DOT HILL SYSTEMS CORP
Form 10-Q
August 12, 2010
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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 June 30, 2010

OR

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

For the transition period from ______ to ______

Commission file number 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 54,963,008 shares of common stock, $0.001 par value, outstanding as of July 31, 2010.

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DOT HILL SYSTEMS CORP.

FORM 10-Q

For the Quarter Ended June 30, 2010

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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, 2009	June 30, 2010
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 57,574	$ 42,636
Accounts receivable, net	34,197	35,524
Inventories	4,333	7,727
Prepaid expenses and other assets	5,314	5,957
Total current assets	101,418	91,844
Property and equipment, net	3,616	3,934
Intangible assets, net	3,029	8,624
Goodwill		4,140
Other assets	217	443
Total assets	$ 108,280	$ 108,985
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 28,411	$ 28,124
Accrued compensation	3,602	3,586
Accrued expenses	4,220	4,474
Deferred revenue	1,217	1,675
Restructuring accrual	1,697	2,429
Bank borrowings and current portion of long-term note payable	261	3,068
Total current liabilities	39,408	43,356
Long-term note payable	346	210
Other long-term liabilities	2,175	1,463
Total liabilities	41,929	45,029
Commitments and Contingencies (Note 11)		
Stockholders Equity:		
Preferred stock, $.001 par value, 10,000 shares authorized, no shares issued and outstanding at December 31, 2009 and June 30, 2010		
Common stock, $.001 par value, 100,000 shares authorized, 48,952 and 54,907 shares issued and outstanding at December 31, 2009 and June 30, 2010, respectively	49	55
Additional paid-in capital	303,841	313,740

Accumulated other comprehensive loss	(3,439)	(3,478)
Accumulated deficit	(234,100)	(246,361)
Total stockholders equity	66,351	63,956
Total liabilities and stockholders equity	$ 108,280	$ 108,985

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE LOSS

(In thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2010**	**2009**	**2010**
NET REVENUE	$ 54,328	$ 65,493	$ 108,217	$ 125,467
COST OF GOODS SOLD	46,358	55,824	90,986	107,673
GROSS PROFIT	7,970	9,669	17,231	17,794
OPERATING EXPENSES:				
Research and development	6,934	8,447	14,086	16,220
Sales and marketing	2,519	3,379	5,085	6,740
General and administrative	2,473	2,225	5,242	5,301
Restructuring charge	326	1,413	411	1,702
Total operating expenses	12,252	15,464	24,824	29,963
OPERATING LOSS	(4,282)	(5,795)	(7,593)	(12,169)
OTHER INCOME:				
Interest income, net	42	4	115	7
Other (income) expenses, net	13	(8)	(7)	(15)
Total other income (expense), net	55	(4)	108	(8)
LOSS BEFORE INCOME TAXES	(4,227)	(5,799)	(7,485)	(12,177)
INCOME TAX EXPENSE	(39)	35	(6)	84
NET LOSS	$ (4,188)	$ (5,834)	$ (7,479)	$ (12,261)
NET LOSS PER SHARE:				
Basic and diluted	$ (0.09)	$ (0.11)	$ (0.16)	$ (0.23)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:				
Basic and diluted	46,952	53,246	46,836	52,397
COMPREHENSIVE LOSS:				
Net loss	$ (4,188)	$ (5,834)	$ (7,479)	$ (12,261)
Foreign currency translation adjustment	(36)	(46)	90	(39)

Comprehensive loss	$ (4,224)	$ (5,880)	$ (7,389)	$ (12,300)

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2010
Cash Flows From Operating Activities:		
Net loss	$ (7,479)	$ (12,261)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,437	1,999
Provision for bad debt reserve	264	
Adjustment to contingent consideration		(285)
Stock-based compensation expense	1,553	1,763
Changes in operating assets and liabilities:		
Accounts receivable	11,216	(1,147)
Inventories	4,410	(3,327)
Prepaid expenses and other assets	545	(809)
Accounts payable	(9,268)	(875)
Accrued compensation and other expenses	(903)	(1,698)
Deferred revenue	(68)	458
Restructuring accrual	(193)	732
Other long-term liabilities	(351)	(459)
Net cash provided by (used in) operating activities	1,163	(15,909)
Cash Flows From Investing Activities:		
Acquisition, net of cash acquired		(625)
Purchases of property and equipment	(1,078)	(655)
Net cash used in investing activities	(1,078)	(1,280)
Cash Flows From Financing Activities:		
Principal payment of note and loan payable	(123)	(904)
Proceeds from bank borrowings		2,800
Proceeds from sale of stock to employees, exercise of stock options and other	277	334
Net cash provided by financing activities	154	2,230
Effect of Exchange Rate Changes on Cash and Cash Equivalents	(15)	21
Net Increase (Decrease) in Cash and Cash Equivalents	224	(14,938)
Cash and Cash Equivalents, beginning of period	56,850	57,574
Cash and Cash Equivalents, end of period	$ 57,074	$ 42,636
Supplemental Disclosures of Non-Cash Investing and Financing Activities:		
Common stock issued in connection with acquisition	$	$ 8,132
Capital assets acquired but not paid	$ 281	$ 249

See accompanying notes to unaudited condensed consolidated financial statements.

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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, except for revisions made to our accrued restructuring liability) 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, 2009. Operating results for the three and six months ended June 30, 2010 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2010.

Use of Accounting Estimates

The preparation of our 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

A majority of our net revenue is derived from a limited number of customers. We currently have two customers that each account for more than 10% of our total net revenue: Hewlett Packard, or HP; and NetApp, Inc., or NetApp. 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.

We have experienced a decline in net revenue from Sun Microsystems, or Sun, primarily due to the products reaching the end of their lifecycle. We do not expect to generate significant net revenue from Sun in future periods.

A small number of customers account for a significant percentage of our net revenue. Net revenue by major customer is as follows (as a percentage of total net revenue):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2009	**2010**	**2009**	**2010**
Sun	5%	0%	9%	0%
HP	51%	58%	47%	54%
NetApp	24%	27%	24%	29%
Other customers less than 10%	20%	15%	20%	17%
Total	100%	100%	100%	100%

Recent Accounting Pronouncements

In October 2009, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update or ASU No. 2009-13, *Multiple-Deliverable Revenue Arrangements*, or ASU 2009-13. The new standard changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable based on the relative selling price. The selling price for each deliverable is based on vendor-specific objective evidence, or VSOE, if available, third-party evidence, or TPE, if VSOE is not available, or estimated selling price, or ESP, if neither VSOE nor TPE is available.

Concurrently to issuing ASU 2009-13, the FASB also issued ASU No. 2009-14, Certain Revenue Arrangements That Include Software Elements , or ASU 2009-14. ASU 2009-14 excludes software that is contained on a tangible product from the scope of software revenue guidance if the software is essential to the tangible product s functionality.

We early adopted the provisions of ASU 2009-13 and ASU 2009-14 as of the beginning of fiscal 2010 for new and materially modified deals originating after January 1, 2010. The adoption of these provisions did not materially affect the results of operations for the three and six months ended June 30, 2010 and would not have materially impacted previously reported results had the adoption been applied retrospectively. We are not able to reasonably estimate the effect of adopting these standards on future financial periods as the impact will vary based on the nature and volume of new or materially modified revenue transactions in any given period.

In March 2010, the FASB ratified a consensus of the FASB Emerging Issues Task Force that recognizes the milestone method as an acceptable revenue recognition method for substantive milestones in research or development arrangements. This consensus would require its provisions be met in order for an entity to recognize consideration that is contingent upon achievement of a substantive milestone as revenue in its entirety in the period in which the milestone is achieved. In addition, this consensus would require disclosure of certain information with respect to arrangements that contain milestones. This authoritative guidance is effective for interim and annual reporting periods on or after June 15, 2010 and will be effective for Dot Hill in the third quarter of fiscal 2010. Dot Hill is evaluating the potential impact of the implementation of this authoritative guidance on its 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 and six months ended June 30, 2009 or 2010 because we incurred a net loss in each of these periods and the effect of inclusion would have been anti-dilutive.

