DOT HILL SYSTEMS CORP
Form 10-Q
May 06, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended March 31, 2011

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 1-13317

DOT HILL SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

Delaware	**13-3460176**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
1351 S. Sunset Street, Longmont, CO	**80501**
(Address of principal executive offices)	**(Zip Code)**

(303) 845-3200

(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 x No ¨

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

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

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

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

The registrant had 56,494,699 shares of common stock, $0.001 par value, outstanding as of April 30, 2011.

Table of Contents

DOT HILL SYSTEMS CORP.

FORM 10-Q

For the Quarter Ended March 31, 2011

INDEX

Table of Contents

Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value data)

	December 31, 2010	March 31, 2011
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 45,732	$ 46,309
Accounts receivable, net	35,202	27,196
Inventories	7,340	5,150
Prepaid expenses and other assets	3,540	3,615
Total current assets	91,814	82,270
Property and equipment, net	3,597	3,895
Intangible assets, net	7,581	7,061
Goodwill	4,140	4,140
Other assets	370	337
Total assets	$ 107,502	$ 97,703
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 30,555	$ 22,251
Accrued compensation	3,899	2,870
Accrued expenses	4,171	4,173
Deferred revenue	1,371	1,590
Restructuring accrual	1,664	1,421
Current portion of long-term note payable	275	278
Total current liabilities	41,935	32,583
Long-term note payable	71	
Other long-term liabilities	1,118	874
Total liabilities	43,124	33,457
Commitments and Contingencies		
Stockholders Equity:		
Preferred stock, $.001 par value, 10,000 shares authorized, zero shares issued and outstanding at December 31, 2010 and March 31, 2011.		
Common stock, $.001 par value, 100,000 shares authorized, 55,953 and 56,488 shares issued and outstanding at December 31, 2010 and March 31, 2011, respectively.	56	56
Additional paid-in capital	315,257	316,405
Accumulated other comprehensive loss	(3,584)	(3,593)
Accumulated deficit	(247,351)	(248,622)

Total stockholders equity	64,378	64,246
Total liabilities and stockholders equity	$ 107,502	$ 97,703

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

DOT HILL SYSTEMS CORP.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE LOSS

(In thousands, except per share amounts)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2011
NET REVENUE	$ 59,974	$ 49,174
COST OF GOODS SOLD	51,849	37,072
GROSS PROFIT	8,125	12,102
OPERATING EXPENSES:		
Research and development	7,773	7,986
Sales and marketing	3,361	3,033
General and administrative	3,076	2,341
Restructuring charge (recoveries)	289	(41)
Total operating expenses	14,499	13,319
OPERATING LOSS	(6,374)	(1,217)
OTHER INCOME:		
Interest income (expense), net	3	(6)
Other income (expense), net	(7)	2
Total other income (expense), net	(4)	(4)
LOSS BEFORE INCOME TAXES	(6,378)	(1,221)
INCOME TAX EXPENSE	49	50
NET LOSS	$ (6,427)	$ (1,271)
NET LOSS PER SHARE:		
Basic and diluted	$ (0.12)	$ (0.02)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:		
Basic and diluted	51,538	54,334
COMPREHENSIVE LOSS:		
Net loss	$ (6,427)	$ (1,271)
Foreign currency translation adjustment	7	9
Comprehensive loss	$ (6,420)	$ (1,262)

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

DOT HILL SYSTEMS CORP.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2011
Cash Flows From Operating Activities:		
Net loss	$ (6,427)	$ (1,271)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	971	1,049
Adjustment to contingent consideration	(285)	
Stock-based compensation expense	992	803
Changes in operating assets and liabilities, net of effects of business acquisition:		
Accounts receivable	(849)	8,003
Inventories	(2,380)	2,190
Prepaid expenses and other assets	(401)	(46)
Accounts payable	6,064	(8,489)
Accrued compensation and other expenses	(2,081)	(1,022)
Deferred revenue	352	220
Restructuring accrual	(322)	(243)
Other long-term liabilities	(325)	(244)
Net cash provided by (used in) operating activities	(4,691)	950
Cash Flows From Investing Activities:		
Acquisition, net of cash acquired	(625)	
Purchases of property and equipment	(476)	(604)
Net cash used in investing activities	(1,101)	(604)
Cash Flows From Financing Activities:		
Principal payment of note and loan payable	(839)	(68)
Shares withheld for tax purposes		(191)
Proceeds from sale of stock to employees	372	536
Net cash provided by (used in) financing activities	(467)	277
Effect of Exchange Rate Changes on Cash and Cash Equivalents	(5)	(46)
Net Increase (Decrease) in Cash and Cash Equivalents	(6,264)	577
Cash and Cash Equivalents, beginning of period	57,574	45,732
Cash and Cash Equivalents, end of period	$ 51,310	$ 46,309
Supplemental Disclosures of Non-Cash Investing and Financing Activities:		
Common stock issued in connection with acquisition	$ 8,132	$
Capital assets acquired but not paid	$ 144	$ 223

See accompanying notes to unaudited condensed consolidated financial statements.

5

Table of Contents

DOT HILL SYSTEMS CORP.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation

The financial statements of Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) contained herein are unaudited and in the opinion of management contain all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of financial position, results of operations and cash flows for the periods presented. The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, for interim financial information and with the instructions to Securities and Exchange Commission, or SEC, Form 10-Q and Article 10 of SEC Regulation S-X. They do not include all of the information and disclosures required by GAAP for complete financial statements. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010. Operating results for the three months ended March 31, 2011 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2011.

Use of Accounting Estimates

The preparation of our unaudited condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenue and expenses in the reporting periods. The accounting estimates that require management s most significant and subjective judgments include revenue recognition, inventory valuation, the valuation and recognition of stock-based compensation expense, and the valuation of long-lived assets, goodwill and other intangibles, as well as any other assets and liabilities acquired and accounted for under the purchase method of accounting for business combinations. In addition, we have other accounting policies that involve estimates such as the determination of useful lives of long-lived assets, warranty reserves, accruals for restructuring and valuation allowance for deferred tax assets. Actual results may differ from these estimates under different assumptions or conditions and such differences could be material.

Concentration of Customers and Suppliers

A majority of our net revenue is derived from a limited number of customers. We currently have one customer that accounts for more than 10% of our total net revenue: Hewlett Packard, or HP. Our agreements with our original equipment manufacturers, or OEM, partners do not contain any minimum purchase commitments, do not obligate our OEM partners to purchase their storage solutions exclusively from us and may be terminated at any time upon notice from the applicable partner.

Net revenue by major customer is as follows (as a percentage of total net revenue):

	Three Months Ended March 31,	
	2010	2011
HP	50%	76%
NetApp	31%	0%
Other customers less than 10%	19%	24%
Total	100%	100%

We expect sales to HP will represent a substantially higher percentage of our total net revenue in 2011 compared to 2010. If our relationship with HP were disrupted or declined significantly, we would lose a substantial portion of our anticipated net revenue and our business could be materially harmed.

In the fourth quarter of 2010, we decided to exit our low margin business with NetApp, Inc., or NetApp, beginning on or about December 1, 2010. As a result, we currently do not anticipate generating any additional revenue from NetApp.

Over time, we expect to generate additional revenue from our indirect channel sales and from sales of our AssuredUVS and AssuredVRA products as well as new and potential new OEM customers to eventually replace the revenue, and more importantly, the gross profit lost as a result of amending our agreement with NetApp. However, if we are unable to generate sufficient gross profit from these sources to largely replace the reduced gross profit previously associated with NetApp, our financial results could be harmed.

We expect that the sale of our products to a limited number of customers will continue to account for a high percentage of net revenue for the foreseeable future.

We currently rely on a limited number of contract manufacturing partners to produce substantially all of our products. As a result, should our current manufacturing partners such as Foxconn, not produce and deliver inventory for us to sell on a timely basis, operating results may be adversely impacted.

Table of Contents

Recent Accounting Pronouncements

There were no new accounting pronouncements issued subsequent to the filing of our Annual Report on Form 10-K for the year ended December 31, 2010 that are expected to have a material impact on our unaudited condensed consolidated financial statements.

2. Net Loss Per Share

Basic net loss per share is calculated by dividing net loss for the period by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing net loss for the period by the weighted average number of shares of common stock outstanding during the period and including the dilutive effect of common stock that would be issued assuming conversion or exercise of outstanding warrants, stock options, share based compensation awards and other dilutive securities. No such items were included in the computation of diluted loss per share in the three months ended March 31, 2010 or 2011 because we incurred a net loss in each of these periods and the effect of inclusion would have been anti-dilutive.

Outstanding equity awards not included in the calculation of diluted net loss per share because their effect was anti-dilutive were as follows:

	March 31, 2010		March 31, 2011	
	Number of Potential Shares	Range of Exercise Prices	Number of Potential Number	Range of Exercise Prices
Stock options	6,767,179	$ 0.47 - $16.36	6,323,898	$ 0.47 - $16.36
Unvested restricted stock awards	1,466,609	$	1,894,715	$
Warrants	1,602,489	$ 2.40	1,602,489	$ 2.40

3. Inventories

The components of inventories consist of the following (in thousands):

	December 31, 2010	March 31, 2011
Purchased parts and materials	$ 4,901	$ 3,582
Finished goods	2,439	1,568
Total inventory	$ 7,340	$ 5,150

Inventories are valued at the lower of cost (first-in, first-out method) or market value. The valuation of inventory requires us to estimate excess or obsolete inventory. The determination of excess or obsolete inventory requires us to estimate the future demand for our products. Our markets are volatile, subject to technological risks and price changes and inventory reduction programs by our customers. In addition, we are required to make last time buys of certain components on occasion. These factors result in a risk that we will forecast incorrectly and produce excess inventories of particular products or have commitments to purchase excess inventory components from our suppliers. As a result, actual demand will differ from forecasts, and such a difference has in the past and may in the future have a material adverse effect on our gross margin and our results of operations. Any write downs to inventory due to the existence of excess quantities, physical obsolescence, changes in pricing, damage, or other causes establish a new cost basis for the inventory. When we sell or dispose of reserved inventory the new cost basis is charged to cost of sales.

4. Financial Instruments

The Company s financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, notes payable, bank borrowings and certain other long-term liabilities. The carrying values on our balance sheet of our cash and cash equivalents, accounts receivable, accounts payable, bank borrowings and contingent consideration due to Ciprico, Inc. or Ciprico, in connection with the acquisition of certain intangible assets, approximate their fair values due to their short maturities. The carrying value on our balance sheet of our notes payable approximates fair value as our credit-adjusted interest rate continues to represent a market participant rate.

5. Intangible Assets

Identifiable intangible assets are as follows (in thousands):

	December 31, 2010			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
RaidCore technology	4 years	$ 4,256	$ (2,415)	$ 1,841
NAS technology	3 years	214	(162)	52
Software	7 years	6,375	(835)	5,540
Trade name	5 years	181	(33)	148
Total intangible assets		$ 11,026	$ (3,445)	$ 7,581

Table of Contents

	March 31, 2011			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
RaidCore technology	4 years	$ 4,256	$ (2,681)	1,575
NAS technology	3 years	214	(180)	34
Software	7 years	6,375	(1,063)	5,312
Trade name	5 years	181	(41)	140
Total intangible assets		$ 11,026	$ (3,965)	$ 7,061

Amortization expense related to intangible assets totaled $0.4 million and $0.5 million for the three months ended March 31, 2010 and 2011, respectively.

Estimated future amortization expense related to intangible assets as of March 31, 2011 is as follows (in thousands):

2011 (Remaining 9 months)	$ 1,542
2012	1,724
2013	947
2014	947
2015	914
Thereafter	987
Total	$ 7,061

6. Goodwill

The changes in the carrying amount of goodwill are as follows (in thousands):

	Storage Systems	Standalone Storage Software	Total
Balance as of December 31, 2010	$	$ 4,140	$ 4,140
Goodwill acquired			
Impairment losses			
Balance as of March 31, 2011	$	$ 4,140	$ 4,140

We review goodwill for impairment on an annual basis at November 30 and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. There were no indicators that our goodwill was impaired at March 31, 2011. Accumulated impairment losses as of December 31, 2010 and March 31, 2011 were $40.7 million, all of which was associated with our Storage Systems operating segment.

