DOT HILL SYSTEMS CORP
Form 10-Q
November 06, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended September 30, 2009

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 incorporation or organization)	**(I.R.S. Employer Identification No.)**
2200 Faraday Avenue, Suite 100, Carlsbad, CA	**92008**
(Address of principal executive offices)	**(Zip Code)**

(760) 931-5500

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

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

The registrant had 48,944,341 shares of common stock, $0.001 par value, outstanding as of November 4, 2009.

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FORM 10-Q

For the Quarter Ended September 30, 2009

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Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands)

	December 31, 2008	September 30, 2009
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 56,850	$ 59,208
Accounts receivable, net of allowance of $287 and $482	41,035	35,179
Inventories, net	14,127	5,038
Prepaid expenses and other	4,796	6,830
Total current assets	116,808	106,255
Property and equipment, net	2,410	3,611
Intangible assets, net	4,164	3,313
Other assets	515	224
Total assets	$ 123,897	$ 113,403
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 31,050	$ 28,913
Accrued compensation	3,217	2,940
Accrued expenses	5,229	4,822
Deferred revenue	1,121	1,425
Restructuring accrual	681	725
Current portion of long-term note payable	249	258
Total current liabilities	41,547	39,083
Long-term note payable	607	412
Other long-term liabilities	5,091	3,253
Total liabilities	47,245	42,748
Commitments and Contingencies (Note 11)		
Stockholders Equity:		
Preferred stock, $.001 par value, 10,000 shares authorized, no shares issued and outstanding at December 31, 2008 and September 30, 2009		
Common stock, $.001 par value, 100,000 shares authorized, 46,308 and 48,944 shares issued and outstanding at December 31, 2008 and September 30, 2009, respectively	46	49
Additional paid-in capital	300,555	303,169
Accumulated other comprehensive loss	(3,474)	(3,473)
Accumulated deficit	(220,475)	(229,090)
Total stockholders equity	76,652	70,655
Total liabilities and stockholders equity	$ 123,897	$ 113,403

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 September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
NET REVENUE	$ 76,641	$ 63,600	$ 200,494	$ 171,817
COST OF GOODS SOLD	67,700	51,969	180,165	142,955
GROSS PROFIT	8,941	11,631	20,329	28,862
OPERATING EXPENSES:				
Sales and marketing	2,990	2,772	10,909	7,856
Research and development	6,940	7,241	21,489	21,327
General and administrative	3,309	2,320	10,291	7,562
Restructuring charge		530		941
Legal settlement	(200)		(4,036)	
Total operating expenses	13,039	12,863	38,653	37,686
OPERATING LOSS	(4,098)	(1,232)	(18,324)	(8,824)
OTHER INCOME:				
Interest income, net	309	17	1,374	132
Other income (expense), net	(19)	(10)	61	(17)
Total other income, net	290	7	1,435	115
LOSS BEFORE INCOME TAXES	(3,808)	(1,225)	(16,889)	(8,709)
INCOME TAX EXPENSE (BENEFIT)	(117)	(88)	281	(94)
NET LOSS	$ (3,691)	$ (1,137)	$ (17,170)	$ (8,615)
NET LOSS PER SHARE:				
Basic and diluted	$ (0.08)	$ (0.02)	$ (0.37)	$ (0.18)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:				
Basic and diluted	46,223	47,258	46,078	46,978
COMPREHENSIVE LOSS:				
Net loss	$ (3,691)	$ (1,137)	$ (17,170)	$ (8,615)
Foreign currency translation gain (loss)	(27)	(89)	(128)	1
Comprehensive loss	$ (3,718)	$ (1,226)	$ (17,298)	$ (8,614)