As of June 30, 2009, options to purchase 6,266,395 shares of common stock with exercise prices ranging from $0.47 to $16.36 per share, 1,433,728 shares of unvested restricted stock awards, and a warrant to purchase 1,602,489 shares of common stock at a price of $2.40 per share, were outstanding, but were not included in the calculation of diluted net loss per share because their effect was anti-dilutive.

As of June 30, 2010 options to purchase 6,805,743 shares of common stock with exercise prices ranging from $0.47 to $16.36 per share, 1,645,920 shares of unvested restricted stock awards, and a warrant to purchase 1,602,489 shares of common stock at a price of $2.40 per share, were outstanding, but were not included in the calculation of diluted net loss per share because their effect was anti-dilutive.

3. Inventories

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

	December 31, 2009	June 30, 2010
Purchased parts and materials	$ 2,095	$ 7,089
Finished goods	2,238	638
Total inventory	$ 4,333	$ 7,727

4. Business Combinations

On January 26, 2010, or the acquisition date, Dot Hill acquired 100% of the voting equity interests of Cloverleaf Communications Inc., a Delaware corporation, or Cloverleaf. Prior to the acquisition, Cloverleaf was a privately held software company focused on heterogeneous storage virtualization and unified storage technologies. Following the acquisition, Dot Hill changed its operating segment reporting structure and Cloverleaf joined Dot Hill s Standalone Storage Software business segment, augmenting its existing software offering portfolio of products. The acquisition of Cloverleaf is intended to broaden Dot Hill s market opportunities and help accelerate Dot Hill s transition from a provider of storage arrays to a provider of storage solutions and software. The Cloverleaf acquisition also provided Dot Hill with a new team of software developers and other professionals located in Israel.

Dot Hill acquired all of the outstanding equity interests in Cloverleaf in exchange for (i) $0.7 million of cash, (ii) 4,758,530 shares of Dot Hill common stock valued at $8.1 million, or $1.71 per share, which represents the closing price of Dot Hill common stock on the acquisition date, or January 26, 2010, (iii) $1.8 million of specified assumed outstanding liabilities of Cloverleaf at the acquisition date, and (iv) 327,977 shares of restricted common stock that were issued to the employees of Cloverleaf who became employees of Dot Hill on the acquisition date pursuant to Dot Hill s 2009 Equity Incentive Plan.

Dot Hill also incurred estimated direct transaction costs in connection with the acquisition of approximately $0.8 million, of which $0.5 million was recognized as expense in the fourth quarter of 2009 and $0.3 million was recognized as expense in the first quarter of 2010. Dot Hill has recorded these costs as general and administrative expenses in its statement of operations. The majority of these costs were paid in the first quarter of 2010. Equity issuance costs incurred in connection with the transaction were not material.

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Dot Hill did not assume or exchange any Cloverleaf stock options or other stock-based payment awards in connection with the acquisition of Cloverleaf. Under the terms of the Merger Agreement, all Cloverleaf stock options and warrants that were outstanding immediately prior to the acquisition date and not exercised prior to the acquisition date expired and became null and void as of the acquisition date. All outstanding options expired and had no fair value. In connection with the employment of certain Cloverleaf employees, Dot Hill granted 327,977 shares of restricted common stock. The fair value of the 327,977 shares of restricted common stock that were issued on the acquisition date will be recognized as compensation cost in the post-combination financial statements over the period in which the shares of restricted common stock vest. These shares vest as follows: one-third of such shares vest upon issuance; one-third of such shares vest one year from the date of issuance; and one-third of such shares vest two years from the date of issuance.

The consideration transferred in connection with the acquisition of Cloverleaf approximates $8.8 million as follows (in thousands):

Cash consideration	$ 703
Dot Hill common stock issued to Cloverleaf	8,132
Consideration transferred	$ 8,835

The acquisition of Cloverleaf has been accounted for under the purchase method of accounting in accordance with the requirements of Accounting Standard Codification topic 805 Business Combinations . Under the purchase method of accounting, the purchase price is allocated to the assets acquired and liabilities assumed based on their estimated fair values.

The allocation of the purchase price has been prepared based on preliminary estimates of fair values and is currently incomplete primarily due to certain potential tax and warranty liabilities of Cloverleaf that may have existed prior to the date of the acquisition. Dot Hill is currently in the process of quantifying such amounts, if any, and has not recorded any possible tax or other liabilities as of June 30, 2010. Therefore, actual amounts recorded upon the finalization of certain potential tax liabilities may differ materially from the information presented in this quarterly report on Form 10-Q.

The preliminary allocation of the acquisition date fair value of the total consideration transferred in connection with the acquisition of Cloverleaf is summarized below (in thousands):

Cash	$ 78
Accounts receivable	55
Inventory	67
Other current assets	37
Property and equipment	452
Other non-current assets	23
Amortizable intangible assets:	
Acquired software	6,375
Trade name	181
Goodwill	4,140
Accounts payable	(269)
Current maturities of long-term loan	(775)
Accrued compensation	(401)
Accrued expenses	(172)
Accrued Cloverleaf transaction costs	(924)
Other non-current liabilities	(32)
	$ 8,835

The acquired software consists of 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. Dot Hill expects to amortize the fair value of the acquired software and the trade name on a straight-line basis over a period of seven years and five years, respectively, which management believes to reasonably reflect the pattern over which the economic benefits are being derived.

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The goodwill of $4.1 million arising from the Cloverleaf acquisition consists largely of expected synergies in the research and development and sales and marketing areas as a result of combining the operations of Dot Hill and Cloverleaf. In addition, approximately $0.9 million of the goodwill acquired relates to intangible assets that do not qualify for separate recognition. None of the goodwill is expected to be deductible for income tax purposes. All of the goodwill arising from the acquisition of Cloverleaf has been assigned to our Standalone Storage Software operating segment and to the Israel operating reporting unit.

In accordance with the requirements of Accounting Standard Codification topic 305 Intangibles - Goodwill and Other , goodwill will not be amortized but instead will be tested for impairment at least annually, or more frequently if indicators of impairment are present. In the event that Dot Hill management determines that the goodwill has become impaired, Dot Hill will incur a charge for the amount of impairment during the period in which the determination is made.

Revenue of $0.3 million and a net loss of $2.7 million attributable to the operations of Cloverleaf since the acquisition date are included in our consolidated results of operations for the six months ended June 30, 2010. The $2.7 million net loss includes $0.1 million of non-recurring restructuring costs and $0.3 million of stock-based compensation expense

Pro forma results

The following unaudited pro forma financial information presents the combined results of operations of Dot Hill and Cloverleaf as if the acquisition had occurred on January 1, 2009 and January 1, 2010 and excludes certain non-recurring charges related to the acquisition. The unaudited pro forma financial information is not intended to represent or be indicative of the consolidated results of operations or financial condition of Dot Hill that would have been reported had the acquisition been completed as of the dates presented, and should not be taken as representative of the future consolidated results of operations or financial condition of Dot Hill.

	Six Months Ended	
(in thousands, except per share data)	**June 30, 2009**	**June 30, 2010**
Net revenue	$ 109,156	$ 125,544
Net loss	$ (10,840)	$ (12,247)
Basic and diluted net loss per share	$ (0.21)	$ (0.23)

5. 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 and bank borrowings approximate their fair values due to their short maturities. The carrying value on our balance sheet of our notes payable approximates its fair value as our credit-adjusted interest rate continues to represent a market participant rate. Payments under the note are due in equal monthly installments over a 42 month period and commenced in October 2008 and end in March 2012. We have therefore excluded these financial instruments from the table below.

The carrying amounts and fair values of certain other long-term liabilities as of December 31, 2009 and June 30, 2010 were as follows (in thousands):

	December 31, 2009		June 30, 2010	
	Carrying Value	**Fair Value (Level 2)**	**Carrying Value**	**Fair Value (Level 2)**
Liabilities:				
Ciprico contingent consideration	$ 421	$ 390	$ 126	$ 131

We estimated the fair value of Ciprico contingent consideration using a discounted cash flows approach and incorporated our credit risk for the liability measurement. The current portion of the Ciprico contingent consideration is classified within accrued expenses and the non-current portion is classified within Other long-term liabilities on our consolidated balance sheets.