7. Product Warranties

Our standard warranty provides that if our systems do not function to published specifications, we will repair or replace the defective component or system without charge generally for a period of approximately three years. We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are intended to be covered by corresponding supplier warranties. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future or that our warranty obligations to our customers will be covered by corresponding warranties from our suppliers, the absence of which could have a material adverse effect on our operating results and financial condition. Estimated liabilities for product warranties are included in accrued expenses.

Beginning in the fourth quarter of 2009, we experienced quality issues associated with certain power supply devices provided by one of our component suppliers that required us to make substantial repairs. Our component supplier has agreed to reimburse us for the majority of costs of the replacement parts and related expenses. Although our component supplier has reimbursed us or committed to reimburse us for the majority of our costs incurred through March 31, 2011, there could be significant additional costs passed onto us by our customers. To the extent that our customers provide us with claims for reimbursement for product quality issues caused by this component supplier, we believe that our component supplier is contractually obligated to reimburse us for any such costs. In the event that we cannot recover such costs from our component supplier, we believe our insurance policies would provide us with sufficient coverage for reimbursement. An estimate as to the possible amount of claims or range of claims that our customers may present to us related to these product quality issues cannot be made as of March 31, 2011. To the extent that our component supplier cannot or does not continue to reimburse us for the majority of all expenses incurred by us or our customers, and we are unsuccessful in recovering such expenses from our insurance provider, we could incur material amounts of warranty claims and expenses.

Table of Contents

Our warranty accrual and cost activity is as follows as of and for the three months ended March 31, (in thousands):

	Three Months Ended March 31,	
	2010	2011
Balance, beginning of period	$ 993	$ 982
Charged to operations	1,011	484
Deductions for costs incurred	(948)	(585)
Balance, end of period	$ 1,056	$ 881

8. Restructuring

In December 2008, our management approved, committed to, and initiated a restructuring plan, or the 2008 Plan, to improve efficiencies in our operations, which was largely driven by our plan to consolidate our facility in Carlsbad, California into the Longmont, Colorado facility. As a result of this relocation, we terminated approximately 70 California employees whose positions have been relocated to Colorado and incurred approximately $1.5 million in severance-related costs, all of which was recognized and paid as of December 31, 2010.

As part of the 2008 Plan, we also incurred contract termination costs of $3.2 million since the inception of the 2008 Plan through March 31, 2011. We record charges for contract termination and other associated costs as restructuring expense, which is presented as a separate component within operating expenses. Accrued contract termination and other associated costs are recorded in the restructuring accrual line on our consolidated balance sheets. We expect to pay these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our estimates, we expect we will receive sublease income of approximately $0.6 million beginning in the fourth quarter of 2011 through the remainder of the lease term. To the extent that we are unable to find a tenant to sublease our unused space or if we do not sublease our unused space at a price per square foot that approximates our current estimate, we may incur additional cash restructuring charges of up to the $0.6 million of sublease income we currently expect to receive.

All of the 2008 Plan activity relates to our storage systems operating segment.

The following table summarizes our 2008 Plan activities (in thousands):

	Contract Termination and Other Associated Costs
Accrued restructuring balance as of December 31, 2010	$ 1,500
Restructuring plan recoveries	(40)
Cash payments	(182)
Accrued restructuring balance as of March 31, 2011	$ 1,278

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan includes severance and related costs for the reduction of approximately 10% of our workforce, and fees associated with the acceleration of the closure of our Carlsbad, California facility. As a result of these actions, we intend to terminate approximately 26 employees located in the United States, of which 25 have been terminated as of March 31, 2011. We expect to incur approximately $0.4 million in severance-related costs, all of which was recognized as of December 31, 2010. Accrued severance-related costs are recorded in the restructuring accrual line on our consolidated balance sheets. We anticipate the remainder of the severance and related restructuring costs attributable to our 2010 Plan will be paid out during 2011.

As part of the 2010 Plan, we also incurred contract termination costs of $0.2 million since the inception of the 2010 Plan through March 31, 2011 for facility lease and other associated costs that we continue to incur without economic benefit, as we exited the remaining portion of our Carlsbad, California facility. We record charges for contract termination costs and other associated costs as restructuring expense, which is presented as a separate component within operating expenses. Accrued contract termination and other associated costs are recorded in the restructuring accrual line on our consolidated balance sheets. We expect to pay these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our estimates, we expect we will receive sublease income of approximately $0.1 million beginning in the fourth quarter of 2011 through the remainder of the lease term. To the extent that we are unable to find a tenant to sublease our unused space or if we do not sublease our unused space at a price per square foot that approximates our current estimate, we may incur additional cash restructuring charges of up to the $0.1 million of sublease income we currently expect to receive.

The majority of the 2010 Plan activity relates to our storage systems operating segment.

Table of Contents

The following table summarizes our 2010 Plan activities (in thousands):

	Severance and Related Costs	Contract Termination and Other Associated Costs	Total
Accrued restructuring balance as of December 31, 2010	$ 20	$ 144	$ 164
Restructuring plan recoveries		(1)	(1)
Cash payments		(20)	(20)
Accrued restructuring balance as of March 31, 2011	$ 20	$ 123	$ 143

9. Credit Facilities

We maintain a credit facility with Silicon Valley Bank for cash advances and letters of credit of up to an aggregate of $30 million based upon an advance rate of 85% of eligible accounts receivable. In February 2011, we amended our credit agreement with Silicon Valley Bank. The amendment extends the maturity date to July 21, 2013, revises the definition of eligible accounts receivable to be less restrictive and also revises the definition of net worth. Borrowings under the credit facility bear interest at the prime rate and are secured by substantially all of our accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on our inventory and intellectual property, subject to certain exceptions, and contains usual and customary covenants for an arrangement of its type, including an obligation that we maintain at all times a net worth, as defined in the agreement, of $50 million (subject to certain increases). The agreement also includes provisions to increase the financing facility by $20 million subject to our meeting certain requirements, including $40 million in borrowing base for the immediately preceding 90 days, and Silicon Valley Bank locating a lender willing to finance the additional facility. In addition, if our cash and cash equivalents net of the total amount outstanding under the credit facility fall below $20 million (measured on a rolling three-month basis), the interest rate will increase to prime plus 1% and additional restrictions will apply. Our credit facility also provides for a cash management services sublimit under the revolving credit line of up to $300,000. As of March 31, 2011 we had an outstanding letter of credit issued to our contract manufacturer in China in the amount of $5.0 million.

As of March 31, 2011, there were no amounts outstanding under the Silicon Valley Bank line of credit.

10. Commitments and Contingencies

We may be involved in certain legal actions and claims from time to time arising in the ordinary course of business. Management believes that the outcome of such litigation and claims will likely not have a material adverse effect on our financial condition or results of operations.

11. Segment Information

We have two operating segments, which include storage systems and standalone storage software. Our storage hardware operating segment consists predominantly of our business prior to the acquisition of Cloverleaf in January of 2010 and includes our AssuredSAN products. Our standalone storage software operating segment consists primarily of the business we acquired from Cloverleaf and the intellectual property assets we purchased from Ciprico and includes our AssuredUVS and AssuredVRA products.

The Chief Operating Decision Maker, or CODM, is our President and Chief Executive Officer. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating income (loss).

The CODM does not evaluate operating segments using discrete asset information. Although the CODM uses operating income to evaluate the segments, operating costs included in one segment may benefit other segments. The accounting policies Dot Hill uses to derive operating segment results are substantially the same as those the consolidated Company uses.

Description of Segments

Storage Systems

We offer, primarily through our AssuredSAN products, a flexible, broad line of networked data storage solutions composed of standards-based hardware and embedded software for open systems environments including Fiber Channel, or FC, Internet Small Computer Systems Interface, or iSCSI, and Serial Attached SCSI, or SAS, storage markets. We incorporate many of the performance attributes and other features demanded by high-end/data center end-users into our products, at prices that we believe are suitable for the entry-level or midrange markets. Our end-users consist of entry-level and mid-range users, requiring cost-effective, easily managed, high-performance, reliable storage systems. Our AssuredSAN product lines range from approximately 146 gigabyte, or GB, to large 192 terabyte, or TB, storage systems. These offerings allow our products to be integrated in a modular building block fashion or configured into a complete storage solution, increasing OEM flexibility in creating differentiated products. Modular products also allow our OEM partners to customize solutions, bundling our products with value-added hardware, software and services.

Table of Contents

Our storage systems segment products and services are sold worldwide to facilitate server and storage area network, or SAN, storage implementations, primarily through OEMs, and supplemented by system integrators, or SIs, distributors and value added resellers, or VARs.

Standalone Storage Software

We offer a line of unified virtual storage appliances called the AssuredUVS product line. To OEM customers, we market this technology as a software-only product with a license based business model. To end-user customers, we market this as complete appliance products (hardware servers, software, and storage options) primarily through our indirect sales channel under the Dot Hill brand. The AssuredUVS product line delivers the following:

Simplified Unified Storage Management . The AssuredUVS provides the ability to create and manage virtual volumes for block (SAN) and file (NAS) storage with complete storage ecosystem management using a unified set of management tools so IT personnel can do more with the same resources.

Storage Virtualization . The AssuredUVS provides a full set of virtualization tools for volume management, thin provisioning, snapshots, replication, and tiered storage across a set of heterogeneous storage arrays.

Business Continuity . The AssuredUVS delivers data protection through snapshots, virtual replicas and mirroring both local and remote. Our communications layer over wide area network connections supports policy-based Recovery Point Objective and Recovery Time Objective quality of service as the globally distributed geographical scale.

Scaling and Maximizing assets . The AssuredUVS offers support for existing and new storage arrays in a data center, eliminating the need to replace existing storage systems. The technology allows non-disruptive data migration from existing storage volumes to new virtual volumes and the ability to integrate existing storage volumes as proxy volumes without moving data.

Through our acquisition of Ciprico s RAIDCore assets in September 2008, we offer a high performance, feature rich, host-based redundant array of independent disks, or RAID, stack that can be included as a key ingredient of an entry-level or mid-level enterprise class server built by OEMs or SIs. This product line, called AssuredVRA, provides a cost effective solution for standard Windows and Linux servers that utilizes existing built in SATA or SAS I/O capabilities of motherboards or simple storage I/O adapters to replace expensive dedicated hardware RAID adapter solutions.

Net revenue and operating loss were as follows (in thousands):

	Three Months Ended March 31,	
	2010	**2011**
Storage Systems net revenue	$ 59,816	$ 47,843
Standalone Storage Software net revenue	236	1,424
Total segment net revenue	60,052	49,267
Elimination of intersegment net revenue	(78)	(93)
Total Dot Hill consolidated net revenue	$ 59,974	$ 49,174
Storage Systems operating loss	$ (4,407)	$ (106)
Standalone Storage Software operating loss	(1,967)	(1,111)
Total operating loss	$ (6,374)	$ (1,217)

Total other income (expense), net	(4)	(4)
Loss before income taxes	$ (6,378)	$ (1,221)

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Cautionary Statement for Forward-Looking Information

Certain statements contained in this quarterly report on Form 10-Q, including, statements regarding the development, growth and expansion of our business, our intent, belief or current expectations, primarily with respect to our future operating performance and the products we expect to offer, and other statements regarding matters that are not historical facts, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and are subject to the safe harbor created by these sections. Because such forward-looking statements are subject to risks and uncertainties, many of which are beyond our control, actual results may differ materially from those expressed or implied by such forward-looking statements. Some of the factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements can be found in Part II, Item 1A, Risk Factors and in our reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the year ended December 31, 2010. Readers are cautioned not to place undue reliance on forward-looking statements. The forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.

The following discussion of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and notes thereto included in the preceding pages in this quarterly report on Form 10-Q and our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010.

Overview

We design, manufacture and market a range of software and hardware storage systems for the entry and midrange storage markets. Beginning in the second half of 2009, we began placing more emphasis on selling higher gross margin products which includes software, appliance products, and hardware products through indirect sales channels. We have two operating segments, which include storage systems and standalone storage software.

