currently reviewing the applicability of WEEE and RoHS Legislation to our electronic products Accordingly, we cannot currently estimate the extent of increased costs resulting from the WEEE and RoHS Legislation Similar legislation may be enacted in other geographies, including federal and state legislation in the United States, the cumulative impact of which could be significant costs.

Increased international political instability may decrease customer purchases, increase our costs and disrupt our business.

Increased international political instability as demonstrated by the September 11, 2001 terrorist attacks, disruption in air transportation and enhanced security measures as a result of the terrorist attacks and increasing tension in the Middle East, may hinder our ability to do business and may increase our costs Additionally, this increased instability may, for example, negatively impact the capital markets and the reliability and cost of transportation and adversely affect our ability to obtain adequate insurance at reasonable rates or require us to incur costs for extra security precautions for our operations In addition, to the extent that air transportation is delayed or disrupted, the operations of our contract manufacturers and suppliers may be disrupted, particularly if shipments of components and raw materials are delayed If this international political instability continues or increases, our business and results of operations could be seriously harmed and we may not be able to obtain financing in the capital markets

If we lose key personnel or if we are unable to hire additional qualified personnel, we may not be successful.

Our success depends to a significant degree upon the continued contributions of our key management, technical, sales and marketing, finance and operations personnel, many of whom would be difficult to replace In particular, we believe that our future success is highly dependent on our senior executive team In the past we have experienced high turnover in our senior executive team.

In addition, our engineering and product development teams are critical in developing our products and have developed important relationships with customers and their technical staffs The loss of any of these key personnel, including our senior sales staff, could harm our operations and customer relationships We do not have key person life insurance on any of our key personnel Given our recent acquisitions of Nishan and Sanera, a large percentage of our engineering development team is now located in California, is new to the Company and may not operate as efficiently during the transition period In January 2004, we announced a 9% reduction in-force (RIF) of our employee base and we have closed down our Canadian engineering operations.

We believe our future success will also depend in large part upon our ability to attract and retain highly-skilled managerial, engineering, sales and marketing, and finance and operations personnel If we increase our production and sales levels, we will need to attract and retain additional qualified skilled workers for our operations In the last year, there has been an increasing demand for such personnel by companies, some of which are larger and have greater resources to attract and retain highly qualified personnel We cannot assure you that we will continue to be able to attract and retain qualified personnel, or that delays in hiring required personnel, particularly engineers, will not delay the development or introduction of products or materially adversely impact our ability to sell our products.

Risks related to internal controls.

Public companies in the United States are required to review their internal controls under the Sarbanes-Oxley Act of 2002. It should be noted that any system of controls, however well-designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. If the internal controls put in place by us are not adequate or in conformity with the requirements of the Sarbanes-Oxley Act of 2002, and the rules and regulations promulgated by the Securities and Exchange Commission, we may be forced to restate our financial statements and take other actions which will take significant financial and managerial resources, as well as be subject to fines and other government enforcement actions.

If we are unable to adequately protect our intellectual property, we may not be able to compete effectively.

We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality and/or license agreements with our employees, consultants and corporate partners Despite our efforts to protect our proprietary rights, unauthorized parties may copy or otherwise obtain and use our products or technology Monitoring unauthorized use of our products is difficult and we may not be aware that someone is using our rights without our authorization In addition, the steps we have taken, and those we may take in the future, may not prevent unauthorized use of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States We may be a party to intellectual property litigation in the future, either to protect our intellectual property or as a result of alleged infringements of others' intellectual property.

These or other claims and any resulting litigation or arbitration could subject us to significant costs, liability for damages or could cause our proprietary rights to be invalidated or deemed unenforceable, which could allow third parties to use our rights without reservation. Litigation or arbitration, regardless of the merits of the claim or outcome, would likely be time consuming and expensive to resolve and would divert management time and attention. Any potential intellectual property litigation filed against us could also force us to do one or more of the following:

- stop using the challenged intellectual property or selling our products or services that incorporate it;
- obtain a license to use the challenged intellectual property or to sell products or services that incorporate it, which license may not be available on reasonable terms, or at all, and
- redesign those products or services that are based on or incorporate the challenged intellectual property.

If we are forced to take any of these actions, we may be unable to manufacture and sell our products, our customer relationships would be seriously harmed and our revenue would be reduced

In March 1999, we, as an EMC subsidiary, granted IBM a license to all of our patents under a cross license agreement between IBM and EMC. Under the terms of that agreement, effective upon EMC's February 7, 2001 distribution of our Class A common stock to its stockholders, the sublicense we previously held to those IBM patents terminated We believe that the termination of the sublicense does not materially affect our business We are not aware of any issued or pending IBM patents that are infringed by our products, but if IBM were to allege any such infringement, and we were unable to negotiate a settlement with IBM, our ability to produce the alleged infringing product could be affected, which could materially and adversely affect our business

If we fail to optimize our distribution channels and manage our distribution relationships, our revenue or operating results could be significantly reduced. Our competitors may sell their products directly to end-user customers.