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6. Intangible Assets

Identifiable intangible assets are as follows (in thousands):

	December 31, 2009			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
RaidCore technology	4 years	$ 4,256	$ (1,350)	$ 2,906
NAS technology	3 years	214	(91)	123
Total intangible assets		$ 4,470	$ (1,441)	$ 3,029

	June 30, 2010			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
RaidCore technology	4 years	$ 4,256	$ (1,883)	$ 2,373
NAS technology	3 years	214	(127)	87
Software	5 years	6,375	(378)	5,997
Trade name	7 years	181	(14)	167
Total intangible assets		$ 11,026	$ (2,402)	$ 8,624

Amortization expense related to intangible assets totaled $0.3 million, $0.6 million, $0.6 million and $1.0 million for the three and six months ended June 30, 2009 and 2010, respectively.

Estimated future amortization expense related to intangible assets as of June 30, 2010 is as follows (in thousands):

2010 (Remaining 6 months)	$ 1,043
2011	2,063
2012	1,724
2013	947
2014	947
Thereafter	1,900
Total	$ 8,624

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7. Goodwill

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

	Storage Systems	Standalone Storage Software	Total
Balance as of January 1, 2010			
Goodwill	$ 40,700	$	$ 40,700
Accumulated impairment losses	(40,700)		(40,700)
Goodwill acquired during the six months ended June 30, 2010		4,140	4,140
Impairment losses			
Balance as of June 30, 2010			
Goodwill	40,700	4,140	44,840
Accumulated impairment losses	(40,700)		(40,700)
	$	$ 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 June 30, 2010.

8. Product Warranties Activity

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, which could have a material adverse effect on our operating results and financial condition.

In the first half of 2010, we experienced quality issues associated with certain components provided by one of our suppliers that required us to make substantial repairs. Our supplier has agreed to reimburse us for the costs of the replacement parts and related damages. However, the magnitude of potential damages is currently unknown and to the extent that our supplier cannot or does not continue to reimburse us for any and all damages incurred by us or our customers we could incur material amounts of warranty claims and expenses.

Estimated liabilities for product warranties are included in accrued expenses. Our warranty cost activity is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
Balance, beginning of period	$ 1,425	$ 1,056	$ 1,560	$ 993
Charged to operations	323	704	876	1,529
Deductions for costs incurred	(579)	(527)	(1,267)	(1,289)
Balance, end of period	$ 1,169	$ 1,233	$ 1,169	$ 1,233

9. Restructuring Charge

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 has been recognized since the plan inception through June 30, 2010. Accrued severance-related costs are recorded in the restructuring accrual line on our consolidated balance sheets. With the exception of future minimum lease payments relating to the Carlsbad, California facility, we anticipate the remainder of the restructuring costs will be paid out during the third quarter of 2010.

As part of the 2008 Plan, we also incurred contract termination costs of $2.8 million since the plan inception through June 30, 2010. In the second quarter of 2010, we incurred additional contract termination costs of $0.8 million for facility lease costs that we continue to incur without economic benefit, as we exited an additional portion of our Carlsbad facility and revised our assumptions

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regarding the timing and amount of tenant sublease income. We have recorded charges for contract termination costs as restructuring expense, which is presented as a separate component within operating expenses. Accrued contract termination costs are recorded in the restructuring accrual line on our consolidated balance sheets. We expect to pay the majority of these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our revised estimates, we expect we will receive sublease income of approximately $0.9 million beginning in the first 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 up to the $0.9 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):

2008 Plan

	Severance and Related Costs	Contract Termination and Other Associated Costs	Total
Accrued restructuring balance as of 12/31/09	$ 439	$ 1,258	$ 1,697
2008 restructuring plan charges	233	860	1,093
Cash payments	(295)	(517)	(812)
Accrued restructuring balance as of 6/30/10	$ 377	$ 1,601	$ 1,978

Also 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 27 employees located in the United States. We expect to incur approximately $0.4 million in severance-related costs, the majority of which was recognized in the second quarter of 2010. Accrued severance-related costs are recorded in the restructuring accrual line on our consolidated balance sheets. With the exception of future minimum lease payments relating to the Carlsbad, California facility, we anticipate the remainder of the restructuring costs will be paid out during the third and fourth quarters of 2010.

As part of the 2010 Plan, we also incurred contract termination costs of $0.2 million in the second quarter of 2010 for facility lease costs that we continue to incur without economic benefit, as we exited the remaining portion of our Carlsbad, California facility. We have recorded charges for contract termination costs as restructuring expense, which is presented as a separate component within operating expenses. Accrued contract termination costs are recorded in the restructuring accrual line on our consolidated balance sheets. We expect to pay the majority of these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our revised estimates, we expect we will receive sublease income of approximately $0.1 million beginning in the first 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 up to the $0.1 million of sublease income we currently expect to receive.

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

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

2010 Plan

	Severance and Related Costs	Contract Termination and Other Associated Costs	Total
Accrued restructuring balance as of 12/31/09	$	$	$
2010 restructuring plan charges	349	153	502
Cash payments	(51)		(51)
Accrued restructuring balance as of 6/30/10	$ 298	$ 153	$ 451

We also 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. All of the severance-related costs were paid to this employee in the first quarter of 2010.

10. 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. The credit agreement expires three years from its effective date, or in the third quarter of 2011. 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 June 30, 2010 we had an outstanding letter of credit issued to our contract manufacturer in China in the amount of $5.0 million and had outstanding cash advances or borrowings of approximately $2.8 million.

11. 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.

12. Segment Information

Primarily as a result of our acquisition of Cloverleaf in January 2010, as well as our ongoing strategic development, planning and evaluation, we changed the structure of our internal organization to focus on our storage systems and standalone software products. As a result, we now 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. Our standalone storage software operating segment consists primarily of the business we acquired from Cloverleaf and the intellectual property assets we purchased from Ciprico Inc., or Ciprico.

All prior period amounts have been adjusted to reflect the new operating segment structure.

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.

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Description of Segments

Storage Systems

We offer 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. Our end-users consist of entry-level and midrange users, requiring cost-effective, easily managed, high-performance, reliable storage systems. Our product lines range from approximately 146 gigabyte, or GB, to complete 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.

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.

Stand Alone Storage Software

Dot Hill s new heterogeneous storage virtualization products or iSN provide a multi-vendor storage solution for growing enterprise and high performance computing needs. Providing both unified storage and advanced storage virtualization features, up to two petabytes of storage can be managed and protected both locally and remotely, supporting both network attach server, or NAS, file and storage area network, or SAN, block services under one integrated storage management interface.

Our Virtual RAID Adapter, or VRA, technology, or RAIDCore, was purchased in 2008 from Ciprico Inc. This product is a host-based software RAID solution that offers data protection services and a single RAID driver, RAID management and BIOS for multiple controller types, and allows volume server OEMs or ODMs to offer built-in, RAID functionality without the expense of a dedicated RAID-on-chip acceleration device.

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

	Three Months Ended		Six Months Ended	
	June 30, 2009	June 30, 2010	June 30, 2009	June 30, 2010
Storage Systems net revenue	$ 54,328	$ 65,201	$ 108,217	$ 125,017
Standalone Storage Software net revenue		366		602
Total segment net revenue	54,328	65,567	108,217	125,619
Elimination of intersegment net revenue		(74)		(152)
Total Dot Hill consolidated net revenue	54,328	65,493	108,217	125,467
Storage Systems operating loss	(3,259)	(3,217)	(5,557)	(7,624)
Standalone Storage Software operating loss	(1,023)	(2,578)	(2,036)	(4,545)
Total operating loss	(4,282)	(5,795)	(7,593)	(12,169)

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, 2009. 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, 2009.

Overview

We are a provider of entry-level and midrange storage systems and enterprise server software for 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 capacity or data protection schemes as needed. Our broad range of products, from medium capacity stand-alone storage units to complete multi-terabyte storage area networks, or SANs, provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our current product family based on our Rapid Evolution, or R/Evolution, 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 replacement products for the legacy SANnet II products, the 2000 series, have been distinguished by compliance with 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 2010, we launched a new line of products to address the need for higher speed storage which is delivered with faster controller processors, as well as 8Gb Fibre Channel and 6Gb SAS host connections and are targeted primarily at mainstream enterprise and small-to-medium businesses, or SMB, applications.