Typical customers for our storage systems operating segment, which includes our AssuredSAN line of storage array products, include organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware, firmware and software products employing a modular system that allows end-users to add various protocol, performance, capacity or data protection schemes as needed. Our broad range of products, from small capacity direct attached to complete multi-hundred terabyte, or TB, storage area networks, or SANs, provide end-users with a cost-effective means of addressing increasing storage demands at compelling price-performance points. Our current product family based on our AssuredSAN architecture provides high performance and large disk array capacities for a broad variety of environments, employing Fibre Channel, or FC, Internet Small Computer Systems Interface, or iSCSI or Serial Attached SCSI, or SAS, interconnects to switches and/or hosts. In addition, our Assured family of data protection software products provides additional layers of data protection options to complement our line of storage disk arrays. Our current mainstream 2000 and 3000 series of entry-level storage products and Just a Bunch of Disks, or JBOD, arrays are targeted primarily at mainstream enterprise and small-to-medium business, or SMB, applications. Our AssuredSAN 5000 Series products have been distinguished by certification as Network Equipment Building System, or NEBS, Level 3 (a telecommunications standard for equipment used in central offices) and are MIL-STD-810F (a military standard created by the U.S. government) compliant based on their ruggedness and reliability. In February 2010, we launched the latest AssuredSAN 3000 series of storage arrays that provide high speed interface options including 8 gigabyte, or GB, FC, 1GB and 10GB iSCSI over Ethernet and 6GB SAS connectivity.

Our standalone storage software operating segment consists of our AssuredUVS and AssuredVRA product lines.

In November 2010, we launched the AssuredUVS unified virtual storage appliance product line for our branded products through our indirect sales channels and we continue to sell the AssuredUVS software-only to qualified OEM accounts worldwide. This product line, formerly known as the intelligent storage networking system, or iSN$_{TM}$, is based on the technology we acquired in January 2010 from Cloverleaf Communications, Inc, or Cloverleaf, a privately held software company focused on heterogeneous storage virtualization and unified storage technologies. The appliance products consist of a standard off-the-shelf x86 server, combined with the proprietary software that delivers the unified virtual storage feature set. Our storage arrays are also available bundled with this appliance. We believe this product line will broaden market opportunities in both OEM and branded indirect sales channels and help accelerate our transition from a provider of hardware storage arrays to a provider of unified virtual storage solutions. Sales of AssuredUVS products were not significant in 2010 or in the first quarter of 2011. Although we expect sales of our AssuredUVS products to increase, we do not expect such sales to represent a significant percentage of our total net revenue in 2011.

In September 2008, we acquired certain assets, namely RAIDCore from Ciprico Inc., or Ciprico. These products are marketed to OEM accounts as the AssuredVRA product line. This acquisition opened up new markets for us in the enterprise server and workstation markets for data protection internal to the servers and workstations. In particular, the RAIDCore acquisition allows us to broaden our product portfolio in the redundant array of independent disks, or RAID, market while allowing us to sell into the Band 1 market, and to pursue opportunities at current and target OEM customers. We signed our first customer agreement relating to RAIDCore products in May 2009 and began selling to this customer during the third quarter of 2009. Sales of AssuredVRA products were not significant in 2010 or in the first quarter of 2011. Although we expect sales of our AssuredVRA products to increase in 2011, we do not expect such sales to represent a significant percentage of our total net revenue in 2011.

We have decided to expand our routes to market beyond our focus on original equipment manufacturers, or OEMs, and in October of 2009, we launched a Dot Hill channel program targeted at selling through distributors and open storage partners, or OSPs. We continued to expand our channel program in 2010 and we believe this will provide Dot Hill with additional sales channels for all of our products. The majority of sales to our channel partners were represented by our AssuredSAN line of products in 2010.

Our agreements with our customers do not contain any minimum purchase commitments and may be terminated at any time upon notice from the applicable customer. Our ability to achieve and maintain profitability will depend on, among other things, the level and mix of orders we actually receive from such customers, the actual amounts we spend on marketing support, the actual amounts we spend for inventory support and incremental internal investment, our ability to reduce product cost, our product lead time, our ability to meet delivery schedules required by our customers and the economic environment.

Table of Contents

Our products and services are sold worldwide to facilitate server and SAN storage implementations, primarily through OEMs, and supplemented by system integrators, or SIs, distributors and value added resellers, or VARs. Our storage system operating segment OEM partners currently include, among others, Hewlett-Packard, or HP, Lenovo, Ericsson, Motorola, Inc., or Motorola, General Dynamics Government Systems Corporation, or General Dynamics, Lockheed Martin Corporation, or Lockheed Martin, NEC, Tektronix Inc., or Tektronix, Samsung Electronics, or Samsung, Stratus Technologies, or Stratus, and Fujitsu Technology Solutions GmbH, or FTS. Our standalone storage software operating segment OEM partners currently include, among others, Dell Inc., or Dell, Xiotech and Computer Dynamics, Inc., or Computer Dynamics. Although our products and services are sold worldwide, the majority of our net revenue is derived from our U.S. operations.

We began shipping products to HP in the fourth quarter of 2007. In January 2008, we amended our agreement with HP to allow for sales of additional products to additional divisions within HP. Our products are primarily sold as HP s MSA 2000/P2000 product family. Sales to HP increased significantly during 2008 and increased again in 2009 primarily as a result of the successful launch and market acceptance of the HP MSA 2000 products. HP launched its third generation product line, now called the P2000 product line, in February 2010. Sales to HP increased again in 2010 as we began selling our next generation host interfaces across the HP P2000 product line. The agreement with HP does not contain any minimum purchase commitments. Sales to HP approximated 51% of our total net revenue in 2009, 57% of our total net revenue in 2010 and 76% of our total net revenue in the first quarter of 2011. We expect sales to HP to continue to represent a substantial portion of our net revenue in 2011. We also expect sales to HP will represent a higher percentage of our total net revenue in 2011 compared to 2010.

We previously designed and developed general purpose disk arrays for a variety of products that were sold under private label by NetApp, Inc., or NetApp. In the fourth quarter of 2010, we decided to exit our low margin business with NetApp beginning on or about December 1, 2010. As a result, we currently do not anticipate generating any additional revenue from NetApp.

Over time, we expect to generate additional revenue from our indirect channel sales and from sales of our AssuredUVS and AssuredVRA products as well as new and potential new OEM customers to eventually replace the revenue, and more importantly, the gross profit lost as a result of amending our agreement with NetApp. However, if we are unable to generate sufficient gross profit from these sources to largely replace the gross profit previously associated with NetApp, our financial results could be harmed. Sales to NetApp approximated 25% of our total net revenue in 2009, 26% of our total net revenue in 2010 and 0% of our net revenue in the first quarter of 2011. All NetApp revenue was attributable to our storage systems operating segment.

We expect our total net revenue to decrease in 2011 compared to 2010 as a result of exiting our relationship with NetApp.

In addition, the demand for our products has been affected in the past, and may continue to be affected in the future, by various factors, including, but not limited to, the following:

- our ability to maintain and enhance relationships with our customers, in particular our OEM customers, as well as our ability to win new business;
- the amount of field failures resulting in product replacements or recalls;
- our ability to launch new products in accordance with OEM schedules and milestones;
- general economic and political conditions and specific conditions in the markets we address, including the continuing volatility in the technology sector, current general economic volatility and trends in the data storage markets in various geographic regions;
- the timing, rescheduling or cancellation of significant customer orders and our ability, as well as the ability of our customers, to manage inventory; and

the inability of certain of our customers who depend on credit to have access to their traditional sources of credit to finance the purchase of products from us, particularly in the current global economic environment, which may lead them to reduce their level of purchases or to seek credit or other accommodations from us.

For these and other reasons, our net revenue and results of operations in the first quarter of 2011 and prior periods may not necessarily be indicative of future net revenue and results of operations.

Our manufacturing strategy includes outsourcing substantially all of our manufacturing to third-party manufacturers in order to reduce sales cycle times and manufacturing infrastructure, enhance working capital and improve margins by taking advantage of the third parties manufacturing and procurement economies of scale. In September 2008, we entered into a manufacturing agreement with Foxconn Technology Group, or Foxconn. Under the terms of the agreement, Foxconn supplies us with manufacturing, assembly and test services from its facilities in China and final integration services including final assembly, testing and configure-to-order services, through its worldwide facilities. The agreement provides for an initial three-year term that is automatically renewed at the end of such three-year term for additional one-year terms unless and until the agreement is terminated by either party. Foxconn began manufacturing products for us in July 2009 and we began shipping products for general availability under the Foxconn agreement during the second half of 2009. The majority of our products sold in 2010 and in the first quarter of 2011 were manufactured by Foxconn. We expect Foxconn to manufacture substantially all of our products in 2011.

We derive the majority of our net revenue primarily from sales of our Series 2000 and 3000 family of products, which are included in our AssuredSAN product line within the storage systems operating segment.

Table of Contents

Cost of goods sold includes costs of materials, subcontractor costs, salary and related benefits for the production and service departments, depreciation of equipment used in the production and service departments, production facility rent and allocation of overhead as well as manufacturing variances and freight.

Research and development expenses consist primarily of project-related expenses, consulting charges and salaries for employees directly engaged in research and development.

Sales and marketing expenses consist primarily of salaries and commissions, marketing related costs, advertising, customer-related evaluation unit expenses, promotional costs and travel expenses.

General and administrative expenses consist primarily of compensation to officers and employees performing administrative functions, as well as expenditures for legal, accounting and other administrative services and fluctuations in currency valuations.

Other income is comprised primarily of interest income earned on our cash and cash equivalents and other miscellaneous income and expense items.

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan included severance and related costs for the reduction of approximately 10% of our workforce, and fees associated with the acceleration of the closure of our Carlsbad, California facility. Substantially all of our 2010 Plan workforce reductions were completed by December 31, 2010 and we completely exited our Carlsbad facility as of June 30, 2010.

Critical Accounting Policies and Estimates

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the unaudited condensed consolidated financial statements. Management believes that there have been no significant changes during the three months ended March 31, 2011, to the items that we disclosed as our critical accounting policies and estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

Results of Operations

The following table sets forth certain items from our statements of operations as a percentage of net revenue for the periods indicated (percentages may not aggregate due to rounding):

	Three Months Ended March 31,	
	2010	2011
Net revenue	100%	100%
Cost of goods sold	86.5	75.4
Gross profit	13.5	24.6
Operating expenses:		
Research and development	13.0	16.2
Sales and marketing	5.6	6.2
General and administrative	5.1	4.8
Restructuring charge	0.5	(0.1)
Total operating expenses	24.1	27.1

Operating loss	(10.6)	(2.5)
Other income (expense), net	0.0	0.0
Loss before income taxes	(10.6)	(2.5)
Income tax expense	0.1	0.1
Net loss	(10.7)%	(2.6)%

Table of Contents

Three Months Ended March 31, 2010 Compared to the Three Months Ended March 31, 2011

Net Revenue

	Three Months Ended March 31, 2010	2011	Decrease	% Change
	(in thousands, except percentages)			
Net Revenue	$ 59,974	$ 49,174	$ (10,800)	-18.0%

The decrease in net revenue for the three months ended March 31, 2011 was primarily due to a decrease in sales to NetApp, which decreased from $18.4 million for the three months ended March 31, 2010 to $0.0 million for the three months ended March 31, 2011. In the fourth quarter of 2010, we decided to exit our low margin business with NetApp beginning on or about December 1, 2010. As a result, we currently do not anticipate generating any additional revenue from NetApp.

We also experienced a decrease in net revenue from Fujitsu Technology Solutions GmbH, or FTS, which decreased from $0.9 million for the three months ended March 31, 2010 to $0.4 million for the three months ended March 31, 2011. The decrease in net revenue from FTS is due to FTS s decision to internally source the product we sell to FTS. Product sales to Oracle Corporation (formerly Sun Microsystems), or Oracle, decreased from $0.4 million for the three months ended March 31, 2010 to $0.0 million for the three months ended March 31, 2011. The decline in Oracle net revenue is due to the products we sell to Oracle reaching the end of their product life cycle.