Our success will depend on our continuing ability to develop and manage relationships with significant OEMs, resellers and systems integrators, as well as on the sales efforts and success of these customers We cannot provide assurance that we will be able to expand our distribution channels or manage our distribution relationships successfully or that our customers will market our products effectively Our failure to expand our distribution channels or manage successfully our distribution relationships or the failure of our OEM and reseller customers to sell our products could reduce our revenue and operating results. Moreover, to the extent our competitors sell directly to end-user customers, we may not be able to compete given the lack of a direct sales force and the current inability to directly provide first and second level customer support If this occurs, we may need to substantially invest in a direct sales force and direct customer support which would increase our expenses.

We are dependent on a single or limited number of suppliers for certain key components of our products, and the failure of any of those suppliers to meet our production needs could seriously harm our ability to manufacture our products, result in delays in the delivery of our products and harm our revenue.

We currently purchase several key components from single or limited sources. We purchase application specific integrated circuits (ASICs), special purpose processors and power supplies from single sources, and gigabit interface converters and optic transceivers from limited sources Additional sole or limited sourced components may be incorporated into our products in the future. Delays in the delivery of components for our products could result in delays or the inability to meet our customers' demands and result in decreased revenue We do not have any long-term supply contracts to ensure sources of supply of components. In addition, our suppliers may enter into exclusive arrangements with our competitors, stop selling their products or components to us at commercially reasonable prices or refuse to sell their products or components to us at any price, which could harm our operating results. Further, we have purchased components from our suppliers from time to time that have been subsequently found not to meet the supplier's published specifications If our suppliers are unable to provide (or we are unable otherwise to obtain) components for our products on the schedule and in the quantities and quality we require, we will be unable to manufacture our products We have experienced and may continue to experience production delays and quality control problems with certain of our suppliers (including our optics suppliers), which, if not effectively managed, could prevent us from satisfying our production requirements. If we fail to effectively manage our relationships with these key suppliers, or if our suppliers experience delays, disruptions, capacity constraints or quality control problems in their manufacturing operations, our ability to manufacture and ship products to our customers could be delayed, and our competitive position, reputation, business, financial condition and results of operations could be seriously harmed.

The loss of our contract manufacturers, or the failure to forecast demand accurately for our products or to manage our relationship with our contract manufacturers successfully, would negatively impact our ability to manufacture and sell our products.

We rely on Sanmina SCI, Inc (SSCI), Solectron Corporation, Pycon Incorporated, IBM and LSI Logic, together our contract manufacturers, to manufacture our products Our contract manufacturers are not obligated to supply products to us for any specific period, or in any specific quantity, except as may be provided in a particular purchase order In addition, our contract manufacturers do not guarantee that adequate capacity will be available to us within the time required to meet additional demand for our products. We generally place forecasts for products with our contract manufacturers approximately four to five months prior to the anticipated delivery date, with order volumes based on forecasts of demand for our products We generally place purchase orders ninety calendar days in advance of delivery. If we fail to forecast demand for our products accurately, we may be unable to obtain adequate manufacturing capacity from our contract manufacturers to meet our customers' delivery requirements or unexpected increases in customer purchase orders As a result, we may not be able to benefit from any incremental demand and could lose customers. If we over-estimate demand for our product, we may accumulate excess inventories and obligations to our contract manufacturers under binding purchase orders in excess of our needs At October 31, 2004, our commitment with our contract manufacturers for purchases and anticipated transformation costs over the next sixty days totaled approximately $62.7 million.

In addition, we coordinate our efforts with those of our component suppliers and contract manufacturers in order to rapidly achieve volume production We have experienced and may continue to experience production delays and quality control problems with certain of our suppliers and with our contract manufacturers, which, if not effectively managed, could prevent us from satisfying our production requirements on a timely basis and could harm our customer relationships If we should fail to manage effectively our relationships with our component suppliers or contract manufacturers, or if any of our suppliers or our manufacturers experience delays, disruptions, capacity constraints or quality control problems in their manufacturing operations, our ability to ship products to our customers could be delayed, and our competitive position and reputation could be harmed. Qualifying a new contract manufacturer and commencing volume production can be expensive and time consuming If we are required to change or choose to change contract manufacturers, we may lose significant revenue and seriously damage our customer relationships.