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)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2009
Cash Flows From Operating Activities:		
Net loss	$ (17,170)	$ (8,615)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,385	2,079
Loss on disposal of property and equipment	57	
Provision for bad debt reserve	(153)	292
Share-based compensation expense	2,224	2,151
Issuance of warrant to customer	2,282	
Changes in operating assets and liabilities:		
Accounts receivable	(15,566)	5,587
Inventories	(3,578)	9,086
Prepaid expenses and other assets	(42)	(2,046)
Accounts payable	6,710	(2,125)
Accrued compensation and other expenses	(2,042)	(449)
Deferred revenue	(251)	(1,199)
Income taxes payable	205	48
Restructuring accrual		47
Other long-term liabilities	(147)	(367)
Net cash provided by (used in) operating activities	(23,086)	4,489
Cash Flows From Investing Activities:		
Purchases of property and equipment	(1,503)	(2,421)
Purchases of intangible assets	(2,482)	
Net cash used in investing activities	(3,985)	(2,421)
Cash Flows From Financing Activities:		
Principal payment of note payable		(185)
Proceeds from exercise of stock options and warrants	284	
Proceeds from sale of stock to employees	912	466
Net cash provided by financing activities	1,196	281
Effect of Exchange Rate Changes on Cash and Cash Equivalents	41	9
Net (Decrease) Increase in Cash and Cash Equivalents	(25,834)	2,358
Cash and Cash Equivalents, beginning of period	82,358	56,850
Cash and Cash Equivalents, end of period	$ 56,524	$ 59,208
Supplemental Disclosures of Cash Flow Information:		
Cash paid for income taxes	$ 78	$ 37

Supplemental Disclosures of Non-Cash Investing and Financing Activities:				
Construction-in-progress costs incurred but not paid	$	108	$	175
Promissory note for intangible assets purchase	$	918	$	
Contingent payment for intangible assets purchase	$	1,070	$	

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

The Company

Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) is a provider of entry-level and midrange storage systems for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture.

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 marketing efforts focus toward indirect sales through channel partners and OEMs. These channel partners and OEMs either incorporate our products into their own private-label products or sell our products off the shelf. Our headquarters are located in Carlsbad, California and our research and development facility is located in Longmont, Colorado. We currently plan to consolidate our facility in Carlsbad, California into our Longmont, Colorado facility. Additionally, we have sales offices in the United States, Germany, Japan and the United Kingdom.

Basis of Presentation

The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States 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 generally accepted accounting principles, or GAAP, for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. 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, 2008. Operating results for the three and nine months ended September 30, 2009 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2009.

We have evaluated subsequent events through November 6, 2009, the date of issuance of our unaudited condensed consolidated financial statements.

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. We regularly evaluate estimates and assumptions related to allowances for doubtful accounts, sales returns and allowances, warranty reserves, inventory reserves, share-based compensation expense, deferred income tax asset valuation allowances, uncertain tax positions, litigation, restructuring costs, purchased intangible asset valuations, long-lived asset impairments and other contingencies. We base our estimates and assumptions on current facts, historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the accrual of costs and expenses that are not readily apparent from other sources. The actual results experienced by us may differ materially and adversely from our estimates. To the extent there are material differences between the estimates and the actual results, future results of operations would be affected.

Revenue Recognition

We recognize product revenue when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the price is fixed or determinable; and (iv) collectability is reasonably assured. Revenue is recognized for product sales upon transfer of title and risk of loss to the customer. We record reductions to revenue for estimated product returns and pricing adjustments in the same period that the related revenue is recorded. These estimates are based on historical sales returns, analysis of credit memo data and other factors known at the time. If actual future returns and allowances differ

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from past experience, additional allowances may be required. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 to 36 months. We defer revenue on upfront nonrefundable payments from our customers and recognize it ratably over the term of the agreement, unless the payment is in exchange for products delivered that represent the culmination of a separate earnings process. When we provide consideration to our customer we recognize the value of that consideration as a reduction in net revenue. We may be required to maintain inventory, or hubbing, arrangements with certain of our largest OEM customers. Pursuant to these arrangements we deliver products to a customer or a designated third-party warehouse based upon the customer s projected needs, but do not recognize product revenue unless and until the customer has removed our product from the warehouse to incorporate into its end products.

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. We typically incur significant design and development costs prior to being designed in with our OEM partners. Our agreements with our 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 expect net revenue from Sun Microsystems, or Sun, to continue to decline over future periods. The decline is primarily due to the Sun products nearing the end of their lifecycle and the lack of development of follow-on products.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Sun	16%	1%	28%	6%
HP	44%	59%	30%	51%
NetApp	21%	19%	22%	22%
Other customers less than 10%	19%	21%	20%	21%
Total	100%	100%	100%	100%

Cash and Cash Equivalents

Cash equivalents include highly liquid investments with maturities of three months or less when purchased and consist principally of money market funds. At September 30, 2009, we had $59.2 million in cash and cash equivalents.