These decreases were partially offset by an increase in net revenue from HP, other OEM and channel customers and from sales of our AssuredUVS and AssuredVRA software products. Sales to HP increased from $30.1 million for the three months ended March 31, 2010 to $37.3 million for the three months ended March 31, 2011. The increase in HP net revenue is due to the successful launch and market acceptance of the HP MSA 2000 products, based on our Series 2000 products and the launch by HP of its third generation product line, now called the P2000 product line, in February 2010, which includes our Series 3000 products. Although our Series 2000 products are in the decline phase of the product life cycle and are being replaced by our Series 3000 products, demand for these products continues to be significant. We released our next generation Series 3000 products in the first quarter of 2010 and sales of these products have increased significantly subsequent to release. We expect sales to HP to continue to represent a significant portion of our net revenue in 2011.

Sales to our other OEM and channel customers and from sales of our AssuredUVS and AssuredVRA software products increased approximately $1.3 million for the three months ended March 31, 2011 compared to the three months ended March 31, 2010.

Cost of Goods Sold and Gross Profit

	Three Months Ended March 31, 2010		Three Months Ended March 31, 2011		(Decrease) Increase	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Cost of Goods Sold	$ 51,849	86.5%	$ 37,072	75.4%	$ (14,777)	-28.5%
Gross Profit	$ 8,125	13.5%	$ 12,102	24.6%	$ 3,977	48.9%

Cost of goods sold decreased for the three months ended March 31, 2011 compared to the three months ended March 31, 2010 primarily as a result of a decrease in sales to NetApp and decreases in manufacturing support costs and manufacturing variances. These decreases were partially offset by an increase in cost of goods sold as a result of the increase in sales to HP and other OEM customers.

Gross profit and gross profit margin increased to $12.1 million and 24.6%, respectively, for the three months ended March 31, 2011 compared to $8.1 million and 13.5%, respectively, for the three months ended March 31, 2010. The increase in gross profit and gross profit margin was primarily due to customer and product mix, as we did not have any sales to NetApp and as the products we sell to HP have a higher gross profit margin compared to the products we previously sold to NetApp. Sales to HP approximated 76% of our net revenue for the three months ended March 31, 2011 compared to 50% of our net revenue for the three months ended March 31, 2010. Sales to NetApp represented 0% of our net revenue for the three months ended March 31, 2011 compared to 31% of our net revenue for the three months ended March 31, 2010. In addition, sales of our software products have a much higher gross profit and gross profit margin than sales of our hardware products, and sales to our channel customers typically have a higher gross profit and gross profit margin than sales to HP. Sales to our channel customers and from our AssuredUVS and AssuredVRA software products approximated 5% of our net revenue for the three months ended March 31, 2011 compared to 2% of our net revenue for the three months ended March 31, 2010. We expect that the mix of products we sell, in particular, the products we sell to HP, to our channel customers and from our software products, will continue to affect our gross profit and gross profit margin.

Also contributing to the increase in gross profit and gross profit margin were lower manufacturing support costs and lower manufacturing variances. Manufacturing support costs decreased to $3.3 million for the three months ended March 31, 2011 compared to $3.9 million for the three months ended March 31, 2010 primarily as a result of our restructuring activities, which lowered our operating cost structure. In addition, manufacturing variances decreased to $1.2 million for the three months ended March 31, 2011 compared to $2.4 million for the three months ended March 31, 2010, primarily as a result of a reduction in freight costs due to lower sales and leveraging lower cost ocean freight opportunities and a reduction in excess and obsolete inventory charges as we more efficiently managed our slow moving inventory and contractual obligations with our contract manufacturing partners.

Table of Contents

Research and Development Expenses

	Three Months Ended March 31, 2010		Three Months Ended March 31, 2011		Increase	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Research and Development Expenses	$ 7,773	13.0%	$ 7,986	16.2%	$ 213	2.7%

Research and development expense increased $0.2 million to $8.0 million for the three months ended March 31, 2011 compared to $7.8 million for the three months ended March 31, 2010. This increase was primarily due to a $0.3 million reduction to research and development expense in the first quarter of 2010 related to an adjustment to our Ciprico contingent consideration liability, as we determined it was probable that the amount of contingent consideration due to Ciprico would be lower based on lower actual and projected sales of products eligible for the contingent consideration through the end of the contingent consideration period. Accordingly, we reduced the contingent consideration liability and research and development expense in the statement of operations to reflect the reduction in estimated contingent consideration liability. Also contributing to the increase in research and development expense for the three months ended March 31, 2011 was an increase of depreciation expense of $0.1 million as a result of additional equipment acquired in the Cloverleaf acquisition and due to additional capital expenditures for our Longmont and Israel engineering labs. These increases were partially offset by a decrease in facilities and common costs of $0.2 million as a result of restructuring activities completed in the second quarter of 2010.

We also incurred higher research and development salaries and salary related expenses in the three months ended March 31, 2011 as we had a full quarter of expenses attributable to our acquired Cloverleaf business compared to two months of expenses in the three months ended March 31, 2010. However, these expenses were offset by transitioning certain of our research and development activities to India and also as a result of the restructuring activities completed in the second quarter of 2010.

We expect that the timing of our engineering material purchases to support new product releases will affect the amount of research and development expenses in future periods.

Sales and Marketing Expenses

	Three Months Ended March 31, 2010		Three Months Ended March 31, 2011		Decrease	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Sales and Marketing Expenses	$ 3,361	5.6%	$ 3,033	6.2%	$ (328)	-9.8%

Sales and marketing expense decreased approximately $0.3 million to $3.0 million for the three months ended March 31, 2011 compared to $3.4 million for the three months ended March 31, 2010. The decrease was due to lower customer-related evaluation product expenses of $0.3 million as we incurred higher expenses in the three months ended March 31, 2010 due to the introduction of our new Series 3000 products released in the first quarter of 2010 and due to the newly acquired products from Cloverleaf. Also contributing to the decrease were lower salaries and payroll related expenses and facilities and common costs as a result of restructuring activities completed in the second quarter of 2010.

We expect that the timing of our marketing activities and variable employee sales compensation will affect the amount of sales and marketing expenses in future periods.

General and Administrative Expenses

	Three Months Ended March 31, 2010		Three Months Ended March 31, 2011		Decrease	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
General and Administrative Expenses	$ 3,076	5.1%	$ 2,341	4.8%	$ (735)	-23.9%

General and administrative expenses decreased approximately $0.7 million to $2.3 million for the three months ended March 31, 2011 compared to $3.1 million for the three months ended March 31, 2010. This decrease was primarily attributable to a reduction in salaries and payroll related expenses of $0.4 million, a reduction in Cloverleaf transaction costs of $0.3 million, a reduction in stock-based compensation expense of $0.1 million, a reduction in accounting and related fees of $0.1 million and a reduction in facilities and common costs. These decreases were partially offset by changes in foreign currency gains and losses of approximately $0.2 million.

The reduction in salaries and payroll related expenses was the result of completing the transition of certain of our administrative functions to Longmont, Colorado from Carlsbad, California in the second half of 2010, as we incurred costs of duplicative personnel during the transition period. The reduction in stock-based compensation expense was primarily the result of a deferral in the timing of equity awards granted to certain of our executive officers. The reduction in accounting and related fees was primarily the result of negotiating lower fees with our service providers. The reduction in facilities and common costs were primarily the result of restructuring activities completed in the second quarter of 2010.

Table of Contents

The change in foreign currency gains and losses were primarily the result of changes in the value of the Euro, British Pound, Israeli Shekel and Japanese Yen in relation to the United States dollar.

We expect that general and administrative stock-based compensation expense is likely to increase during the remainder of 2011 as a result of equity awards expected to be granted to certain of our executive officers in the second quarter of 2011.

Restructuring Charge (Recoveries)

	Three Months Ended March 31, 2010		Three Months Ended March 31, 2011		Decrease	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Restructuring Charge (Recoveries)	$ 289	0.5%	$ (41)	(0.1)%	$ (330)	-114.2%

In December 2008, our management approved, committed to, and initiated a restructuring plan, or the 2008 Plan, to improve efficiencies in our operations, which was largely driven by our plan to consolidate our facility in Carlsbad, California into the Longmont, Colorado facility. The 2008 Plan included severance and related costs for facility lease and other associated costs that we continued to incur without economic benefit.

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan included severance and related costs for the reduction of approximately 10% of our workforce, and fees associated with the acceleration of the closure of our Carlsbad, California facility.

Restructuring expenses decreased $0.3 million to $0.0 million for the three months ended March 31, 2011 compared to $0.3 million for the three months ended March 31, 2010. The decrease in restructuring expenses is the result of substantially completing all severance and related cost activities in 2010. In addition, we incurred additional severance-related restructuring charges of approximately $0.1 million in the first quarter of 2010 related to the termination of a former employee of Cloverleaf. Also, in the first quarter of 2011, we received a credit of approximately $0.1 million from our landlord related to previously paid common area maintenance charges, which we recorded as a benefit to restructuring expense.

See Note 8 of Notes to Unaudited Condensed Consolidated Financial Statements for more details regarding our restructuring activities.

Other Income (Expense), net

	Three Months Ended March 31, 2010		Three Months Ended March 31, 2011		(Decrease)	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Other Income (Expense), net	$ (4)	0.0%	$ (4)	0.0%	$	%

Other income (expense), net consists of interest income on our cash and cash equivalents, interest expense related to our note payable and other miscellaneous items. Interest expense decreased for the three months ended March 31, 2011 compared to the three months ended March 31, 2010 primarily as a result of a lower notes payable balance. Interest income also decreased for the three months ended March 31, 2011 compared to the three months ended March 31, 2010 primarily as a result of lower cash and cash equivalents.

Income Taxes

We recorded an income tax provision of $0.1 million for the three months ended March 31, 2011 compared to an income tax provision of $0.0 million for the three months ended March 31, 2010. Our provision for income taxes primarily represents state, local and foreign taxes.

Liquidity and Capital Resources

The primary drivers affecting cash and liquidity are net losses, working capital requirements and capital expenditures. Historically, the payment terms we have had to offer our customers have been relatively similar to the terms received from our creditors and suppliers. We typically bill customers on an open account basis subject to our standard credit quality and payment terms ranging between net 30 and net 45 days. If our net revenue increases, it is likely that our accounts receivable balance will also increase. Conversely, if our net revenue decreases, it is likely that our accounts receivable will also decrease, as was the case during the first quarter of 2011. Our accounts receivable could increase if customers, such as large OEM customers, delay their payments or if we grant them extended payment terms.

As of March 31, 2011, we had $46.3 million of cash and cash equivalents and $49.7 million of working capital compared to $45.7 million of cash and cash equivalents and $49.9 million of working capital as of December 31, 2010. The increase in cash and cash equivalents is further described below.

Cash equivalents include highly liquid investments purchased with an original maturity of 90 days or less and consist principally of money market funds. In addition, we had $0.3 million in short-term debt at March 31, 2011, consisting of a note payable issued in connection with the acquisition of certain intangible assets from Ciprico.

Operating Activities

Net cash provided by operating activities for the three months ended March 31, 2011 was $1.0 million compared to $4.7 million of cash used in operations for the three months ended March 31, 2010. The operating activities that affected cash consisted primarily of a net loss, which totaled $1.3 million for the three months ended March 31, 2011 compared to $6.4 million for the three months ended March 31, 2010. The decrease in our net loss was primarily attributable to an increase in our gross profit due to favorable changes in the mix of products sold and lower manufacturing variances due to lower freight and excess and obsolete inventory charges, as well as lower operating expenses due to our 2008 Plan and 2010 Plan restructuring activities.

The adjustments to reconcile net loss to net cash provided by operating activities for the three months ended March 31, 2011 that did not affect cash consisted of depreciation and amortization of $1.0 million and stock-based compensation expense of $0.8 million.

Cash flows from operations reflects the positive impact of $8.0 million related to a decrease in accounts receivable, which was primarily due to our decision to exit our low margin business with NetApp in the fourth quarter of 2010. Cash collection efforts remained strong during the quarter as our days sales outstanding improved from 53 days at the end of the first quarter of 2010 to 50 days at the end of the first quarter of 2011. Cash flows from operations also reflects the positive impact of $2.2 million related to an overall decrease in inventories at March 31, 2011, which was primarily due to our decision to exit our low margin business with NetApp in the fourth quarter of 2010 as well as the timing of in-transit inventory purchases. Primarily as a result of the recent earthquake and related events in Japan, inventories could increase in the short-term as we may make strategic inventory purchases to maintain a sufficient source of supply.