As a result of our ongoing strategic development, planning and evaluation, we are expanding our software offerings. Our investment in bringing software products to market will require significant future investment and development on our part, which will impact our cash and operating results until we generate sufficient revenues to recover our investment.

As part of this strategic development, in January 2010, we acquired Cloverleaf, a privately held software company focused on heterogeneous storage virtualization and unified storage technologies. The acquisition of Cloverleaf could broaden our market opportunities and help accelerate our transition from a provider of storage arrays to a provider of storage solutions and software. The Cloverleaf acquisition also provided us with a new team of software developers and other professionals located in Israel. The Cloverleaf Intelligent Storage Networking System, or iSN , is an intelligent, network resident, storage network management system that provides a combination of benefits, features and capabilities targeted at meeting the demands of mid to large-sized data centers. The iSN incorporates architecture that delivers linear scalability, strong fault tolerance and high levels of availability. The iSN s open software is integrated with off the shelf hardware components and provides interoperability and networking technology flexibility.

Our Virtual RAID Adapter, or VRA, technology, or RAIDCore was purchased in 2008 from Ciprico Inc. This product is a host-based software RAID solution that offers data protection services and a single RAID driver, RAID management and BIOS for multiple controller types, and allows volume server OEMs or ODMs to offer built-in, RAID functionality without the expense of a dedicated RAID-on-chip acceleration device.

We will continue to evaluate acquisition opportunities in the future.

We are also expanding our routes to market beyond our focus on 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 believe this will provide Dot Hill with additional sales channels for all of our products.

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 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, the quality of our products and the economic environment.

Our products and services are sold worldwide to facilitate server and SAN storage implementations, primarily through original equipment manufacturers, or OEMs, and supplemented by system integrators, or SIs, distributors and value added resellers, or VARs. Our OEM channel partners currently include, among others, Hewlett-Packard, or HP, NetApp, Inc., or NetApp, Motorola, Inc., or Motorola, Lockheed Martin Corporation, or Lockheed Martin, Fujitsu Technology Solutions GmbH, or FTS, and Oracle, formerly Sun Microsystems, or Sun. 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 to additional divisions within HP. Our products are primarily sold within HP s MSA product line, which includes our Series 2000 products and next generation of Series 3000 products released in the first quarter of 2010. The agreement with HP does not contain any minimum purchase commitments and the term of the agreement was extended from one to five years. Net revenue from HP approximated 58% and 54% of our total net revenue during the three and six months ended June 30, 2010.

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Pursuant to our Development and OEM Supply Agreement with NetApp, we designed and developed general purpose disk arrays for a variety of products to be sold under private label by NetApp. We began shipping products to NetApp under the agreement for general availability in the third quarter of 2007, and net revenue from NetApp increased significantly during 2008. Net revenue from NetApp decreased slightly in 2009 primarily as a result of general economic conditions. Net revenue from NetApp approximated 27% and 29% of our total net revenue during the three and six months ended June 30, 2010. Under our agreement with NetApp, NetApp has the right to manufacture and sell, on a royalty and royalty-free basis, up to certain specified percentages of the products we currently manufacture and sell to them. The percentage of products that NetApp can elect to manufacture and sell on a royalty and royalty-free basis increases through April 1, 2011. On April 1, 2011 and thereafter, they have the right to manufacture and sell on a royalty-free basis all of the products we currently manufacture and sell to them. If NetApp were to exercise their rights to manufacture such products on a royalty or royalty-free basis and we are unable to identify an alternative source of revenue and margin to replace the reduced revenue and margin currently associated with such products, our financial results could be materially harmed.

We have experienced a decline in net revenue from Sun primarily due to the products reaching the end of their lifecycle. Net revenue from Sun was less than 1% of our total net revenue during the three and six months ended June 30, 2010. We do not expect to generate significant net revenue from Sun in future periods.

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:

- 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 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;

- 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 introduction of new products by us or our competitors, including products with price and/or performance advantages.

For these and other reasons, our net revenue and results of operations in 2010 and prior periods may not necessarily be indicative of future net revenue and results of operations.

Our 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. We have historically outsourced substantially all of our manufacturing operations to Flextronics International Limited, or Flextronics MiTAC International Corporation, or MiTAC and SYNNEX Corporation, or SYNNEX. 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. A larger percentage of our products have been and are expected to continue to be manufactured by Foxconn in 2010.

We derive the majority of our net revenues primarily from sales of our Series 2000, 3000 and 5000 family of products and we are continuing to transition SANnet II customers to this family of products.

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.

Sales and marketing expenses consist primarily of salaries and commissions, advertising and promotional costs and travel expenses.

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

General and administrative expenses consist primarily of compensation to officers and employees performing administrative functions, expenditures for administrative facilities as well as expenditures for legal and accounting 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 December 2008, our management approved, committed to, and initiated a plan, or the 2008 Plan, to restructure and improve efficiencies in our operations. The restructuring was due to a combination of factors, primarily driven by the economic downturn, but also driven by our plan to consolidate a significant portion of our facilities in Carlsbad, California into the Longmont, Colorado facility. With the exception of contract lease termination costs that we will continue to make over the remainder of the Carlsbad facility lease term ending in April 2013, we have largely completed the activities related to the 2008 Plan as of June 30, 2010.

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. We expect to complete our 2010 Plan workforce reductions in the third quarter of 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 financial statements. Except as noted below, management believes that there have been no significant changes during the three and six months ended June 30, 2010 to the items that we disclosed as our critical accounting policies and estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

Revenue Recognition

We early adopted the provisions of ASU 2009-13 and ASU 2009-14 as of the beginning of fiscal 2010 for new and materially modified sales transactions originating after January 1, 2010. The adoption of these provisions did not materially affect our results of operations for the three and six months ended June 30, 2010. However, as our software sales increase, we will be required to make significant estimates including determining if our software is essential to the tangible product s functionality, establishing separate units of accounting in multiple element arrangements and, if applicable, allocating arrangement consideration to each deliverable based on estimates of the relative selling price.

Valuation of Goodwill

We perform an assessment of our goodwill for impairment annually at November 30, or more frequently if we determine that indicators of impairment exist. Our impairment review process compares the fair value of each reporting unit to its carrying value. All of our goodwill at June 30, 2010 has been assigned to our Israel reporting unit, which is a subset of our standalone storage software operating segment. If the fair value of the reporting unit exceeds its carrying value, goodwill is not impaired and no further testing is performed. If the carrying value of the reporting unit exceeds its fair value, then a second step must be performed, and the implied fair value of the reporting unit s goodwill must be determined and compared to the carrying value of the reporting unit s goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, then an impairment loss equal to the difference will be recorded.

We expect to utilize both a market approach and an income approach (discounted cash flows) to estimate the fair value of our reporting units.

Under the market approach, we expect to estimate the fair value of our reporting units using an in-exchange valuation premise based upon the market capitalization of Dot Hill using quoted market prices, adding an estimated control premium, and then assigning that fair market value to the reporting units. The most significant estimates and assumptions under the market approach are expected to be estimating an appropriate control premium and allocating the estimated enterprise fair value to each of our reporting units.

Under the income approach, we expect to estimate the fair value of our reporting units based on the present value of estimated future cash flows. The most significant estimates and assumptions under the income approach are expected to be future cash flows, discount rates, period of cash flows and the determination of terminal value.

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Business Combinations

We allocate the purchase price of acquired companies to the tangible assets acquired, liabilities assumed and intangible assets acquired based on their estimated fair values. The excess of the purchase price over these fair values is recorded as goodwill. We engage independent third-party appraisal firms to assist us in determining the fair values of assets acquired and liabilities assumed. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets. The significant purchased intangible assets recorded by us include acquired software, developed technologies and a trade name.

Critical estimates in valuing certain intangible assets include but are not limited to: future expected cash flows from acquired software and developed technologies; expected costs to internally develop acquired software, as well as assumptions about the period of time that acquired software, developed technologies and an acquired trade name will continue to be used and generate cash flows; and discount and royalty rates. Management s estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates.