Valuation of Inventories

Inventories are comprised of purchased parts and assemblies, which include direct labor and overhead. We record inventories at the lower of cost or market value, with cost generally determined on a first-in, first-out basis. We establish inventory reserves for estimated obsolescence or excess inventory in an amount equal to the difference between the cost of inventory and its estimated realizable value based upon assumptions about future demand and market conditions. If actual demand and market conditions are less favorable than those projected by management, additional inventory reserves could be required. Under the hubbing arrangements that we maintain with certain customers, we own inventory that is physically located in a third-party s warehouse.

Long-Lived Assets

Long-lived assets consist primarily of intangible assets with finite lives and property and equipment. We review long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. An impairment in the carrying value of an asset group is recognized whenever anticipated future undiscounted cash flows from an asset group are estimated to be less than its carrying value. The amount of impairment recognized is the difference between the carrying value of the asset group and its fair value. Fair value estimates are based on assumptions concerning the amount and timing of estimated future cash flows and assumed discount rates, reflecting varying degrees of perceived risk. We recognized $5.4 million of impaired long-lived assets for the year ended December 31, 2008. No impairments of long-lived assets were recognized for the three or nine months ended September 30, 2008 or 2009.

Recent Accounting Pronouncements

In September 2009, the Financial Accounting Standards Board, or FASB, reached a consensus on Accounting Standards Update, or ASU, No. 2009-13, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements*, or ASU 2009-13 and ASU

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No. 2009-14, *Software (Topic 985) Certain Revenue Arrangements That Include Software Elements,* or ASU 2009-14. ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: i) VSOE or ii) third-party evidence, or TPE, before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity s estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product s essential functionality. These new updates are effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. We are currently evaluating the impact that the adoption of these ASUs will have on our future consolidated financial statements.

In August 2009, the FASB, issued Accounting Standards Update No. 2009-05, *Measuring Liabilities at Fair Value*, which provides clarification that in circumstances where a quoted market price in an active market for an identical liability is not available, a reporting entity must measure fair value of the liability using one of the following techniques: 1) the quoted price of the identical liability when traded as an asset; 2) quoted prices for similar liabilities or similar liabilities when traded as assets; or 3) another valuation technique, such as a present value technique or the amount that the reporting entity would pay to transfer the identical liability or would receive to enter into the identical liability that is consistent with the provisions of Topic 820. This statement becomes effective for the first reporting period (including interim periods) beginning after issuance. We will adopt this statement beginning in the fourth quarter of fiscal 2009. Based on the current nature of our operations, we do not expect the adoption of this requirement will have a material impact on our consolidated financial statements.

In June 2009, the FASB issued Accounting Standards Codification, or ASC, No. 810-10-05 which changes the approach to determining the primary beneficiary of a variable interest entity, or VIE and requires companies to more frequently assess whether they must consolidate VIEs. ASC No. 810-10-05 is effective for annual periods beginning after November 15, 2009. Based on the current nature of our operations, we do not expect the adoption of this requirement will have a material impact on our consolidated financial statements.

2. Share-Based Compensation

We account for share-based compensation by measuring and recognizing compensation expense for all share-based payment awards made to employees, directors and consultants, including stock option grants and purchases of stock made pursuant to our 2000 Amended and Restated Equity Incentive Plan, or the 2000 EIP, our 2009 Equity Incentive Plan, or the 2009 EIP, our 2000 Amended and Restated Non-Employee Directors Stock Option Plan, or the 2000 NEDSOP, and our 2000 Amended and Restated Employee Stock Purchase Plan, or the 2000 ESPP, based on estimated fair values.

We estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the award s portion that is ultimately expected to vest is recognized as expense over the requisite service periods in the accompanying unaudited condensed consolidated financial statements for the three and nine months ended September 30, 2008 and 2009.