Additional sources of cash flows from operations include $0.2 million related to an increase in deferred revenue as we received up-front payments for maintenance contracts, net of amortization.

Cash flows from operations include uses of cash of $8.5 million related to a decrease in accounts payable, which was primarily the result of our decision to exit our low margin business with NetApp in the fourth quarter of 2010. The decrease in accounts payable was also due to the timing of inventory purchases and payments to our vendors. Our days payable outstanding decreased from 61 days at the end of the first quarter of 2010 to 56 days at the end of the first quarter of 2011. Cash flows from operations also includes a use of $1.0 million in cash related to a decrease in accrued compensation due to the timing of payroll. In addition, we used $0.2 million of cash from operations for long-term liabilities primarily resulting from deferred rent amortization and to a lesser extent from the reduction of uncertain tax liabilities due to foreign statutes expiring. We also had a decrease in our restructuring accrual of $0.2 million primarily resulting from an increase in cash payments for contract termination costs.

Investing Activities

Cash used in investing activities for the three months ended March 31, 2011 was approximately $0.6 million compared to $1.1 million for the three months ended March 31, 2010. Cash used in investing activities for the three months ended March 31, 2011 was due to purchases of property and equipment primarily associated with test and other equipment used by our contract manufacturing partners to produce our products and for engineering development equipment for our AssuredUVS products. Cash used in investing activities during the three months ended March 31, 2010 was primarily due to the acquisition of Cloverleaf, net of cash acquired, of $0.6 million and purchases of property and equipment of $0.5 million primarily associated with engineering laboratory expansion and equipment as well as additional equipment for our newly acquired Cloverleaf business.

Financing Activities

Cash provided by financing activities for the three months ended March 31, 2011 was approximately $0.3 million compared to cash used in financing activities of $0.5 million for the three months ended March 31, 2010. Cash provided by financing activities for the three months ended March 31, 2011 was due to the sale of stock to employees under our employee stock plans of $0.5 million, which was partially offset by $0.2 million of tax liability payments made by Dot Hill associated with employee equity awards and for the ongoing pay-down of our note payable associated with our 2008 acquisition of certain intangible assets from Ciprico. Cash used in financing activities for the three months ended March 31, 2010 was attributable to the payment of $0.7 million related to a Cloverleaf loan obligation and $0.1 million due to the ongoing pay-down of our note payable. Partially offsetting this use of cash were proceeds received from the sale of common stock to employees under our employee stock plans of $0.4 million.

Based on current macro-economic conditions and conditions in the state of the data storage systems markets, our own organizational structure and our current outlook for 2011, we presently expect our cash and cash equivalents will be sufficient to fund our operations, working capital and capital requirements for at least the next 12 months.

Our standard warranty provides that if our systems do not function to published specifications, we will repair or replace the defective component or system without charge generally for a period of approximately three years. We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are intended to be covered by corresponding supplier warranties. There can be no assurance that our suppliers will continue to provide such warranties to us in the future or that our warranty obligations to our customers will be covered by corresponding warranties from our suppliers, the absence of which could have a potentially significant adverse effect on our operating results and financial condition.

Beginning in the fourth quarter of 2009, we experienced quality issues associated with certain power supply devices provided by one of our component suppliers that required us to make substantial repairs. Our component supplier has agreed to reimburse us for the majority of costs of the replacement parts and related expenses. Although our component supplier has reimbursed us or committed to reimburse us for the majority of all of our costs incurred through March 31, 2011, there could be significant additional costs passed onto us by our customers. To the extent that our customers provide us with claims for reimbursement for product quality issues caused by this component supplier, we believe that our component supplier is contractually obligated to reimburse us for any such costs. In the event that we cannot recover such costs from our component supplier, we believe our insurance policies would provide us with sufficient coverage for reimbursement. An estimate as to the possible amount of claims or range of claims that our customers may present to us related to these product quality issues cannot be made as of March 31, 2011. To the extent that our component supplier cannot or does not continue to reimburse us for the majority of all expenses incurred by us or our customers, and we are unsuccessful in recovering such expenses from our insurance provider, we could incur material amounts of warranty claims and expenses.

The actual amount and timing of working capital and capital expenditures that we may incur in future periods may vary significantly and will depend upon numerous factors, including the timing and extent of net revenue and expenditures from our core business and strategic investments, the overall level of net profits or losses, our ability to manage our relationships with our contract manufacturers, the potential growth or decline in inventory to support our customers, costs associated with product quality issues and the recovery, if any, of such costs from a supplier, the status of our relationships with key customers, partners and suppliers, the timing and extent of the introduction of new products and services, growth in operations and the economic environment. In addition, the actual amount and timing of working capital will depend on our ability to maintain payment terms with our suppliers consistent with the credit terms of our customers. For example, if Foxconn were to shorten our payment terms with them or if HP were to lengthen their payment terms with us, our financial condition could be harmed.

We maintain a credit facility with Silicon Valley Bank for cash advances and letters of credit of up to an aggregate of $30 million based upon an advance rate of 85% of eligible accounts receivable. In February 2011, we amended our credit agreement with Silicon Valley Bank. The amendment extends the maturity date to July 21, 2013, revises the definition of eligible accounts receivable to be less restrictive and also revises the definition of net worth. Borrowings under the credit facility bear interest at the prime rate and are secured by substantially all of our accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on our inventory and intellectual property, subject to certain exceptions, and contains usual and customary covenants for an arrangement of its type, including an obligation that we maintain at all times a net worth, as defined in the agreement, of $50 million (subject to certain increases). The agreement also includes provisions to increase the financing facility by $20 million subject to our meeting certain requirements, including $40 million in borrowing base for the immediately preceding 90 days, and Silicon Valley Bank locating a lender willing to finance the additional facility. In addition, if our cash and cash equivalents net of the total amount outstanding under the credit facility fall below $20 million (measured on a rolling three-month basis), the interest rate will increase to prime plus 1% and additional restrictions will apply. Our credit facility also provides for a cash management services sublimit under the revolving credit line of up to $300,000. As of March 31, 2011 we had an outstanding letter of credit issued to our contract manufacturer in China in the amount of $5.0 million.

As of March 31, 2011, there were no amounts outstanding under the Silicon Valley Bank line of credit.

Our long-term commitments have not materially changed from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010.

Off Balance Sheet Arrangements

At March 31, 2011, we did not have any relationship with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance variable interest, or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving non-exchange traded contracts. As a result, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. We do not have relationships and transactions with persons and entities that derive benefits from their non-independent relationship with us or our related parties except as disclosed herein.

Recent Accounting Pronouncements

Please see Note 1 of the Notes to Unaudited Condensed Consolidated Financial Statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

We place our cash equivalents with high-credit-quality financial institutions, investing primarily in money market accounts. We have established guidelines relative to credit ratings, diversification and maturities that seek to maintain safety and liquidity. Our investment strategy generally results in lower yields on investments but reduces the risk to principal in the short term prior to these funds being invested in our business. Our interest income is sensitive to changes in the general level of interest rates. In this regard, changes in interest rates can affect the interest earned on our cash equivalents. A 10% unfavorable change in the interest rate would not materially impact our March 31, 2011 balance sheet.

We have a line of credit agreement, which accrues interest on any outstanding balances at the prime rate. As of March 31, 2011, there were no amounts outstanding under this line. If we make borrowings under this line, we will be exposed to interest rate risk on such debt.

Indicated changes in interest rates are based on hypothetical movements and are not necessarily indicative of the actual results that may occur. Future earnings and losses will be affected by actual fluctuations in interest rates.

Foreign Currency Exchange Rate Risk

We conduct a portion of our business in currencies other than the U.S. dollar, the currency in which our unaudited condensed consolidated financial statements are reported. The most significant foreign currencies that subjected us to foreign currency exchange rate risk for the three months ended March 31, 2011 were the Euro, British Pound, Japanese Yen and the Israeli Shekel. Correspondingly, our operating results could be adversely affected by foreign currency exchange rate volatility relative to the U.S. dollar. Although we continue to evaluate strategies to mitigate risks related to the effect of fluctuations in currency exchange rates, we will likely continue to recognize gains or losses from international transactions and foreign currency changes. Although foreign currency transaction gains and losses have not historically been material, we incurred $0.1 million in foreign currency transaction losses during the three months ended March 31, 2011, primarily resulting from the remeasurement process of certain of our foreign subsidiaries that maintain their books of record in a currency other than the functional currency. Future changes in foreign currency rates could adversely impact our operating results. A 10% unfavorable change in exchange rates would result in foreign currency losses of approximately $0.8 million.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Based on management s evaluation (with the participation of our chief executive officer and chief financial officer), as of the end of the period covered by this report, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the period covered by this quarterly report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. *Legal Proceedings*

We may be involved in certain legal actions and claims from time to time arising in the ordinary course of business. Historically the outcome of such litigation and claims has not had a material adverse effect on our financial condition or results of operations.

Item 1A. Risk Factors

The following sets forth risk factors that may affect our future results, including certain revisions to the risk factors included in our annual report on Form 10-K for the fiscal year ended December 31, 2010. Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. We face risks described but not limited to those detailed below. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The trading price of our common stock could decline due to any of these risks. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this quarterly report on Form 10-Q, including our financial statements and related notes.

We are dependent on sales to a relatively small number of customers and a disruption in sales to any one of these customers could materially harm our financial results.

Our business is highly dependent on a limited number of customers. For example, sales to HP accounted for 51% of our net revenue for the year ended December 31, 2009, 57% of our net revenue for the year ended December 31, 2010 and 76% of our net revenue for the three months ended March 31, 2011. We expect HP will represent greater than 10% of our overall net revenue for the year ending December 31, 2011. If our relationships with HP or certain of our other customers were disrupted or declined significantly, we would lose a substantial portion of our anticipated net revenue and our business could be materially harmed. We cannot guarantee that our relationship with HP or our other customers will expand or not otherwise be disrupted.

In the fourth quarter of 2010, we decided to exit our low margin business with NetApp and amended our agreement with NetApp to allow them to manufacture and sell on a royalty-free basis all of the products we previously manufactured and sold to them beginning on or about December 1, 2010. As a result, we currently do not anticipate generating any additional revenue from NetApp. Over time, we expect to generate additional revenue from our indirect channel sales, from sales of our AssuredUVS and AssuredVRA products and from potential new OEM customers to eventually replace the revenue, and more importantly, the gross profit lost as a result of amending our agreement with NetApp. However, if we are unable to generate sufficient gross profit from these sources to largely replace the gross profit previously associated with NetApp, our financial results could be harmed.

Factors that could influence our relationship with our significant customers and other potential new customers include:

- our ability to maintain our products at prices that are competitive with those of our competitors;
- our ability to maintain quality levels for our products sufficient to meet the expectations of our customers;
- our ability to produce, ship and deliver a sufficient quantity of our products in a timely manner to meet the needs of our customers;
- our ability to continue to develop and launch new products that our customers feel meet their needs and requirements, with respect to cost, timeliness, features, performance and other factors;
- our ability to provide timely, responsive and accurate customer support to our customers;
- the ability of our customers to effectively deliver, market and increase sales of their own solutions based on our products; and
- management changes and re-organizations.

Product recalls, epidemic failures, post-manufacture repairs of our products, liability claims and associated costs could harm our reputation, divert resources, reduce sales and increase costs and could have a material adverse effect on our financial condition.