The continued general economic slowdown and potential international slowdowns may significantly reduce expenditures on information technology infrastructure.

Unfavorable general economic conditions over the last several years have had a pronounced negative impact on information technology, or IT, spending Demand for SAN products in the enterprise-class sector may continue to be adversely impacted as a result of a weakened economy and because larger businesses have begun to focus on more efficiently using their existing IT infrastructure rather than making new equipment purchases If there are further reductions in either domestic or international IT expenditure, or if IT expenditure does not increase as anticipated from current levels, our revenues, operating results and financial condition may be materially adversely affected.

Failure to manage expansion effectively could seriously harm our business, financial condition and prospects.

Our ability to successfully implement our business plan, develop and offer products, and manage expansion in a rapidly evolving market requires a comprehensive and effective planning and management process. We continue to increase the scope of our operations domestically and internationally In addition, in September 2003, we acquired Sanera and Nishan which significantly increased the size of our operations Our growth in business and relationships with customers and other third parties has placed, and will continue to place, a significant strain on management systems, resources, intercompany communication and coordination. As we grow, our failure to maintain and to continue to improve upon our operational, managerial and financial controls, reporting systems, processes and procedures, and /or our failure to continue to expand, train, and manage our work force worldwide, could seriously harm our business and financial results

If we fail to successfully develop the McDATA brand, our revenue may not grow.

Our name is not widely recognized as a brand in the marketplace given our indirect sales model. We believe that establishing and maintaining the McDATA brand is a critical component in maintaining and developing strategic OEM, reseller and systems integrator relationships, and the importance of brand recognition will increase as the number of vendors of competitive products increases. Our failure to successfully develop our brand may prevent us from expanding our business and growing our revenue. Similarly, if we incur excessive expenses in an attempt to promote and maintain the McDATA brand, our business, financial condition and results of operations could be seriously harmed

Undetected software or hardware defects in our products could result in loss of or delay in market acceptance of our products and could increase our costs or reduce our revenue.

Our products may contain undetected software or hardware errors when first introduced or when new versions are released. Our products are complex, and we have from time to time detected errors in existing products. In addition, our products are combined with products from other vendors. As a result, should problems occur, it might be difficult to identify the source of the problem. These errors could result in a loss of or delay in market acceptance of our products, cause delays in delivering our products or meeting customer demands and would increase our costs, reduce our revenue and cause significant customer relations problems Errors could also result in the need for us to upgrade existing products at customer locations which would increase our costs or cause significant customer relations problems.

We are a defendant in a class action lawsuit and we may be subject to further litigation in the future which could seriously harm our business.

As more fully set forth in Note 15 to our Condensed Consolidated Financial Statements, we are a defendant in a consolidated securities class action know as *In Re Initial Public Offering Securities Litigation (SDNY)*. We may become subject to additional class action litigation following a period of volatility in the market price of our common stock. Securities class action litigation results in substantial costs and diverts the attention of management and our resources and seriously harms our business, financial condition and results of operations.

The sales cycle for our products is long, and we may incur substantial non-recoverable expenses and devote significant resources to prospects that do not produce revenues in the foreseeable future or at all.

Our OEMs, reseller and systems integrator customers typically conduct significant evaluation, testing, implementation and acceptance procedures before they begin to market and sell new solutions that include our products. This evaluation process is lengthy and may extend up to one year or more This process is complex and may require significant sales, marketing and management efforts on our part. This process becomes more complex as we simultaneously qualify our products with multiple customers. As a result, we may expend significant resources to develop customer relationships before we recognize revenue, if any, from these relationships Products that are not qualified by storage and system OEMs and resellers, may not gain market acceptance. Our OEM and reseller customers have multiple sources for products similar to ours, and as such, may not qualify our products for any number of reasons

We may engage in future acquisitions that dilute our stockholders' ownership and cause us to use cash, incur debt or assume contingent liabilities.

As part of our strategy, from time to time we expect to review opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets or enhance our technical capabilities, or that may otherwise offer growth opportunities We may buy businesses, products or technologies in the future In the event of any future purchases, we could:

- issue stock that would dilute our current stockholders' percentage ownership,
- use cash, which may result in a reduction of our liquidity,
- incur debt, or
- assume liabilities

These purchases also involve numerous risks, including

- problems combining and integrating the purchased operations, technologies, personnel or products;
- unanticipated costs;
- diversion of management's attention from our core business;
- adverse effects on existing business relationships with suppliers and customers,
- risks associated with entering markets in which we have no or limited prior experience; and
- potential loss of key employees of acquired organizations.