As of September 30, 2009, total unrecognized share-based compensation cost related to unvested stock options was $3.2 million, which is expected to be recognized over a weighted average period of approximately 2.3 years. We have included the following amounts for share-based compensation expense in the accompanying unaudited condensed consolidated statements of operations (amounts in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Cost of goods sold	$ 102	$ 75	$ 306	$ 292
Sales and marketing	14	57	301	228
Research and development	247	217	705	839
General and administrative	297	248	912	792
Share-based compensation expense before taxes	660	597	2,224	2,151
Related deferred income tax benefits				

Share-based compensation expense	$ 660	$ 597	$ 2,224	$ 2,151
Share-based compensation expense is derived from:				
Stock options	$ 587	$ 537	$ 1,953	$ 1,727
Restricted stock awards		92		234
2000 ESPP	73	(32)	271	190
Total	$ 660	$ 597	$ 2,224	$ 2,151

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Share-based compensation expense recognized during the three and nine months ended September 30, 2009 included (1) compensation expense for awards granted prior to, but not fully vested as of, January 1, 2006 and (2) compensation expense for the share-based payment awards granted subsequent to December 31, 2005, based on the grant date fair values. We estimate forfeitures at the time of grant and revise, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

To estimate compensation expense for the three and nine months ended September 30, 2008 and 2009, we used the Black-Scholes option-pricing model with the following weighted-average assumptions for equity awards granted:

	2000 EIP and 2000 NEDSOP Nine Months Ended September 30,		2000 ESPP Nine Months Ended September 30,	
	2008	2009	2008	2009
Risk-free interest rate	2.79%	2.01%	1.89%	0.32%
Expected dividend yield	%	%	%	%
Volatility	68%	69%	68%	120%
Expected life	5.6 years	5.5 years	0.5 years	0.5 years
Forfeiture rate	12.34%	11.47% - 12.37%	%	%

The risk-free interest rate is based on the implied yield available on U.S. Treasury issues with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the future.

The expected volatility is based on historical volatility of our stock for the expected life of the grant. The expected life of the equity award is based on historical experience.

The forfeiture rate is estimated when awards are granted and updated if information becomes available indicating that actual forfeitures will differ. The eventual consolidation of our Carlsbad facility to Longmont may impact our forfeiture rate. We will analyze the impact once this consolidation occurs and disclose any impact to compensation expense.

Stock Incentive Plans

2009 EIP. Our stockholders approved the 2009 EIP at our Annual Meeting of Stockholders held on June 15, 2009. The 2009 EIP authorizes the issuance or grant of incentive stock options, non-statutory stock options, restricted stock awards, restricted stock unit awards, stock appreciation rights, performance awards, performance cash awards and other stock awards to our employees, directors and consultants and is intended as the successor to and continuation of our 2000 EIP. Following the approval of the 2009 EIP by our stockholders, no additional stock awards may be granted under the 2000 EIP. All outstanding stock awards granted under the 2000 EIP will remain subject to the terms of the 2000 EIP provided, however, that any shares subject to outstanding stock awards granted under the 2000 EIP that expire or terminate for any reason prior to exercise or settlement shall become available for issuance pursuant to awards granted under the 2009 EIP. As of June 15, 2009, the total number of shares of our common stock reserved for issuance under the 2009 EIP consisted of 4,500,000 shares plus 7,112,217 shares that are subject to outstanding stock awards under the 2000 EIP that may become available for grant under the 2009 EIP if they expire or terminate for any reason prior to exercise or settlement under the 2000 EIP. Unless sooner terminated by our Board of Directors, the 2009 EIP shall automatically terminate on April 26, 2019, the day before the tenth anniversary of the date the 2009 EIP was adopted by the Board. The Board of Directors may also amend the 2009 EIP at any time subject to applicable laws and regulations, including the rules and regulations of The NASDAQ Stock Market LLC. In general, no amendment or termination of the 2009 EIP may adversely affect any rights under awards already granted to a participant unless agreed to by the affected participant.

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As of September 30, 2009, 101,667 shares of restricted stock were outstanding under the 2009 EIP. Additionally, 1,409,324 shares of restricted stock were outstanding under the 2000 EIP, of which 800,000 shares were performance-based restricted stock awards. These performance based awards were issued in February 2009 and vest one year from grant date provided that the performance objectives are achieved.