Other estimates associated with the accounting for acquisitions may change as additional information becomes available regarding the assets acquired and liabilities assumed.

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 June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
Net revenue	100.0%	100.0%	100.0%	100.0%
Cost of goods sold:				
Product cost of goods sold	85.3	84.4	84.1	85.0
Amortization of intangible assets		0.8		0.8
Total cost of goods sold:	85.3	85.2	84.1	85.8
Gross profit	14.7	14.8	15.9	14.2
Operating expenses:				
Research and development	12.8	12.9	13.0	12.9
Sales and marketing	4.6	5.2	4.7	5.4
General and administrative	4.6	3.4	4.8	4.2
Restructuring charge	0.6	2.2	0.4	1.4
Total operating expenses	22.6	23.7	22.9	23.9
Operating loss	(7.9)	(8.8)	(7.0)	(9.7)
Other income, net	0.1		0.1	
Loss before income taxes	(7.8)	(8.8)	(6.9)	(9.7)
Income tax expense (benefit)	(0.1)	0.1		0.1

Net loss	(7.7)%	(8.9)%	(6.9)%	(9.8)%

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Three and Six Months Ended June 30, 2009 Compared to the Three and Six Months Ended June 30, 2010

Net Revenue

	Three Months Ended June 30,			
	2009	2010	Increase	% Change
	(in thousands, except percentages)			
Net Revenue	$ 54,328	$ 65,493	$ 11,165	20.6%

	Six Months Ended June 30,			
	2009	2010	Increase	% Change
	(in thousands, except percentages)			
Net Revenue	$ 108,217	$ 125,467	$ 17,250	15.9%

The increase in net revenue for the three and six months ended June 30, 2010 was substantially due to an increase in sales to HP. Sales to HP totaled $37.7 million for the three months ended June 30, 2010 compared to $27.9 million for the three months ended June 30, 2009 and $67.8 million for the six months ended June 30, 2010 compared to $50.5 million for the six months ended June 30, 2009. The increase in HP net revenue is due to the growth in the HP MSA product line, which includes our Series 2000 products and Series 3000 products. Our Series 2000 products are in the maturity phase of the product life cycle, however, demand remains strong. We released our next generation Series 3000 products in the first quarter of 2010 and sales of these products increased significantly in the second quarter of 2010.

In addition, sales to NetApp increased during the three and six months ended June 30, 2010 compared to the three and six months ended June 30, 2009 based on the success of NetApp s FAS 2000 product line. Sales to NetApp totaled $17.7 million for the three months ended June 30, 2010 compared to $13.1 million for the three months ended June 30, 2009 and $35.9 million for the six months ended June 30, 2010 compared to $25.7 million for the six months ended June 30, 2009. However, under our agreement with NetApp, NetApp has the right to manufacture and sell, on a royalty and royalty-free basis, up to certain specified percentages of the products we currently manufacture and sell to them. The percentage of products that NetApp can elect to manufacture and sell on a royalty and royalty-free basis increases through April 1, 2011. On April 1, 2011 and thereafter, they have the right to manufacture and sell on a royalty-free basis all of the products we currently manufacture and sell to them. If NetApp were to exercise their rights to manufacture such products on a royalty or royalty-free basis and we are unable to identify an alternative source of revenue and margin to replace the reduced revenue and margin currently associated with such products, our financial results could be materially harmed.

Network Engines Inc., or NEI, sales increased to $1.5 million for the three months ended June 30, 2010 from $0.4 million for the three months ended June 30, 2009 and to $4.8 million for the six months ended June 30, 2010 from $1.1 million for the six months ended June 30, 2009. The increase in NEI net revenue is due to NEI becoming the contract manufacturer for Sepaton Inc. and as a result of better global economic conditions in the first half of 2010 compared to the first half of 2009.

We also expanded our routes to market and launched a channel sales program in the fourth quarter of 2009 targeted at selling our products through distributors and OSP s. Channel sales approximated 3% of net revenue for both the three and six months ended June 30, 2010.

These increases were partially offset by a decrease in net revenue from Sun, FTS, and other smaller customers. Sun sales decreased to $0.1 million for the three months ended June 30, 2010 compared to $2.5 million for the three months ended June 30, 2009 and to $0.5 million for the six months ended June 30, 2010 compared to $9.3 million for the six months ended June 30, 2009. The decline in Sun net revenue is due to the products we sell to Sun reaching the end of their product life cycle. FTS sales decreased to $0.8 million for the three months ended June 30, 2010 compared to $3.6 million for the three months ended June 30, 2009 and to $1.7 million for the six months ended June 30, 2010 compared to $6.9 million for the six months ended June 30, 2009. The decrease in net revenue from FTS is due to its decision to internally source the product we sell to FTS. We also experienced declines in sales to other smaller customers primarily as a result of product transition.

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Cost of Goods Sold and Gross Profit

	Three Months Ended June 30, 2009		Three Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Cost of Goods Sold	$ 46,358	85.3%	$ 55,824	85.2%	$ 9,466	20.4%
Gross Profit	$ 7,970	14.7%	$ 9,669	14.8%	$ 1,699	21.3%

	Six Months Ended June 30, 2009		Six Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Cost of Goods Sold	$ 90,986	84.1%	$ 107,673	85.8%	$ 16,687	18.3%
Gross Profit	$ 17,231	15.9%	$ 17,794	14.2%	$ 563	3.3%

Cost of goods sold increased for the three months ended June 30, 2010 compared to the three months ended June 30, 2009 primarily as a result of an increase in sales; however, gross profit margin increased to 14.8% from 14.7% for these same periods. Although we experienced a more favorable mix of product sales during the three months ended June 30, 2009, as a higher percentage of our sales were to Sun and a lower percentage of our sales were to HP and Net App, we did incur a $0.7 million inventory reserve charge during the second quarter of 2009, which resulted in a lower gross profit. Partially offsetting the increase in gross profit during the three months ended June 30, 2010 compared to the three months ended June 30, 2009 were higher amortization expense, which increased $0.5 million due to the inclusion of Ciprico amortization in cost of goods sold as a result of the RAIDCore product now generating revenue and the additional amortization resulting from the Cloverleaf acquisition. Prior to 2010, Ciprico amortization was included in research and development expense.

Gross profit margin for the six months ended June 30, 2010 approximated 14.2% compared to 15.9% for the six months ended June 30, 2009. The decrease in gross profit margin was primarily due to product mix, as the products we sell to HP and NetApp typically have a higher product cost and a lower gross profit than the products we sell to Sun. Sales to HP and NetApp approximated 83% of our net revenues for the six months ended June 30, 2010 compared to 71% of our net revenues for the six months ended June 30, 2009 while sales to Sun were less than 1% of our net revenue for the six months ended June 30, 2010 compared to 9% of net revenues for the six months ended June 30, 2009. We expect that the mix of products we sell, in particular, the products we sell to HP and NetApp, will continue to affect our cost of goods sold and gross profit margin. For example, sales of products to HP have higher gross margins than sales of products to NetApp. Therefore, a higher percentage of sales to HP compared to NetApp will have a positive effect on our gross margin. Conversely, a higher percentage of sales to NetApp compared to HP will have a negative effect on our gross margin.

Also contributing to the decrease in gross profit were higher amortization expense and freight costs for the six months ended June 30, 2010 compared to the same period in 2009. Freight costs increased as a result of the increase in revenue and overall shipment volume as well as from expedite charges.

Research and Development Expenses

	Three Months Ended June 30, 2009		Three Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Research and Development Expenses	$ 6,934	12.8%	$ 8,447	12.9%	$ 1,513	21.8%

	Six Months Ended June 30, 2009		Six Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Research and Development Expenses	$ 14,086	13.0%	$ 16,220	12.9%	$ 2,134	15.1%

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Research and development expense increased $1.5 million to $8.4 million for the three months ended June 30, 2010 compared to $6.9 million for the three months ended June 30, 2009. This increase was primarily due to an increase in salaries and payroll related expenses of $0.9 million, an increase in consulting costs of $0.4 million, an increase in engineering materials and tooling related expenses of $0.3 million, and an increase in facilities and depreciation expense of $0.2 million. These increases were partially offset by a decrease in Ciprico intangible asset amortization expense of $0.3 million as the RAIDCore product is now generating revenue. The increase in salary and payroll related expenses is primarily a result of an increase in employees engaged in research and development activities, most of which were associated with the Cloverleaf acquisition. Consulting costs increased primarily as a result of certain engineering functions being performed by consultants in India, which commenced in the second quarter of 2009, and an increase in the use of domestic engineering consultants to assist with certain strategic development projects. The increase in engineering materials and tooling related expenses was primarily the result of new product development activities. The increase in facilities and depreciation expense was largely the result of the Cloverleaf acquisition and also due to additional capital expenditures for our Longmont engineering labs.