We may not be able to successfully integrate any businesses, products, technologies or personnel that we might acquire in the future. In addition, technology acquisitions of start-up companies could result in one-time charges related to acquisition costs, severance costs, employee retention costs and in-process research and development.

We may require, or could elect, to seek additional funding.

Our future capital requirements will depend on many factors, including our rate of revenue growth, the timing and extent of spending to support development of new products and expansion of sales and marketing, the timing of new product introductions and enhancements to existing products, any acquisitions of businesses, and market acceptance of our products. With changes in operating and industry expectations, we could require, or could elect, to seek additional funding including accessing the equity and debt markets.

If we become subject to unfair hiring claims, we could incur substantial costs in defending ourselves.

Companies in our industry whose employees accept positions with competitors frequently claim that their competitors have engaged in unfair hiring practices or that employees have misappropriated confidential information or trade secrets. Because we often seek to hire individuals with relevant experience in our industry, we may be subject to claims of this kind or other claims relating to our employees in the future We could incur substantial costs in defending ourselves or our employees against such claims, regardless of their merits In addition, defending ourselves or our employees from such claims could divert the attention of our management away from our operations

Our products must comply with governmental regulation.

In the United States, our products comply with various regulations and standards defined by the Federal Communications Commission and Underwriters Laboratories. Internationally, products that we develop will be required to comply with standards established by authorities in various countries In the last several years, the European Union (EU) has adopted a number of initiatives (WEEE, RoHS, etc) related to equipment emissions, electronic waste, privacy of information and expanded consumer warranties. Failure to comply with existing or evolving industry standards or to obtain timely domestic or foreign regulatory approvals or certificates could seriously harm our business.

Provisions in our charter documents, our rights agreement and Delaware law could prevent or delay a change in control of McDATA and may reduce the market price of our common stock.

Provisions of our certificate of incorporation, by-laws and rights agreement may discourage, delay or prevent a merger, acquisition or other business combination that a stockholder may consider favorable. These provisions include:

- authorizing the issuance of preferred stock without stockholder approval;
- providing for a classified board of directors with staggered three year terms,
- limiting the persons who may call special meetings of stockholders;
- requiring super-majority voting for stockholder action by written consent,
- establishing advance notice requirements for nominations for election to the board of directors and for proposing other matters that can be acted on by stockholders at stockholder meetings;
- prohibiting cumulative voting for the election of directors,
- requiring super-majority voting to effect certain amendments to our certificate of incorporation and by-laws; and
- requiring parties to request board approval prior to acquiring 15% or more of the voting power of our common stock to avoid economic and voting dilution of their stock holdings.

We are incorporated in Delaware and certain provisions of Delaware law may also discourage, delay or prevent someone from acquiring or merging with us, which may cause the market price of our common stock to decline

Our stock price is volatile.

The market price of our common stock has been volatile Because we are a technology company, the market price of our common stock is usually subject to similar volatility and fluctuations that occur in our sector and to our competitors. This volatility is often unrelated or disproportionate to the operating performance of our company and, as a result, the price of our common stock could fall regardless of our performance.

Risks Related to Our Relationship With EMC

We have entered into agreements with EMC that, due to our prior parent-subsidiary relationship, may contain terms less beneficial to us than if they had been negotiated with unaffiliated third parties.

In October 1997, and in connection with the reorganization of our business, we entered into certain agreements with EMC relating to our business relationship with EMC In addition, we have entered into agreements with EMC relating to our relationship with EMC after the completion of our initial public offering in August 2000 and the distribution by EMC of our Class A common stock in February 2001 We have also entered into an OEM Purchase and License Agreement with EMC that governs EMC's purchases of our products and grants EMC rights to use, support and distribute software for use in connection with these products. The agreement does not provide for the purchase of a guaranteed minimum amount of product These agreements were negotiated and made in the context of our prior parent-subsidiary relationship As a result, some of these agreements may have terms and conditions, including the terms of pricing, that are less beneficial to us than agreements negotiated with unaffiliated third parties Sales and services revenue pursuant to these agreements with EMC represented approximately 49% of our revenue for the three months ended October 31, 2004 In addition, in some instances, our ability to terminate these agreements is limited, which may prevent us from being able to negotiate more favorable terms with EMC or from entering into similar agreements with third parties.

Provisions of our agreements with EMC relating to our relationship with EMC after the distribution of our Class A common stock to EMC's stockholders may prevent a change in control of our company.