Our new integrated storage systems and newly acquired products obtained in the Cloverleaf acquisition, as well as our legacy products, may contain undetected errors, or failures that become epidemic failures, which may be discovered after shipment, resulting in a loss of net revenue, an increase in costs to rework or replace failed products, product liability claims, a tarnished reputation, a loss of customers, or a loss or delay in market acceptance of our products, any of which could harm or disrupt our business. Product failures or recalls could be the result of components purchased from our suppliers not meeting the required specifications or containing undetected quality errors and manufacturing defects or from our own design deficiencies. Beginning in the fourth quarter of 2009, we experienced quality issues associated with certain power supply devices provided by one of our component suppliers that required us to make substantial repairs. Our component supplier has agreed to reimburse us for the majority of costs of the replacement parts and related expenses. Although our component supplier has reimbursed us or committed to reimburse us for the majority of all of our costs incurred through March 31, 2011, there could be significant additional costs passed onto us by our customers. To the extent that our customers provide us with claims for reimbursement for product quality issues caused by this component supplier, we believe that our component supplier is contractually obligated to reimburse us for any such costs. In the event that we cannot recover such costs from our component supplier, we believe our insurance policies would provide us with sufficient coverage for reimbursement. An estimate as to the possible amount of claims or range of claims that our customers may present to us related to these product quality issues cannot be made as of March 31, 2011. To the extent that our component supplier cannot or does not continue to reimburse us for the majority of all expenses incurred by us or our customers, and we are unsuccessful in recovering such expenses from our insurance provider, we could incur material amounts of warranty claims and expenses.

Even if the errors are detected before shipment, such errors could result in the halting of production, delay of shipments, recovery costs, loss of goodwill, tarnishment of reputation and/or a substantial decrease in net revenue. Our standard warranty provides that if our systems do not function to published specifications, we will repair or replace the defective component or system without charge generally for a period of approximately three years. We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are intended to be covered by corresponding supplier warranties. There can be no assurance that our suppliers will continue to provide such warranties to us in the future or that our warranty obligations to our customers will be covered by corresponding warranties from our suppliers, which could have a material adverse effect on our operating results and financial condition. Significant warranty costs could decrease our gross margin and negatively impact our business, financial condition and results of operations. In addition, defects in our products could result in our customers claiming property damages, consequential damages, or bodily injury, which could also result in our loss of customers and goodwill. There can be no assurance that our customers will not assert claims that our products have failed to meet agreed-to specifications or that they have sustained injuries from our products, and we may be subject to lawsuits relating to these claims. There is a risk that these claims or liabilities may exceed, or fall outside of the scope of our insurance coverage. Significant claims exceeding our expected warranty provisions could distract management s attention from operating our business and, if successful, result in material claims against us that might not be covered by our insurance.

Our recent acquisition of Cloverleaf may not be successfully integrated or produce the results we anticipate.

In January 2010, we acquired Cloverleaf, a privately held software company, based primarily in Israel. The Cloverleaf acquisition provided us with a new team of software development and other professionals. Cloverleaf s products provide heterogeneous storage virtualization and unified storage technologies that can simplify data center management, eliminate downtime and reduce storage costs. The Cloverleaf Intelligent Storage Networking System iSN trade name is an intelligent, network resident, storage network management system that provides a combination of benefits, features and capabilities targeted to meet the demands of mid to large-sized data centers. We refer to the products that are based on the Cloverleaf Intelligent Storage Networking System as AssuredUVS. Cloverleaf

Table of Contents

was our first acquisition involving significant international operations. The integration of Cloverleaf s operations with our own continues to be a complex, time-consuming and costly process involving typical acquisition risks and related challenges, some of which are discussed below:

- operating as a larger combined company with operations in Israel, where we have limited operational experience;
- managing geographically dispersed personnel with diverse cultural backgrounds and organizational structures;
- the greater cash management, exchange rate, legal and income taxation risks associated with the combined company s new multinational character and the movement of cash between Dot Hill and its domestic and foreign subsidiaries;
- assessing and maintaining the combined company s internal control over financial reporting and disclosure controls and procedures as required by U.S. securities laws;
- potential incompatibility of business cultures and/or loss of key personnel;
- difficulties in integrating the personnel, operations, technology or products and service offerings of Cloverleaf;
- products derived from this acquisition may not meet the feature and functionality needs of customers or their expectations with respect to reliability;
- insufficient net revenue to offset increased expenses associated with the Cloverleaf acquisition;
- the costs and effects of the purchase accounting associated with this acquisition;
- the possibility that we may incur unanticipated expenses in connection with this transaction or be required to expend material sums on potential contingent intellectual property, tax, environmental or other liabilities associated with Cloverleaf s prior operations or facilities;
- increased difficulty in financial forecasting due to our limited familiarity with Cloverleaf s operations, customers and markets or their impact on the overall results of operations of the combined company;
- our ability to sell and support installations of the acquired Cloverleaf products;
- market and customer receptivity to the acquired Cloverleaf products; and
- the ability of our open storage partners to sell and support the acquired Cloverleaf products.

In addition, the accounting treatment for the Cloverleaf acquisition resulted in significant amortizable intangible assets, which when amortized negatively affects our consolidated results of operations. The accounting treatment for the Cloverleaf acquisition also resulted in significant goodwill, which, if impaired, will negatively affect our consolidated results of operations.

Failure to successfully address one or more of the above risks may result in unanticipated liabilities and cash outlays, lower than expected net revenue, losses from operations, failure to realize any of the expected benefits of the acquisition, and potentially related declines in our stock price.

Our inability to grow and manage our indirect sales channel may significantly impact our ability to increase net revenue, gross margin and operating income.

We have recently expanded our indirect sales model to access end-user markets primarily through our distributors, VARs and OSPs and are investing significant monetary and human resources in order to grow this indirect sales channel. If we cannot successfully identify, manage, develop, and generate sufficient net revenue through our indirect sales channel, our business could be harmed. In addition, even if we are able to grow our indirect sales channel, managing the interaction of our OEMs , distributors , VARs and OSPs efforts to reach various potential customer segments for our products and services is a complex process. Moreover, since each channel method has distinct risks and gross margins, our failure to implement the most advantageous balance in the delivery model for our products and services could adversely affect our net revenue and gross margin and our profitability.

Recent turmoil in the global economy, credit markets and the financial services industry may negatively impact our net revenue, access to capital, our customers access to capital and ability to pay for their purchases in a timely manner, and our suppliers access to capital and ability to provide us with goods and timely delivery, or willingness to provide credit terms to us.

The current global economic condition could continue to affect the demand for our products and negatively impact our net revenue and operating profit. We are unable to predict changes in general macroeconomic conditions and when, or if, global IT spending rates will be affected and to what degree they will be impacted. Furthermore, even if IT spending rates increase, we cannot be certain that the market for external storage solutions will be positively impacted. If there are future reductions in either domestic or international IT spending rates, or if IT spending rates do not increase, our net revenue, operating results and financial condition may be adversely affected. In addition, the global economic condition could also adversely impact our customers, and/or their customers, ability to finance the purchase of storage systems from us or our suppliers ability to provide us with product, any of which may negatively impact our business, financial condition and results of operations.

Our smaller customers may not be as well capitalized as, nor do they have the financial resources of, our larger customers. In addition, sales to all our customers are typically made on credit without collateral. There is a risk that customers will not pay, or that payment may be delayed, because of their liquidity constraints, or because they are awaiting payment from their customers, or other factors beyond our control, which could increase our exposure to losses from bad debts, or increase accounts receivable, and thus reduce cash.

Table of Contents

Our third-party manufacturers rely on other third parties to supply key components of our storage products. Some of these components are available only from one or limited sources in the quantities and quality we require. Should any of the component suppliers cease to operate due to current economic conditions or otherwise, we would have to qualify and locate alternative suppliers. We estimate that replacing key components we currently use in our products with those of another supplier could involve several months of hardware and software modification, which could significantly harm our ability to meet our customers orders for our products, damage our customer relationships and result in a loss of sales.

As a result of the recent earthquake and related events in Japan, we continue to assess our operations and supply chain and currently do not expect to incur significant short-term disruptions. We continue to work with suppliers and have made strategic inventory purchases to maintain an appropriate short-term supply. Of principal focus was securing supply of integrated circuits, memory and other components, which are included in many of our products. At this time we do not anticipate the situation in Japan will have a significant effect on our near-term cash flows, competitive position, financial condition or results of operations. However, we are continuing to assess the longer term impact of the recent earthquake on our operations and supply chain.

Our manufacturing suppliers provide us with credit terms that have in some cases been negotiated and documented in our manufacturing agreements. The credit terms we receive from these suppliers vary amongst our manufacturing partners but they all provide for adequate credit limits and credit terms. Should any of our manufacturing partners reduce our credit limits or shorten payment terms, due to their inability to purchase credit insurance or due to uncertainty regarding our financial position, our cash resources and working capital could be significantly impacted.

Our contracts with our customers do not include minimum purchase requirements and are not exclusive, and we cannot assure you that our relationship with these customers will not be terminated or will generate significant sales.

None of our contracts with our existing customers, including HP, contain minimum purchase commitments and our customers may cancel purchase orders at any time, cease making purchases or elect not to renew the applicable contract upon the expiration of the current term. Consequently, our customers generally order only through written purchase orders. Further, we do not expect that future contracts with customers, if any, will include any minimum purchase commitments. Changes in the timing, or volume of purchases by our major customers, could result in lower net revenue. For example, we cannot be certain that our sales to any of our customers will continue at historical levels or will reach expected levels. In addition, our existing contracts do not require our customers to purchase our products exclusively or on a preferential basis over the products of any of our competitors. Consequently, to the extent they are not sole sourced, our customers may sell the products of our competitors. The decision by any of our customers to cancel purchase orders, cease making purchases or terminate their respective contracts could cause our net revenue to decline substantially, and our business, financial condition and results of operations could be significantly harmed.

We sell on a purchase order basis, making us subject to uncertainties and variability in demand by our customers, and our component suppliers may make obsolete certain components we incorporate into our products, either of which could decrease net revenue and adversely affect our operating results.

We sell to our customers on a purchase order basis rather than pursuant to long-term contracts or contracts with minimum purchase requirements. Consequently, our sales are subject to demand variability by our customers. The level and timing of orders placed by our customers vary for a variety of reasons, including seasonal buying by end-users, the introduction of new technologies and general economic conditions. Customers submitting a purchase order may cancel, reduce or delay their orders. If we are unable to anticipate and respond to the demands of our customers, we may lose customers because we have an inadequate supply of products, or we may have excess inventory which may have to be sold in the open market at a substantial discount, if at all possible, either of which may harm our business, financial position and operating results.

In addition, there are occasions when some of our component suppliers make obsolete certain components that we incorporate into our products. In these situations we may be required to purchase such components on a last time buy basis, based on our forecasts of customer demand. If we incorrectly forecast customer demand or if our customers over or under forecast demand, we may have an inadequate supply of products, or we may have excess inventory which may have to be sold in the open market at a substantial discount, if at all possible, either of which may harm our business, financial position and operating results.

Our sales cycle varies substantially from customer to customer and future net revenue in any period may be lower than our historical net revenue or forecasts.

Our sales are difficult to forecast because the open systems storage market is rapidly evolving and our sales cycle varies substantially from customer to customer. Customer orders for our products can range in value from a few thousand dollars to over a million dollars. The length of time between initial contact with a potential customer and the sale of our product may last from 6 to 36 months. This is particularly true during times of economic slowdown and when selling products that require complex installations.

Additional factors that may extend our sales cycle, particularly orders for new products, include:

- the amount of time needed for technical evaluations by customers;

Table of Contents

- customers budget constraints and changes to customers budgets during the course of the sales cycle;
- customers internal review and testing procedures;
- our engineering work necessary to integrate a storage solution with a customer s system;
- the complexity of technical challenges that need to be overcome during the development, testing and/or qualification process for new products and/or new customers;
- meeting unique customer specifications and requirements; and
- difficulties by our customers in integrating our products and technologies into their own products.

Our net revenue is difficult for us to predict since it is directly affected by the timing of large orders. We may ship products representing a significant portion of our net revenue for a quarter during the last month of that quarter. In addition, our expense levels are based, in part, on our expectations as to future sales. As a result, if sales levels are below expectations, our operating results may be disproportionately affected. We cannot assure you that our sales will not decline in future periods.

The open systems storage market is rapidly changing and we may be unable to keep pace with or properly prepare for the effects of those changes and if we fail to develop and market new software and hardware products that meet customer requirements, our business will be harmed.