Research and development expense increased $2.1 million to $16.2 million for the six months ended June 30, 2010 compared to $14.1 million for the six months ended June 30, 2009. This increase was primarily due to an increase in salaries and payroll related expenses of $1.5 million, an increase in consulting costs of $0.8 million, an increase in facilities and depreciation expense of $0.4 million and increases in various other items such as travel, rental equipment and training programs, which approximated $0.2 million. Salaries and payroll related expenses, consulting costs and facilities and depreciation costs increased for the same reasons as outlined above. These increases were partially offset by a decrease in Ciprico intangible asset amortization expense of $0.5 million. In addition, during the first quarter of 2010, 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 $0.3 million reduction in estimated contingent consideration liability.

Sales and Marketing Expenses

	Three Months Ended June 30, 2009		Three Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Sales and Marketing Expenses	$ 2,519	4.6%	$ 3,379	5.2%	$ 860	34.1%

	Six Months Ended June 30, 2009		Six Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Sales and Marketing Expenses	$ 5,085	4.7%	$ 6,740	5.4%	$ 1,655	33%

Sales and marketing expense increased $0.9 million to $3.4 million for the three months ended June 30, 2010 compared to $2.5 million for the three months ended June 30, 2009. This increase was primarily due to an increase in salaries and payroll related expenses of $0.4 million, an increase in customer-related evaluation product expenses of $0.2 million, an increase in marketing and promotional materials of $0.2 million and increases in other items such as travel, professional services and consulting costs, which approximated $0.1 million. The increase in salary and payroll related expenses is primarily a result of an increase in employees engaged in sales and marketing activities, as we launched a Dot Hill channel program targeted at selling through distributors and OSPs in the second half of 2009. Customer-related valuation product expenses and marketing and promotional materials increased due to the introduction of our new Series 3000 and the newly acquired products from Cloverleaf.

Sales and marketing expense increased $1.7 million to $6.7 million for the six months ended June 30, 2010 compared to $5.1 million for the six months ended June 30, 2009. This increase was primarily due to an increase in salaries and payroll related expenses of $0.7 million, an increase in customer-related evaluation product expenses of $0.5 million, an increase in marketing and promotional materials of $0.2 million, an increase in travel expenses of $0.1 million and increases in other items such as trade shows, professional services and consulting costs, which approximated $0.2 million. Salaries and payroll related costs, customer-related evaluation product expenses, marketing and promotional expensed materials increased for the same reasons as outlined above. The increase in travel expenses was primarily the result of an increase in headcount and customer visits.

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General and Administrative Expenses

	Three Months Ended June 30, 2009		Three Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase (Decrease)	% Change
	(in thousands, except percentages)					
General and Administrative Expenses	$ 2,473	4.6%	$ 2,225	3.4%	$ (248)	-10.0%

	Six Months Ended June 30, 2009		Six Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
General and Administrative Expenses	$ 5,242	4.8%	$ 5,301	4.2%	$ 59	1.1%

General and administrative expenses decreased $0.2 million to $2.2 million for the three months ended June 30, 2010 compared to $2.5 million for the three months ended June 30, 2009. This decrease was primarily attributable to foreign currency gains of $0.3 million and a reduction in professional services fees of $0.2 million. The foreign currency gains were primarily the result of the strengthening of the United States dollar compared to the Euro. The reduction in professional services fees were primarily the result of negotiating lower fees with many of our administrative service providers. These decreases were partially offset by an increase in salaries and payroll related expenses of $0.2 million, which increased primarily as a result of duplicative personnel to insure an effective transition of certain of our administrative functions to Longmont, Colorado from Carlsbad, California.

General and administrative expenses increased $0.1 million to $5.3 million for the six months ended June 30, 2010 compared to $5.2 million for the six months ended June 30, 2009. This increase was primarily attributable to an increase in salaries and payroll related expenses of $0.4 million, travel expenses of $0.1 million and consulting fees of $0.1 million. Salaries and payroll related expenses, travel expenses and consulting fees increased primarily as a result of the transition of certain of our administrative functions to Longmont, Colorado from Carlsbad, California. These increases were partially offset by foreign currency gains of $0.5 million as a result of the strengthening of the United States dollar compared to the Euro.

Restructuring Charge

	Three Months Ended June 30, 2009		Three Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Restructuring Charge	$ 326	0.6%	$ 1,413	2.2%	$ 1,087	333.4%

	Six Months Ended June 30, 2009		Six Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Restructuring Charge	$ 411	0.4%	$ 1,702	1.4%	$ 1,291	314.1%

The increase in restructuring charges for the three months and six months ended June 30, 2010 is primarily the result of $0.8 million of additional contract termination costs incurred in the second quarter of 2010 related to our 2008 Plan for facility lease costs that we continue to incur without economic benefit, as we exited an additional portion of our Carlsbad facility and revised our assumptions regarding the timing and amount of tenant sublease income. In addition, in the second quarter of 2010, our management approved, committed to, and initiated 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 incurred a restructuring charge of $0.5 million under our 2010 Plan, of which $0.3 million related to severance and related costs and $0.2 million related to contract termination costs.

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Other Income, net

	Three Months Ended June 30, 2009		Three Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Other Income/(loss), net	$ 55	0.1%	$ (4)	0.0%	$ (59)	-107.3%

	Six Months Ended June 30, 2009		Six Months Ended June 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Other Income/(loss), net	$ 108	0.1%	$ (8)	0.0%	$ (116)	-107.4%

The decrease in other income, net for the three and six months ended June 30, 2010 is primarily attributable to a decrease in interest income primarily due to declining interest rates and lower cash balances.

Income Taxes

We recorded an income tax provision of $0.0 million for the three months ended June 30, 2009, $0.0 million for the three months ended June 30, 2010, $0.0 million for the six months ended June 30, 2009 and $0.1 million for the six months ended June 30, 2010. Our effective income tax rate differs from the U.S. federal statutory rate primarily due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

Liquidity and Capital Resources

The primary drivers affecting cash and liquidity are working capital requirements, net losses, and capital expenditures, as well as the acquisition of Cloverleaf in the first quarter of 2010. 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. Our accounts receivable could further increase if customers delay their payments or if we grant extended payment terms to customers.

As of June 30, 2010, we had $42.6 million of cash and cash equivalents and $48.5 million of working capital. 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 $3.1 million in short-term debt and $0.2 million in long-term debt at June 30, 2010, consisting of bank borrowings against our line of credit and a note payable issued in connection with the acquisition of certain intangible assets from Ciprico.

Operating Activities

Net cash used in operating activities for the six months ended June 30, 2010 was $15.9 million compared to $1.2 million of cash provided by operations for the six months ended June 30, 2009. The operating activities that affected cash consisted primarily of increase in our net loss, which totaled $12.3 million for the six months ended June 30, 2010 compared to $7.5 million for the six months ended June 30, 2009. The increase in our net loss was primarily attributable to higher operating expenses as a result of the additional costs associated with the acquired Cloverleaf business, additional restructuring costs related to our 2008 Plan as well as our 2010 Plan, which was implemented in the second quarter of 2010 and lower interest income due to lower interest rates and cash balances. Partially offsetting the increase in our net loss was a higher gross profit, which was largely due to an increase in revenue and lower excess inventory charges.

The adjustments to reconcile net loss to net cash used in operating activities for the six months ended June 30, 2010 that did not affect cash consisted of depreciation and amortization of $2.0 million, stock-based compensation expense of $1.8 million, and a gain associated with an adjustment to our contingent consideration liability to Ciprico.