Under the terms of the May 2000 Master Confidential Disclosure and License Agreement between EMC and us, EMC has granted us a license to then existing EMC patents and we granted to EMC a license to then existing McDATA patents. If we are acquired, our acquirer will retain this license as long as our acquirer grants to EMC a license under all of the acquirer's patents for all products licensed under the agreement under the same terms as the license we have granted to EMC under the agreement The potential loss of the license from EMC under this agreement could decrease our attractiveness as an acquisition target.

We may be obligated to indemnify EMC if the distribution of our Class A common stock to EMC's stockholders was not tax free.

The May 2000 Tax Sharing Agreement that we have entered into with EMC obligates us to indemnify EMC for taxes relating to the failure of EMC's distribution to EMC's stockholders of our Class A common stock to be tax free if that failure results from, among other things:

- any act or omission by us that would cause the distribution to fail to qualify as a tax-free distribution under the Internal Revenue Code;
- any act or omission by us that is inconsistent with any representation made to the Internal Revenue Service in connection with the request for a private letter ruling regarding the tax-free nature of the distribution by EMC of our Class A common stock indirectly held by it to its stockholders,
- any acquisition by a third party of our stock or assets, or
- any issuance by us of stock or any change in ownership of our stock.

While the risk associated with the Company's obligations under the Tax Sharing Agreement should diminish over time, the Company's tax years covered by the agreement, as it relates to the Distribution, will remain open to examination by the IRS for at least three years from the date the returns for those years were filed.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risks

We are exposed to market risk, primarily from changes in interest rates, foreign currency exchange rates and credit risks.

Interest Rate Risk

We earn interest income on both our cash and cash equivalents and our investment portfolio Our investment portfolio consists of readily marketable investment-grade debt securities of various issuers and maturities ranging primarily from overnight to three years. All investments are denominated in U S. dollars and are classified as "available for sale " These instruments are not leveraged, and are not held for trading purposes. As interest rates change, the amount of realized and unrealized gain or loss on these securities will change. The quantitative and qualitative disclosures about market risk are discussed in Item 7A –Qualitative and Quantitative Disclosure About Market Risk, contained in our Form 10-K for fiscal year 2003

Our convertible subordinated debt is subject to a fixed interest rate and the notes are based on a fixed conversion ratio into Class A common stock In July 2003, the Company entered into an interest-rate swap agreement with a notional amount of $155.3 million that has the economic effect of modifying the fixed interest obligations associated with the notes so that the interest payable on the majority of the notes effectively becomes variable based on the six-month London Interbank Offered Rate (LIBOR) minus 152 basis points If interest rates on this variable rate debt were to increase or decrease, our annual interest expense would increase or decrease accordingly. This increased or decreased interest expense would be partially offset by the effects of these interest rate changes on our cash and investment portfolio The notes are not listed on any securities exchange or included in any automated quotation system; however, the notes are eligible for trading on the PortalSM Market On December 2, 2004, the approximate bid price per $100 of our notes was $94 50 and the approximate ask price of our Notes was $95 00, resulting in an aggregate fair value of between $163.0 million and $163.9 million Our Class A common stock is quoted on the Nasdaq National Market under the symbol, "MCDTA." On December 3, 2004, the last reported sale price of our Class A common stock on the Nasdaq National Market was $5.79 per share.

Foreign Currency Exchange Risk

We operate sales and support offices in several countries. All of our sales contracts have been denominated in U.S. dollars, therefore our transactions in foreign currencies are limited to operating expense transactions Due to the limited nature and amount of these transactions, we do not believe we have had or will have material exposure to foreign currency exchange risk.

Credit Risk

Financial instruments, which potentially subject us to concentrations of credit risk, consist principally of temporary cash investments, investments and trade receivables We place our temporary cash investments and investment securities in primarily investment grade instruments and limit the amount of investment with any one financial institution We evaluate the credit risk associated with each of our customers but generally do not require collateral We depend on two customers for most of our total revenue who comprise a significant portion of our trade receivables and, therefore, expose us to a concentration of credit risk.

In conjunction with the issuance of our convertible subordinated notes, we also entered into share option transactions on our Class A common stock with Bank of America, N A and /or certain of its affiliates Subject to the movement in our Class A common stock price, we could be exposed to credit risk arising out of net settlement of these options in our favor. Based on our review of the possible net settlements and the credit strength of Bank of America, N A and its affiliates, we have concluded that we do not have a material exposure to credit risk as a result of these share option transactions

In July 2003, we entered into an interest-rate swap agreement with JPMorgan Chase Bank (JPMorgan). Subject to the movement in interest rates, we could be exposed to credit risk arising out of net interest payments due to us from JPMorgan. Based on our review of the possible movement in interest rates and the credit strength of JPMorgan, we have concluded that we do not have a material exposure to credit risk as a result of this interest-rate swap.