The open systems data storage market in which we operate is characterized by rapid technological change, frequent new product introductions, new interface protocol, evolving industry standards and consolidation among our competitors, suppliers and customers. Customer preferences in this market are difficult to predict and changes in those preferences and the introduction of new products by our competitors, new entrants into the open systems storage market, or us could render our existing products obsolete or uncompetitive. Our success will depend upon our ability to address the increasingly sophisticated needs of customers, to enhance existing products, and to develop and introduce on a timely basis, new competitive products, including new software and hardware, and enhancements to existing software and hardware that keep pace with technological developments and emerging industry standards. If we cannot successfully identify, manage, develop, manufacture or market product enhancements or new products, our business will be harmed. In addition, consolidation among our competitors, suppliers and customers may harm our business by increasing the resources of our competitors, reducing the number of suppliers available to us for our product components and increasing competition for customers by reducing the number of customer-purchasing decisions.

We believe that to remain competitive, we will need to continue to develop new hardware and software products, which will require a significant investment in new product development. Our competitors and new market participants may be developing alternative technologies, which may adversely affect the market acceptance of our products. If alternative technologies and interface protocols are adopted by the industry that we have not incorporated into our products, we may become uncompetitive and not have product offerings for select market segments. Even if our new products are developed on time, we may not be able to manufacture them at competitive prices or in sufficient volumes.

We may not be able to reduce expenses timely in response to any shortfalls in net revenue or gross margin.

We primarily sell to HP and thus do not need to make substantial incremental investments in sales and marketing to generate demand for our products to our largest customer. Additionally we outsource substantially all of our manufacturing to very large contract manufacturing partners in Asia. Hence, there is little incremental cost required to increase our production capacity. Furthermore, we have an adopted modular architecture to our storage systems products and consequently if our customers do not require substantial customization, we are able to launch products based on existing product platforms for new OEMs or channel partners at modest incremental expenditures.

In the past we have taken and may have to take further measures to reduce expenses if net revenue or gross margins decline and we experience greater operating losses or do not achieve profitable results. A number of factors could preclude us from successfully bringing variable costs and expenses in line with our net revenue, such as the fact that our variable expense levels are based in part on our expectations as to future sales. This limits our ability to reduce expenses quickly in response to any shortfalls in net revenue or gross margin. Consequently, if net revenue does not generate enough gross margin to cover operating expenses, our operating results may be negatively affected.

The market for storage products is intensely competitive and subject to substantial pricing pressure that may harm our net revenue, gross margin and operating results.

The storage market is intensely competitive and is characterized by rapidly changing technology. For our AssuredSAN storage hardware products, we compete primarily against independent storage system suppliers, including EMC Corp., or EMC, Hitachi Data Systems Corp., or Hitachi, Engenio Information Technologies, Inc., a subsidiary of LSI Logic Corp, or LSI., Infortrend, Xyratex Ltd., or Xyratex, NEC Corporation, and PROMISE Technology, Inc. We also compete with traditional suppliers of computer systems, including IBM, Oracle, Dell and HP, which market storage systems as well as other computer products. For our AssuredVRA products we compete primarily with LSI and Intel, and for our AssuredUVS products we compete primarily with Falconstor Software Inc., or Falconstor, Compellent, which was recently acquired by Dell, and DATACORP. Future competitors could include original design manufacturers and contract manufacturers, some of whom we partner with today.

Table of Contents

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources than we do. In addition, some of our competitors have much lower labor costs than we do. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service, more financial leverage and access to more customers than we do. Other large companies with significant resources could become direct competitors, either through acquiring a competitor or through internal efforts. Additionally, a number of public and privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. In the future, it is conceivable that we could compete with some of the original design manufacturers, one of whom is currently our manufacturing partner, as they develop expertise in chassis design and power and cooling technologies.

We could also lose current or future business to certain of our suppliers or manufacturers, some of which directly and indirectly compete with us. Currently, we leverage our supply and manufacturing relationships to provide substantially all of our products. Our suppliers and manufacturers are very familiar with the specific attributes of our products and may be able to provide our customers with similar products.

We also expect that competition will increase as a result of industry consolidation and the creation of companies with new, innovative product offerings. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our prospective customers.

Accordingly, it is possible that new competitors, or alliances among competitors, may emerge and rapidly acquire significant market share. Increased competition is likely to result in price reductions, and may reduce operating margins and create a potential loss of market share, any of which could harm our business. We believe that the principal competitive factors affecting the storage systems market include: performance, features, scalability and reliability; price; product breadth; product availability and quality; timeliness of new product introductions; interoperability; and ease of management.

We cannot assure you that we will be able to successfully incorporate these factors into our products and compete against current or future competitors or that competitive pressures we face will not harm our business. If we are unable to cost effectively develop and market products to compete with the products of competitors, our business will be materially and adversely affected. In addition, if major customers who are also competitors cease purchasing our products in order to concentrate on sales of their own products, our business will be harmed.

Additional pricing pressures are due, in part, to continuing decreases in component prices, such as those of disks, memory, semiconductors and RAID controllers. Decreases in component prices are typically passed on to customers by storage companies through a continuing decrease in the price of storage hardware systems.

Pricing pressures could also result when we cannot pass increased material costs onto our customers. For example, a significant increase in fuel prices could result in higher steel and freight costs which we may not be able to pass onto our customers.

Pricing pressures also exist from our significant customers that may attempt to change the terms, including pricing and payment terms of their agreements, with us. As our customers are pressured to reduce prices as a result of competitive factors, we may be required to contractually, or otherwise, commit to price reductions for our products prior to determining if we can implement corresponding cost reductions. If we are unable to achieve such cost reductions, or are unable to pass along cost increases to our customers, and have to reduce the pricing of our products, our gross margin may be negatively impacted which could have a material adverse effect on our business, financial condition and results of operations.

Our inability to lower product costs or changes in the mix of products we sell may significantly impact our gross margin and results of operations.

Our gross margin is determined in large part based on our contract manufacturing costs, our component costs, the timing and magnitude of product cost reductions, and our ability to include RAID controllers and value added features into our products, such as DMS, as well as the prices at which we sell our products. The amount of revenue recognized from software and service sales and the relative mix of such sales in comparison to sales of our other products will also impact our gross margin, as the gross margin on sales of software and services is higher than that of our other products. If we are unable to lower production costs to be consistent with our projections or if we experience any decline in selling prices, our gross margin and results of operations may suffer. Some of the new products we are currently shipping or expect to begin shipping are in the early stages of their lifecycle. Our historical experience indicates that gross margin on new products are low initially and increase over time as a result of maturing manufacturing processes, component cost reductions and re-engineering the products to reduce costs. If we fail to achieve these improvements, our gross margin will be negatively impacted and our business, financial condition and results of operations could be significantly harmed.

In addition, we typically plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. Our customer s forecasts have not historically demonstrated a high degree of accuracy. From time to time, in response to anticipated long lead times to obtain inventory and materials from our outside suppliers, we may order materials in advance of anticipated customer demand. This advance ordering may result in excess inventory levels or unanticipated inventory write-downs due to expected orders that fail to materialize.

Additional factors which could adversely impact gross margin dollars and gross margin percentage include:

changes in the mix of products we sell to our customers;

increased price competition;

Table of Contents

- introduction of new products by us or our competitors, including products with price performance advantages;
- our inability to reduce production or component costs;
- entry into new markets or the acquisition of new customers;
- sales discounts and marketing development funds;
- increases in material or labor costs;
- excess inventory, inventory shrinkages and losses and inventory holding charges;
- the timing of purchase price variances resulting from reductions in component costs purchased on our behalf by our contract manufacturers or owned by us in inventory versus the original cost of those components;
- increased warranty costs and costs associated with any potential future product quality and product defect issues;
- our inability to sell our higher performance products, or our software products and our services;
- component shortages which can result in expedite fees, overtime or increased use of air freight; and
- increased freight costs resulting from higher fuel prices, or from the need to expedite shipments of components to our contract manufacturers or finished goods to some of our customers and their hub locations.

Our customers may have very aggressive product launch and ramp schedules and our efforts to accommodate these schedules may divert our management s attention, cause component shortages and force us to allocate products across many customers, all of which could harm our customer relations.

Our efforts to accommodate our customers aggressive launch and ramp schedules can divert management s attention from the rest of our business and force us to allocate product volumes across many customers due to component shortages, all of which could harm our relations with customers. In addition, we could incur overtime, expedite charges, and other charges such as shipping products by air as opposed to by ocean as a result of efforts to meet such schedules. Any of these factors could result in lower net revenue and gross margin as well as increased operating expenses which could have an impact on our business, financial condition and results of operations.

Manufacturing and supplier disruptions could harm our business.

We primarily rely on Foxconn to manufacture the majority of all of our products. If our agreement with Foxconn is terminated, or if they do not perform their obligations under our agreement, or if we otherwise determine to transition manufacturing of our products to another third party manufacturer, it could take several months to establish and qualify alternative manufacturing for our products and we may not be able to fulfill our customers orders in a timely manner. If our agreement with Foxconn terminates, we cannot be certain that we will be able to identify a suitable alternative manufacturing partner that meets the requirements of our customers and one that is cost competitive. Failure to identify a suitable alternative manufacturing partner could impact our customer relationships and our financial condition.

Due to our use of third-party manufacturers, our ability to control the timing of shipments could decrease. Delayed shipment could result in the deferral or cancellation of purchases of our products. Any significant deferral or cancellation of these sales would harm our results of operations in any particular quarter. Net revenue for a period may be lower than predicted if large orders forecasted for that period are delayed or are not realized, which could also impact cash flow or result in a decline in our stock price. To the extent we establish a relationship with an alternative manufacturer for our products, we may be able to partially mitigate potential disruptions to our business. We may also suffer manufacturing disruptions as we ramp up manufacturing processes for newly introduced products, which could result in delays in delivery of these products to our customers and adversely affect our results of operations. Additionally, production of our products could be disrupted as a result of geo-political events in Asia and other manufacturing locations.

We also generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are covered by supplier warranties. For warranty costs not covered by our suppliers, we reserve for estimated warranty costs in the period the net revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future, or that we have estimated these costs correctly, which could have a material adverse effect on our business, financial condition and results of operations.

Any shortage of disk drives, memory or other components could increase our costs or harm our ability to manufacture and deliver our storage products to our customers in a timely manner.

From time to time there is significant market demand for disk drives, semiconductors, memory and other components, and we may experience component shortages, selective supply allocations and increased prices of such components. In such event, we may be required to purchase our components from alternative suppliers, and we cannot be certain that alternative sources of supplies will be available on competitive terms. Even if alternative sources of supply for critical components such as disk drives and memory become available, incorporating substitute components into our products could delay our ability to deliver our products in a timely manner.

Demand for disk drives and memory has at times surpassed supply, forcing drive, memory and component suppliers, including those who supply the components that are integrated into many of our storage products, to manage allocation of their inventory. If such a shortage were

Table of Contents

prolonged, we may be forced to pay higher prices for disk drives, memory or components or may be unable to purchase sufficient quantities of these components to meet our customers demand for our storage products in a timely manner or at all. Similar circumstances could occur with respect to other necessary components.

We may continue to experience losses in the future, and may have difficulty forecasting future operating results, which could result in revenue and earnings volatility, which could cause our stock price to decline.

For the three months ended March 31, 2011 we incurred a net loss of $1.3 million. For the year ended December 31, 2010 we incurred a net loss of $13.3 million. For the year ended December 31, 2009 we incurred a net loss of $13.6 million. We expect our business to remain volatile as we are often unable to reliably predict net revenue from HP and our other customers. Our ability to reliably predict net revenue has become more challenging as a result of our recent acquisition of Cloverleaf and the termination of our relationship with NetApp. Net revenue from our customers, the mix of products sold to our customers, our ability to introduce new products as planned and our ability to reduce product costs and manage our operating expenses and manufacturing variances will continue to affect our financial results for 2011. Consequently, we cannot assure you that we will be profitable in any future period.