Cash flows from operations reflects the negative impact of $1.1 million related to an overall increase in accounts receivable, which was primarily due to higher net revenue in the second quarter of 2010 compared to the fourth quarter of 2009 and the timing of shipments during the quarter. Cash collection efforts remained strong as our days sales outstanding remained at 49 days for both of the three month periods ended June 30, 2010 and December 31, 2009. Cash flows from operations also reflects the negative impact of $3.3 million related to an overall increase in inventories at June 30, 2010 compared to December 31, 2009, as we had contractual purchase obligations for certain components with some of our contract manufacturing partners and we also built inventory related to the products we acquired from Cloverleaf and for service inventory requirements. In addition, cash flows from operations reflects the negative impact of a decrease in accounts payable of $0.9 million at June 30, 2010 compared to December 31, 2009 due to the timing of payments to our vendors. In particular, we made a $3.5 million early payment at the end of the second quarter to one of our suppliers to take advantage of better pricing terms in future periods.

Additional uses of cash flows from operations include $0.8 million related to an increase in prepaid and other assets, which is primarily the result of an increase in other receivables from our contract manufacturing partners due to component parts we procured and shipped to them. We also used $1.7 million of cash from operations related to a decrease in accrued compensation and other expenses, which was the result of the payment of $1.4 million of accrued Cloverleaf liabilities assumed in the business combination, $0.5 million of various bonus program payments that were made in 2010 and the payment of $0.3 million for tax liabilities related to employee stock awards. This was partially offset by an increase in our accrued vacation liability of $0.4 million and an increase in our warranty accrual of $0.2 million. In addition, we used $0.5 million of cash from operations for long-term liabilities resulting from $0.2 million of amortization related to a customer prepayment and $0.3 million of deferred rent amortization.

Cash flows from operations include sources of cash of $0.5 million related to an increase in deferred revenue as we received up-front payments for engineering services and maintenance contracts. Additional sources of cash flows from operations include a net increase in our restructuring accrual of $0.7 million, which is primarily the result of $1.7 million of additional restructuring charges incurred during the six months ended June 30, 2010 for contract termination and severance costs partially offset by cash payments of $1.0 million. We expect to make future restructuring payments for severance of approximately $0.7 million during the remainder of 2010 and future restructuring payments for contract termination and other associated costs of approximately $1.8 million through the remainder of our Carlsbad, California lease term, which ends in April 2013.

Investing Activities

Cash used in investing activities for the six months ended June 30, 2010 was $1.3 million compared to $1.1 million for the six months ended June 30, 2009. Cash used in investing activities during the six month ended June 30, 2010 was due to the acquisition of Cloverleaf, net of cash acquired, of $0.6 million and purchases of $0.7 million of additional property and equipment 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 six months ended June 30, 2010 was $2.2 million compared to $0.2 million for the six months ended June 30, 2009. Cash provided by financing activities for the six months ended June 30, 2010 is attributable to the drawdown of $2.8 million against our credit facility in the second quarter of 2010 and cash received from the sale of stock to employees under our employee stock purchase plan of $0.3 million. This was partially offset by a $0.7 million payment related to a Cloverleaf loan obligation and $0.2 million for the ongoing pay-down of our note payable associated with our 2008 acquisition of certain intangible assets from Ciprico.

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 2010, 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.

Cloverleaf s historical expenses have exceeded their net revenue, which is a trend we expect to continue in 2010. For example, Cloverleaf generated net revenue of $1.2 million and incurred a net loss of $3.9 million in 2009. In addition, our Cloverleaf business generated net revenue of $0.3 million and incurred a net loss of $2.7 million during the six months ended June 30, 2010. As a result, we expect that the acquisition of Cloverleaf will be dilutive to our results of operations and also result in a significant net cash outflow through the remainder of 2010 as we continue to invest in new product development. The amount of cash needed to support the business we acquired from Cloverleaf in 2010 will depend primarily on new customer installations, the timing of capital expenditures, product development costs and additional headcount needed to support customer requirements and improving the existing infrastructure of Cloverleaf s operations.

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. In the first half of 2010, we experienced quality issues associated with certain components provided by one of our suppliers that required us to make substantial repairs. Our supplier has agreed to reimburse us for the costs of the replacement parts and related damages. However, the magnitude of potential damages is currently unknown and to the extent that our supplier cannot or does not continue to reimburse us for any and all damages incurred by us or our customers 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, including the acquisition of Cloverleaf, 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 by 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.

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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. The credit agreement expires three years from its effective date, or in the third quarter of 2011. 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 June 30, 2010 we had an outstanding letter of credit issued to our contract manufacturer in China in the amount of $5.0 million and had outstanding cash advances or borrowings of approximately $2.8 million.

Off Balance Sheet Arrangements

At June 30, 2010, 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 June 30, 2010 balance sheet.

We have a line of credit agreement, which accrues interest on any outstanding balances at the prime rate. As of June 30, 2010, $2.8 million remained outstanding under this line. If we make additional borrowings under this line for extended periods of time, 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 consolidated financial statements are reported. The most significant foreign currencies that subjected us to foreign currency exchange rate risk for the six months ended June 30, 2010 were the Euro, Japanese yen and the Israeli New 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 $0.5 million in foreign currency transaction gains during the six months ended June 30, 2010, primarily resulting from the remeasurement process of certain of our European 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.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we evaluated the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended, or the Exchange Act, as of June 30, 2010. On the basis of this review, our management, including our principal executive officer and principal financial officer, concluded that our disclosure controls and procedures are designed, and are effective, to give reasonable assurance that the information required to be disclosed by us in reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and to ensure that information required to be disclosed in the reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, in a manner that allows timely decisions regarding required disclosure.

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Changes in Internal Controls

There were no changes in our internal control over financial reporting that occurred during the period covered by this quarterly report on Form 10-Q that has materially affected, or is 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, 2009. 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 OEM customers. For example, sales to HP accounted for 51% and 54% of our net revenues for the year ended December 31, 2009 and six months ended June 30, 2010, respectively. In addition, sales to NetApp accounted for 25% and 29% of our net revenues for the year ended December 31, 2009 and six months ended June 30, 2010, respectively. We expect HP and NetApp will each represent greater than 10% of our overall revenues for the year ending December 31, 2010. If our relationships with HP and NetApp or certain of our other OEM customers were disrupted or significantly cut back, we would lose a significant portion of our anticipated net revenue and our business could be materially harmed. We cannot guarantee that our relationship with HP, NetApp or our other OEM customers will expand or not otherwise be disrupted. For example, under our agreement with NetApp, NetApp has the right to manufacture and sell, on a royalty and royalty-free basis, up to certain specified percentages of the products we currently manufacture and sell to them. The percentage of products that NetApp can elect to manufacture and sell on a royalty and royalty-free basis increases through April 1, 2011. On April 1, 2011 and thereafter, they have the right to manufacture and sell on a royalty-free basis all of the products we currently manufacture and sell to them. If NetApp were to exercise their rights to manufacture such products on a royalty or royalty-free basis and we are unable to identify an alternative source of revenue and margin to replace the reduced revenue and margin currently associated with such products, our financial results could be materially harmed.

Factors that could influence our relationship with our significant OEM customers include:

- our ability to maintain our products at prices that are competitive with those of other hardware storage system suppliers;
- our ability to maintain quality levels for our products sufficient to meet the expectations of our OEM customers;
- our ability to produce, ship and deliver a sufficient quantity of our hardware products in a timely manner to meet the needs of our OEM customers;

our ability to continue to develop and launch new products that our OEM 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 OEM customers; and

the ability of our OEM customers to effectively launch, ramp, ship, sell and market their own solutions based on our products.

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Product recalls, epidemic failures, post-manufacture repairs of our products liability claims, absence or cost of insurance, 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 failure, 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, which could harm our business. The product failure or recall 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. For example, during the first half of 2007, we experienced several product quality issues associated with our then recently introduced Series 2000 products. The cost of rectifying these issues had a negative impact on gross margins during the first half of 2007. In addition, in the first half of 2010, we experienced quality issues associated with certain components provided by one of our suppliers that required us to make substantial repairs. Our supplier has agreed to reimburse us for the costs of the replacement parts and related damages, but to the extent our supplier is unable or does not do so, our results of operations and liquidity could be significantly harmed.