ITEM 4. Controls and Procedures

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14(c) as of the end of the period covered by this report Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended October 31, 2004 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting

PART II – OTHER INFORMATION

ITEM 1. Legal Proceedings

From time to time, we become involved in various lawsuits and legal proceedings that arise in the normal course of business Litigation is subject to inherent risks and uncertainties and an adverse result in any matter may harm our business, financial condition or results of operations. In the opinion of management and except as otherwise noted, the ultimate disposition of any of the claims described herein are not expected to have a material adverse effect on our consolidated results of operations, financial position or cash flow. Please see Note 15 of the Condensed Consolidated Financial Statements for a description of the litigation matters

ITEMS 2, 3 and 5 are not applicable and have been omitted.

ITEM 4. Submission of Matters to A Vote of Security Holders

The annual meeting of the Company's stockholders was held on October 27, 2004. At that meeting, three proposals were submitted to a vote of the Company's stockholders Proposal 1 was a proposal to elect three directors, John A. Kelley, Jr., John W. Gerdelman and Betsy S. Atkins to serve until the 2007 Annual Meeting of Stockholders Proposal 2 was a proposal to ratify the appointment of Deloitte & Touche LLP as the Company's independent public accountants for the fiscal year ending January 31, 2005. Proposal 3 was a proposal to amend certain provisions of the 2001 McDATA Equity Incentive Plan For further information regarding the annual meeting, please see the Company's Proxy Statement on Schedule 14A filed with the SEC.

	Number of Votes			
Proposal	**For**	**Against**	**Abstain/ Withhold**	**Broker Non-Votes**
Proposal 1 - Election of director: John A. Kelley, Jr.	72,288,332	—	1,739,563	N/A
Proposal 1 - Election of director: John W. Gerdelman	72,463,888	—	1,564,007	N/A
Proposal 1 - Election of director Betsy S. Atkins	69,181,682	—	4,846,212	N/A
Proposal 2 - Ratification of Deloitte & Touche LLP appointment	73,074,640	898,140	55,112	N/A
Proposal 3 - Approval to amend the McDATA 2001 Equity Incentive Plan	33,769,480	9,822,228	232,849	30,203,336

Consequently, all proposals were approved by stockholders Broker non-votes are not counted as votes cast or affect the outcome of Proposal 3.

ITEM 6. Exhibits

(a) *Exhibits filed for the Company through the filing of this Form 10-Q*

10 14.2+	IBM OEM Purchase Agreement
10.19.6+	New Headquarters Office Lease Agreement
10 20.2	Amended and Restated Executive Severance Agreement
31 1	Section 302 Certification of Principal Executive Officer
31.2	Section 302 Certification of Principal Financial Officer
32	Section 906 Certifications of Principal Executive Officer and Principal Financial Officer

\+ Portions of these Exhibits have been omitted and filed separately with the SEC pursuant to an order or a request for confidential treatment.

SIGNATURE

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.

McDATA CORPORATION

By: /s/ ERNEST J. SAMPIAS

Ernest J Sampias
Senior Vice President of Finance and
Chief Financial Officer

December 6, 2004

<u>Exhibit C</u>

Management Biographies

Jean M. Becker, Senior Vice President of Engineering

Jean M. Becker has been the Senior Vice President of Engineering since December 2002. Just prior to joining McDATA, Ms. Becker was President of Qwest Solutions from July 2001 and Senior Vice President of Qwest National xDSL/Broadband Deployment from July 2000. Prior to Qwest, Ms. Becker held the Chief Technology Officer and Senior Vice President, Vice President of Network Planning and other senior management positions with U S WEST since 1988. Ms. Becker earned a Masters of Business and Administration degree in 1992 from Portland State University and earned a Bachelor of Science degree in electrical engineering in 1988 from Portland State University. Ms. Becker also serves on the board of directors of Aarohi Communications, Inc.

Robert F. Finley, Vice President of Manufacturing

Robert F. Finley has been the Vice President of Manufacturing since June 2001. Prior to joining McDATA, he served as Vice President, Business Programs Management--Global Accounts at SMTC Corp. from December 1996 to May 2001. Prior to joining McDATA, Mr. Finley held several positions at SMTC including Director of Materials, MIS, Document Control, Component Engineering and Supplier Quality Assurance and Director of Manufacturing Operations from February 1991 to December 1996. In addition, Mr. Finley worked for McDATA from 1987 to 1990 as a manager of quality assurance, reliability engineering and mechanical procurement and a manager of turnkey operations. Mr. Finley holds a Bachelor of Science degree in electronics engineering technology from Arizona State University.