Our future operating results and profitability will depend on, and could vary substantially as a result of many factors, including:

- our ability to maintain and enhance relationships with our customers, in particular our OEM customers, as well as our ability to win new business;
- our ability to implement and achieve targeted gross margin and cost reduction objectives and;
- our ability to contain operating expenses and manufacturing variances;
- our ability to meet product delivery schedules for HP and other customers which could result in increased air freight, expedite and overtime charges;
- the extent to which we invest in new initiatives such as channel sales and software development;
- our plans to maintain and enhance our engineering, research, development and product testing programs;
- the success of our manufacturing strategy and relationships with our contract manufacturing partners;
- the success of our sales and marketing efforts;
- the amount of field failures resulting in product replacements, recalls or customer penalties;
- the extent and terms of any development, marketing or other arrangements;
- changes in economic, regulatory or competitive conditions, including the current worldwide economic crisis;

increased costs associated with our Israeli operations;

costs of filing, prosecuting, defending and enforcing intellectual property rights;

costs of litigating and defending law suits; and

our ability to capitalize on new customer opportunities resulting from industry consolidation.

Our success depends significantly upon our ability to protect our intellectual property and to avoid infringing the intellectual property of third parties, which has already resulted in costly, time-consuming litigation and could result in the inability to offer certain products.

We rely primarily on patents, copyrights, trademarks, trade secrets, nondisclosure agreements and common law to protect our intellectual property. Despite our efforts to protect our intellectual property, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. In addition, the laws of foreign countries may not adequately protect our intellectual property rights. Our efforts to protect our intellectual property from third party discovery and infringement may be insufficient and third parties may independently develop technologies similar to ours, duplicate our products or design around our patents.

In addition, third parties may assert infringement claims against us, which would require us to incur substantial license fees, legal fees and other expenses, and distract management from the operations of our business.

We expect that providers of storage products will increasingly be subject to infringement claims as the number of products and competitors increase. We receive, from time to time, letters from third parties suggesting that we may require a license from such third parties to manufacture or sell our products. We evaluate all such communications to assess whether to seek a license from the patent owner. We may be required to purchase licenses that could have a material impact on our business, or, we may not be able to obtain the necessary license from a third party on commercially reasonable terms, or at all. Consequently, we could be prohibited from selling and marketing products that incorporate the protected technology or incur substantial costs to redesign our products in a manner to avoid infringement of third party intellectual property rights.

Table of Contents

Our success depends on our ability to attract and retain key personnel.

Our performance depends in significant part on our ability to attract and retain talented senior management and other key personnel. Our key personnel include Dana Kammersgard, our Chief Executive Officer and President, Hanif Jamal, our Senior Vice President, Chief Financial Officer, Treasurer and Corporate Secretary, James Kuenzel, our Senior Vice President of Engineering and Ernest Hafersat, our Senior Vice President of World-Wide Manufacturing, Operations, and Supply Base Management. If any of these individuals were to terminate his employment with us, we would be required to locate and hire a suitable replacement. In addition, if any of our additional key engineering, sales and general and administrative employees were to terminate their employment with us, our business could be harmed. Competition for attracting talented employees in the technology industry can be intense. We may be unable to identify suitable replacements for any employees that we lose. In addition, even if we are successful in locating suitable replacements, the time and cost involved in recruiting, hiring, training and integrating new employees, particularly key employees responsible for significant portions of our operations, could harm our business by delaying our production schedule, our research and development efforts, our ability to execute on our business strategy and our client development and marketing efforts.

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan included, among other things, severance and related costs for the reduction of approximately 10% of our workforce, a 10% salary reduction for all employees at or above the vice-president level and a 5% salary reduction for certain other employee groups. As of March 31, 2011, salaries have not been reinstated to their pre-2010 Plan levels. As a result of these actions, we may experience higher employee attrition rates, which would require us to locate and hire suitable replacements and could cause our business to be harmed.

Many of our customer relationships are based on personal relationships between the customer and our executives or sales representatives. If these representatives terminate their employment with us, we may be forced to expend substantial resources to attempt to retain the customers that the sales representatives serviced. Ultimately, if we were unsuccessful in retaining these customers, our net revenue would decline.

Our inability to further develop and increase sales from our AssuredVRA software may significantly impact our ability to increase net revenue, gross margin and operating income.

In September 2008, we bought certain assets from Ciprico including RAIDCore, now AssuredVRA. We have an agreement with one primary partner to market or integrate AssuredVRA into their solutions. While we restructured the agreement in the third quarter of 2010 so that the revenue generated under the agreement should exceed the costs of developing, manufacturing and marketing these products, we cannot be assured that revenue will exceed costs in the future, which could cause our financial results to be negatively impacted and could also result in an impairment of our related intangible assets.

Protective provisions in our charter and bylaws and the existence of our stockholder rights plan could prevent a takeover which could harm our stockholders.

Our certificate of incorporation and bylaws contain a number of provisions that could impede a takeover or prevent us from being acquired, including, but not limited to, a classified board of directors, the elimination of our stockholders ability to take action by written consent and limitations on the ability of our stockholders to remove a director from office without cause. Our board of directors may issue additional shares of common stock or establish one or more classes or series of preferred stock with such designations, relative voting rights, dividend rates, liquidation and other rights, preferences and limitations as determined by our board of directors without stockholder approval. In addition, we adopted a stockholder rights plan in May 2003 that is designed to impede takeover transactions that are not supported by our board of directors. Each of these charter and bylaw provisions and the stockholder rights plan gives our board of directors, acting without stockholder approval, the ability to prevent, or render more difficult or costly, the completion of a takeover transaction that our stockholders might view as being in their best interests.

Unanticipated changes in tax laws or adverse outcomes resulting from examination of our income tax returns could adversely affect our results of operations.

We are subject to income taxes in the United States and various foreign jurisdictions. Our effective income tax rates have recently been and could in the future be adversely affected by changes in tax laws or interpretations of those tax laws, by changes in the mix of earnings in countries with differing statutory tax rates, by discovery of new information in the course of our tax return preparation process, or by changes in the valuation of our deferred tax assets and liabilities. Our effective income tax rates are also affected by intercompany transactions for licenses, services, funding and other items. Additionally, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities which may result in the assessment of additional income taxes. We regularly assess the likelihood of adverse outcomes resulting from these examinations. However, there can be no assurance that the outcomes from these examinations will not have a material adverse effect on our business, financial condition and results of operations.

The exercise of outstanding stock options and warrants may result in dilution to our stockholders.

We have a large number of outstanding stock options and warrants. Dilution of the per share value of our common stock could result from the exercise of outstanding stock options and warrants. When the exercise price of outstanding stock options and warrants is less than the trading price of our common stock, the exercise of such stock options and warrants would have a dilutive effect on our stockholders. The possibility of the issuance of shares of our common stock upon exercise of stock options and warrants could cause the trading price of our common stock to decline.

Table of Contents

Furthermore, it is also possible that future large customers or suppliers may make our relationship with them contingent on receiving warrants to purchase shares of our common stock. The impact of potentially issuing additional warrants could have a dilutive effect on our stockholders.

Our stock price may be highly volatile and could decline substantially and unexpectedly, which can and has in some cases resulted in litigation.

The market price of our common stock has fluctuated substantially, and there can be no assurance that such volatility will not continue. Several factors could impact our stock price including, but not limited to:

- differences between our actual operating results and the published expectations of analysts;
- quarterly fluctuations in our operating results;
- mergers and acquisitions in the data storage marketplace;
- introduction of new products or changes in product pricing policies by our competitors or us;
- conditions in the markets in which we operate;
- changes in market projections by industry forecasters;
- changes in estimates of our earnings by us or industry analysts;
- overall market conditions for high technology equities;
- rumors or dissemination of false information; and
- general economic and geopolitical conditions.

It is often the case that securities class action litigation is brought against a company following periods of volatility in the market price of its securities. Securities litigation could result in the expenditure of substantial funds, divert management s attention and resources, harm our reputation in the industry and the securities markets and reduce our profitability.

Future sales of our common stock may hurt our market price.

A significant portion of our common stock is owned by a few institutional stockholders. As a result, a substantial number of shares of our common stock may become available for resale. If these or other of our stockholders sell substantial amounts of our common stock in the public market, the market price of our common stock could decline. These sales might also make it more difficult for us to sell equity securities in the future at times and prices that we deem appropriate.

Our system of internal controls may be inadequate.

We maintain a system of internal controls in order to ensure we are able to collect, process, summarize, and disclose the information required by the Securities and Exchange Commission within the time periods specified. 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. Due to 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. Additionally, public companies in the United States are required to review their internal controls under the Sarbanes-Oxley Act of 2002. If the internal controls put in place by us are not adequate or fail to perform as anticipated, errors could occur that would not be detected, which could require us to restate our consolidated financial statements, receive an adverse audit opinion on the effectiveness of our internal controls, and/or take other actions that will divert significant financial and managerial resources, as well as be subject to fines and/or other government enforcement actions. Furthermore, the price of our stock could be adversely affected.

Environmental compliance costs could adversely affect our results of operations.

Many of our products are subject to various laws governing chemical substances in products, including those regulating the manufacture and distribution of chemical substances and those restricting the presence of certain substances in electronic products. We could incur substantial costs, or our products could be restricted from entering certain countries, if our products become non-compliant with environmental laws.

We face increasing complexity in our product design and procurement operations as we adjust to new and future requirements relating to the materials composition of our products, including the restrictions on lead and certain other substances that apply to specified electronic products put on the market in the European Union as of July 1, 2006 (Restriction of Hazardous Substances Directive, or RoHS). We design our products to ensure that they comply with these requirements as well as related requirements imposed by our customers. We are also working with our suppliers to provide us with compliant materials, parts and components. If our products do not comply with the European substance restrictions, we could become subject to fines, civil or criminal sanctions, and contract damage claims. In addition, we could be prohibited from shipping non-compliant products into the European Union, and required to recall and replace any products already shipped, if such products were found to be non-compliant, which would disrupt our ability to ship products and result in reduced net revenue, increased obsolete or

Table of Contents

excess inventories and harm to our business and customer relationships. Various other countries and states in the United States have issued, or are in the process of issuing, other environmental regulations that may impose additional restrictions or obligations and require further changes to our products. These regulations could impose a significant cost of doing business in those countries and states.

The European Union has enacted 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. Similar legislation has been or may be enacted in other jurisdictions, including in the United States, Canada, Mexico, China and Japan, the cumulative impact of which could be significant.

Item 6. Exhibits

The following exhibits are included as part of this quarterly report on Form 10-Q:

2.1	Agreement and Plan of Merger and Reorganization dated as of January 4, 2010, among Dot Hill Systems Corp., Telluride Acquisition Sub, Inc., Cloverleaf Communications Inc., Cloverleaf Communications (Israel) Ltd., Cloverleaf Communications Corporation (BVI) and E. Shalev Management 2000 (1999) Ltd. (1)
3.1	Certificate of Incorporation of Dot Hill Systems Corp. (2)
3.2	Amended and Restated Bylaws of Dot Hill Systems Corp. (3)
4.1	Certificate of Incorporation of Dot Hill Systems Corp. (2)
4.2	Amended and Restated Bylaws of Dot Hill Systems Corp. (3)
4.3	Form of Common Stock Certificate. (4)
4.4	Certificate of Designation of Series A Junior Participating Preferred Stock, as filed with the Secretary of State of Delaware on May 19, 2003. (5)
4.5	Form of Rights Certificate. (5)
4.6	Warrant to Purchase Shares of Common Stock dated January 4, 2008. (6)
10.1	Second Amendment to Loan and Security Agreement dated February 3, 2011 by and between Dot Hill Systems Corp. and Silicon Valley Bank.(7)
10.2	Israeli Appendix to the Amended and Restated 2000 Employee Stock Purchase Plan.(8)
31.1	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 5, 2010 and incorporated herein by reference.
(2) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on September 19, 2001 and incorporated herein by reference.
(3) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 26, 2007 and incorporated herein by reference.
(4) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 14, 2003 and incorporated herein by reference.
(5) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on May 19, 2003 and incorporated herein by reference.
(6) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 7, 2008 and incorporated herein by reference.
(7) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on February 7, 2011 and incorporated herein by reference.
(8) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2010 and incorporated herein by reference.
Dot Hill s Current Reports on Form 8-K have a Commission File Number of 001-13317.

Table of Contents

SIGNATURES

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

Dot Hill Systems Corp.

Date: May 6, 2011

By: /s/ DANA W. KAMMERSGARD
Dana W. Kammersgard
Chief Executive Officer, President and Director
(Principal Executive Officer)

Date: May 6, 2011

By: /s/ HANIF I. JAMAL
Hanif I. Jamal
Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

31