Even if the errors are detected before shipment, such errors could result in the halting of production, the 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 about 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. Any such claim could distract management s attention from operating our business and, if successful, result in damage claims against us that might not be covered by our insurance.

Recent turmoil in the global economy, credit markets and the financial services industry may negatively impact our revenues, 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 net revenues 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 revenues, operating results and financial condition may be adversely affected. In addition, the recent economic crisis 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 OEM customers may not be as well capitalized as, nor do they have the financial resources of, our larger customers. In addition, our 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.

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 the 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.

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.

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

None of our contracts with our existing customers, including HP and NetApp, contain any minimum purchasing 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 OEM customers will continue at historical levels or will ramp to expected levels. In addition, our existing contracts do not require our OEM 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 OEM customers may sell the products of our competitors. The decision by any of our OEM customers to cancel purchase orders, cease making purchases or terminate their respective contracts could cause our net revenues 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 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, 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 OEMs 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 deep 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 revenues 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 for sales to OEM customers and for the sale and installation of complex solutions.

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

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

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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. The Cloverleaf acquisition also provided us with a new team of software development and other professionals, primarily based primarily in Israel. 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. Cloverleaf was our first acquisition involving significant international operations. We expect that the integration of Cloverleaf s operations with our own will 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;
- diversion of management s attention from normal daily operations of our business;
- 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 needs of customers or their expectations with respect to reliability;
- insufficient net revenues to offset increased expenses associated with the Cloverleaf acquisition;
- increased professional advisor fees related to the new profile of the combined company;
- 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 iSN product;

- market and customer receptivity to the iSN family of product; and

- the ability of our open storage partners to sell and support iSN.

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

In September 2008, we bought certain assets from Cirprico including RAIDCore. We have an agreement with one primary partner to market or integrate RAIDCore 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 revenues 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.

The common stock we issued in the acquisition of Cloverleaf in 2010 and charges associated with this acquisition may negatively impact our earnings per share.

Based on the increase in our number of common shares outstanding in connection with our Cloverleaf acquisition, projected amortization charges and the additional costs associated with integrating Cloverleaf, the acquisition may result in lower earnings per share than would have been earned by us in the absence of the transaction. We expect that over time this acquisition will yield benefits to the combined company that will ultimately be accretive to earnings per share. However, there can be no assurance that an increase in earnings per share will be achieved. In order to achieve increases in earnings per share as a result of this acquisition, management will, among other things, need to successfully manage the combined company s operations, increase revenue and compete effectively in its end-markets. Failure to achieve any of these objectives could cause our stock price to decline.

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 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 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.

A significant percentage of our expenses are fixed, and if we fail to generate targeted net revenues or gross margins in associated periods, our operating results will be harmed.

We primarily sell to OEMs and thus do not need to make substantial investments in sales and marketing to generate demand for our products. These investments are typically made by our OEMs. Additionally we outsource our manufacturing to very large contract manufacturing partners in Asia. Hence, there is little incremental cost 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. As a result a significant percentage of our expenses are relatively fixed.

In the past we have taken and may have to take further measures to reduce expenses if net revenues 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 revenues do 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 revenues, gross margins and operating results.

The storage market is intensely competitive and is characterized by rapidly changing technology. We compete primarily against independent storage system suppliers, including EMC, NetApp, Hitachi, LSI, Infortrend and Xyratex, but also against server companies such as HP, IBM and Sun, some of whom are our customers. We also compete with smaller storage software and hardware companies such as Nexsan Corporation, or Nexsan, Compellent and Falconstor. The server companies and independent storage systems suppliers are also potential customers as well and as indicated we have established a relationship with HP and NetApp. Future competitors could include original design manufacturers and contract manufacturers, some of whom we partner with today.

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 us. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service 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 new, privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. Any of these existing or potential competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, devote greater resources to the development, promotion and sale of products or deliver competitive products at lower prices than us.

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 a significant share 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; and 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 OEM 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, if fuel prices were to increase significantly again, this 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 OEM customers that may attempt to change the terms, including pricing and payment terms of their agreements, with us. As our OEM 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 margins 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 margins and results of operations.

Our gross margins are determined in large part based on our manufacturing costs, our component costs, our 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 margins, 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 any decline in selling prices, our gross margins and results of operations may suffer. Several 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 margins 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 margins 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.

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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;
- 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;
- 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 Series 5000, 3000 and 2000 products, our DMS software and our RAIDCore software;
- 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 manufacturer or finished goods to some of our customers and their hub locations.

Our OEM 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.

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 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 , 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.

Manufacturing and supplier disruptions could harm our business.

We rely on third parties to manufacture substantially all of our products. If our agreements with Foxconn, Flextronics, MiTAC or SYNNEX are 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 agreements with Foxconn, Flextronics, MiTAC or SYNNEX terminate, we cannot be certain that we will be able to identify a suitable alternative manufacturing partner that meets the requirements of our OEM customers and one that is cost competitive. Failure to identify a suitable alternative manufacturing partner could impact our customer relationships and our financial condition.

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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 our new integrated storage systems, which could result in delays in delivery of these products to our OEM 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 at 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 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 year ended December 31, 2009 and for the six months ended June 30, 2010, we incurred net losses of $13.6 million and $12.3 million, respectively. For the remainder of 2010, we expect our business to remain volatile as we are often unable to reliably predict net revenues from our major customers including NetApp, HP and our other customers. Our ability to reliably predict net revenues has become more challenging as a result of our recent acquisition of Cloverleaf. Net revenue levels achieved from NetApp, HP and our other 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 the remainder of 2010. 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 implement and achieve targeted gross margin 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 extent to which we consolidate our facilities and relocate employees and assets;

the success of our manufacturing strategy and the move of the manufacturing of some of our products to a newer contract manufacturing partner;

the success of our sales and marketing efforts;

the amount of field failures resulting in product replacements or recalls;

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- 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 intangible amortization and other costs associated with our recent acquisition of Cloverleaf;
- costs of filing, prosecuting, defending and enforcing intellectual property rights; and
- costs of litigating and defending law suits.

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. For example, in 2003, Crossroads filed a lawsuit against us alleging that our products infringe two United States patents assigned to Crossroads. In 2006, we entered into a Settlement and License Agreement with Crossroads that settled the lawsuit and licensed to us the family of patents from which it stemmed. We incurred significant legal expenses in connection with these matters. Other third parties may assert additional infringement claims against us in the future, which would similarly 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 increases. 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 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.

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 and Chief Financial Officer, 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. 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 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.

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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 our tax provisions 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 to determine the adequacy of our provision for income taxes. However, there can be no assurance that the outcomes from these continuous examinations will not have a material adverse effect on our business, financial condition and results of operations.

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

Dilution of the per share value of our common stock could result from the exercise of outstanding warrants. As of June 30, 2010 there was an outstanding warrant to purchase 1,602,489 shares of our common stock. The warrant has an exercise price of $2.40 per share, which at June 30, 2010 exceeded the trading price of our common stock. The warrant is exercisable for a period of five years from the date of issuance, or five years from January 2008. When the exercise price of the warrant is less than the trading price of our common stock, exercise of the warrant would have a dilutive effect on our stockholders. The possibility of the issuance of shares of our common stock upon exercise of the warrant could cause the trading price of our common stock to decline.

Furthermore, it is also possible that future large customers or suppliers, make our relationship with them contingent on receiving warrants to purchase shares of our common stock. The impact of potentially issuing additional warrants can 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;
- 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 industry analysts;

overall market conditions for high technology equities;

rumors or dissemination of false information; and

general economic and geopolitical conditions.

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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 OEM 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 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. The deadline for the individual member states of the European Union to enact the directive in their respective countries was August 13, 2004. Producers participating in the market became financially responsible for implementing these responsibilities beginning in August 2005. 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.

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Item 6. Exhibits

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

Exhibit Number	Description
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)
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.

Dot Hill s Current Reports on Form 8-K have a Commission File Number of 001-13317.

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: August 12, 2010

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

Date: August 12, 2010

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