Gary M. Gysin, Senior Vice President of World Wide Sales and Services

Gary M. Gysin, has been the Senior Vice President of World Wide Sales and Services since January 2004. Mr. Gysin joined McDATA in December 2002 as Vice President and General Manager of Software. Prior to joining McDATA, Mr. Gysin was Senior Vice President of products at Volera from February 2000 to November 2002, where he drove development of strategic direction, and Sales and Marketing activities. Additionally, Mr. Gysin has shown strong success in previous sales leaderships roles at growth companies, and has a wide range of sales leadership experience including previous vice president of sales positions, territory management, compensation organization, and routes-to-market development. Mr. Gysin received his Bachelor of Arts degree in Economics in 1992 from the University of California at Santa Cruz.

John A. Kelley, Jr., Chief Executive Officer and Chairman of the Board of Directors

John A. Kelley, Jr. has been Chairman of the Board of Directors since February 2004, President and Chief Executive Officer since August 2002 and was President and Chief Operating Officer from August 2001 to August 2002. Prior to joining McDATA, Mr. Kelley was Executive Vice President for Qwest Communications International Inc , or Qwest, from July 2000 to January 2001. Prior to the acquisition of US WEST by Qwest, he was Executive Vice President for U S WEST from April 1995 to June 2000. Prior to his employment at US WEST, Mr. Kelley was in key senior leadership positions at Mead Corporation from 1991 to 1995. Mr. Kelley received his Bachelor of Science degree in business from the University of Missouri, St Louis. He serves on the board of directors of Polycom, Inc. and Captaris, Inc., and is also Vice Chairman of the

National INROADS Board, a not-for-profit mentoring program and a board member of the Women's Vision Foundation and Tie-Rockies.

Thomas O. McGimpsey, General Counsel and Vice President of Business Development

Thomas O. McGimpsey is General Counsel and Vice President of Business Development. In 2002, Mr. McGimpsey also held the position of Vice President of Corporate Development. Mr. McGimpsey is responsible for managing all internal and external legal efforts, corporate governance matters, business development, mergers and acquisition activities, hardware and software purchase/licensing contracts, and the internationalization efforts for the company. Prior to joining McDATA in June 2000, Mr. McGimpsey was the Senior Corporate and Securities Attorney at U S WEST, Inc. and U S WEST Communications, Inc. from 1998 until U S WEST's merger with Qwest in June 2000. From 1991 to 1998, Mr. McGimpsey was in private practice at national law firms. From 1984 to 1988, Mr. McGimpsey was a Senior Engineer for Software Technology, Inc. Mr. McGimpsey received his Juris Doctor degree from the University of Colorado in 1991 and his Bachelor of Science degree in Computer Science (with a minor in electrical and microprocessor systems) from Embry-Riddle Aeronautical University in 1984.

Karen L. Niparko, Vice President of Human Resources

Karen L. Niparko has been Vice President of Human Resources since January 2004, Vice President of Business Operations since October 2002 and prior thereto was Vice President of Human Resources from September 2001 to October 2002. Prior to joining McDATA, Mrs. Niparko was Executive Consultant for Corporate Solutions, Inc. from April 2001 to September 2001, Corporate Vice President of Human Resources and Officer and former Vice-President of Human Resources for Worldwide Sales & Service of Storage Technology Corporation from April 1997 to February 2001, and Vice President of Operations for Auto-trol Technology Corporation from January 1993 to April 1997. Mrs. Niparko has a Masters of Business Administration degree from the University of Colorado, a Bachelor of Arts degree from the University of Michigan and a Certificate for Leadership for Sr. Executives Programs from Harvard University. Mrs. Niparko serves on the Boards of the Colorado Safety Association and INROADS-Colorado Inc., both non-profit organizations. She served as Chair for the eLearning committee of Governor Owen's Strategy Workforce Development Council. She is an advisor for the Chancellor's Community Advisory Committee for the University of Colorado at Boulder and a member of the Women's Vision Foundation.

Ernest J. Sampias, Senior Vice President of Finance and Chief Financial Officer

Ernest J. Sampias has been the Senior Vice President of Finance and Chief Financial Officer since June 1, 2002. Prior thereto he was Vice President of Finance from September 2001 to June 2002 and Controller from September 2001 to February 2003. Prior to joining McDATA, Mr. Sampias was Vice President and Chief Financial Officer of Convergent Communications, Inc. from November 2000 to May 2001, was Vice President and Chief Financial Officer of U S WEST Dex, Inc. from 1997 to 2000 and held various financial management positions with U S WEST from 1985 to 2000. Mr. Sampias is a Certified Public Accountant, received a Masters degree in Taxation in 1979 from DePaul University in Chicago, Illinois, and received a Bachelor of Science degree (with distinction) in Business in 1973 from Indiana University Mr. Sampias also sat on the Board of Directors of PointServe Corporation from March 2000 to November 2000.

Michael J. Sophie

Michael J. Sophie, has served as a Director of McDATA since March 2003. Mr. Sophie has served as Senior Vice President Finance of UTStarcom Inc , a manufacturer and marketer of telecommunications equipment for use in worldwide markets, from January 2003 to present and as Chief Financial Officer from August 1999 to present. He served as Vice President Finance of UTStarcom from August 1999 to January 2003. From 1993 to 1999, Mr. Sophie was Vice President Finance and Chief Financial Officer of P-Com, Inc., a manufacturer of microwave radio stations for worldwide wireless telecommunications markets. Mr. Sophie holds a Bachelor of Science degree in business administration from California State University and a Masters of Business Administration degree from the Santa Clara University.

Thomas M. Uhlman, Ph.D.

Thomas M. Uhlman, has served as a Director of McDATA since May 1998. Mr. Uhlman has been Managing Partner, New Venture Partners, LLC since January 2001. From 1997 to 2001, Mr. Uhlman was President, New Ventures Group at Lucent Technologies. From 1996 to 1997, Mr. Uhlman was Senior Vice President, Corporate Strategy, Business Development and Public Affairs of Lucent Technologies. From 1995 to 1996 Mr. Uhlman was the Vice President, Corporate Development of AT&T Corp. Prior to joining AT&T, he was with Hewlett-Packard Company in various advisory and management roles He received his Ph D. in Political Science from the University of North Carolina--Chapel Hill, his Masters degree in management from Stanford University School of Business and his Bachelor of Arts degree in political science from the University of Rochester

Laurence G. Walker

Laurence G. Walker, an independent investor, has served as a Director of McDATA since May 1998 and Lead Director since February 2004. Previously, Mr. Walker served as Vice President of Strategy of the Network & Computing Systems Group of Motorola from February 2002 until May 2002. From August 2001 until February 2002, Mr. Walker served as Vice President and General Manager of the Network & Computing Systems Group of Motorola. Mr. Walker co-founded C-Port in November 1997 and was Chief Executive Officer until August 2001. C-Port was acquired by Motorola in May 2000. From June 1997 until October 1997, Mr. Walker was self-employed. From August 1996 until May 1997, Mr. Walker served as Chief Executive Officer of CertCo, a digital certification supplier. Prior thereto, he was Vice President and General Manager, Network Product Business Unit, Digital Equipment Corporation from January 1994 to July 1996. From 1981 to 1994, he held a variety of other management positions at Digital Equipment Corporation He received his Ph.D. and Master of Science degree in electrical engineering from the Massachusetts Institute of Technology and his Bachelor of Science degree in Electrical Engineering from Princeton. He serves as a Director of Silicon Laboratories, Oasis Semiconductors, and Propagate Networks.

Verifications

STATE OF COLORADO)
) ss
COUNTY OF BROOMFIELD)

VERIFICATION

I, Thomas O McGimpsey, state that I am Vice President, General Counsel and Business Development of McDATA Corporation, a Party in the foregoing filing, that I am authorized to make this Verification on behalf of McDATA Corporation, that the foregoing filing was prepared under my direction and supervision; and that the contents are true and correct to the best of my knowledge, information, and belief.

Thomas O. McGimpsey

Vice President, General Counsel and
Business Development
McDATA Corporation

Sworn and subscribed before me this 20th day of January, 2005.

Kathleen Ann Mc Mann
Notary Public

My commission expires April 4, 2006

KATHLEEN A. McMANN
NOTARY
PUBLIC
STATE OF COLORADO

Tennessee

STATE OF MINNESOTA)
) ss.
COUNTY OF HENNEPIN)

VERIFICATION

I, Gregory T. Barnum, state that I am Chief Financial Officer of Computer Network Technology Corporation, a Party in the foregoing filing; that I am authorized to make this Verification on behalf of Computer Network Technology Corporation; that the foregoing filing was prepared under my direction and supervision; and that the contents are true and correct to the best of my knowledge, information, and belief.

Gregory T. Barnum

Chief Financial Officer
Computer Network Technology Corporation

Sworn and subscribed before me this 20 day of January, 2005.

Notary Public

My commission expires January 31, 2005

SUZANNE A LAIDLAW
NOTARY PUBLIC MINNESOTA
My Commission Expires Jan 31, 2005

Tennessee