As of September 30, 2009, options to purchase 5,564,539 shares of common stock were outstanding under the 2000 EIP and 5,396,349 shares of common stock remained available for grant under the 2009 EIP.

2000 NEDSOP. Under the 2000 NEDSOP, nonqualified stock options to purchase common stock are automatically granted to our non-employee directors upon appointment to our board of directors (initial grants) and upon each of our annual meetings of stockholders (annual grants). Options granted under the 2000 NEDSOP expire 10 years from the date of the grant. Initial grants vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. Annual grants are fully vested on the date of grant. 1,000,000 shares of common stock are reserved for issuance under the 2000 NEDSOP. As of September 30, 2009, options to purchase 640,000 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 273,124 shares of common stock remained available for grant under the 2000 NEDSOP.

2000 ESPP. Our stockholders approved an amendment to our 2000 ESPP at our Annual Meeting of Stockholders held on June 15, 2009, primarily to increase the share reserve under the 2000 ESPP by 4,000,000 shares. The 2000 ESPP qualifies under the provisions of Section 423 of the Internal Revenue Code, or IRC, and provides our eligible employees, as defined in the 2000 ESPP, with an opportunity to purchase shares of our common stock at 85% of fair market value. There were 368,498 and 1,076,265 shares issued under the 2000 ESPP during the nine months ended September 30, 2008 and 2009, respectively.

A summary of stock option activity is as follows:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at December 31, 2008	6,912,141	$ 4.35		
Granted	189,500	0.75		
Exercised				
Forfeited	(12,103)	3.26		
Expired	(884,997)	5.73		
Outstanding at September 30, 2009	6,204,541	$ 4.05	6.8	$ 356,690
Vested and expected to vest at September 30, 2009	5,993,867	$ 4.12	6.8	$ 308,551
Exercisable at September 30, 2009	4,005,910	$ 4.91	6.0	$ 53,420

A summary of restricted stock award activity is as follows:

	Number of shares	Weighted Average grant date fair value
Outstanding at December 31, 2008	332,128	$ 2.34
Granted *	1,487,267	0.52
Vested	(48,654)	1.49
Forfeited	(259,750)	2.30
Outstanding and unvested at September 30, 2009	1,510,991	$ 0.58

* Includes 800,000 performance-based restricted stock awards. These performance based awards were issued in February 2009 and vest one year from grant date provided that the performance objectives are achieved.

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The weighted average grant-date fair values of options granted during the three months ended September 30, 2008 was $1.42 per share. There were no options granted during the three months ended September 30, 2009. The weighted average grant-date fair values of options granted during the nine months ended September 30, 2008 and 2009 were $1.45 per share and $0.45 per share, respectively.

The weighted average grant-date fair value of restricted stock awards granted during the three months ended September 30, 2008 and 2009 were $2.45 and $1.18 per share, respectively. The weighted average grant-date fair value of restricted stock awards granted during the nine months ended September 30, 2008 and 2009 were $2.45 and $0.52 per share, respectively.

During the nine months ended September 30, 2009, cash generated from share-based compensation arrangements amounted to $0.5 million from the purchase of shares through the 2000 ESPP. We issue new shares from the respective plan share reserves upon the grant of restricted stock, exercise of options to purchase common stock and for purchases through the 2000 ESPP.

The total fair value of options to purchase common stock that vested during the three months ended September 30, 2008 and 2009 was $0.4 million and $0.7 million, respectively. The total fair value of options to purchase common stock that vested during the nine months ended September 30, 2008 and 2009 was $2.0 million and $1.8 million, respectively.

3. Net Loss Per Share

Basic net loss per share is calculated by dividing net loss by the weighted average number of common shares outstanding during the period.

Diluted net loss per share reflects the potential dilution by including common stock equivalents, such as stock options, stock warrants and convertible preferred stock, in the weighted average number of common shares outstanding for a period, if dilutive.

For the three and nine months ended September 30, 2008, outstanding options to purchase 6,748,436 shares of common stock with exercise prices ranging from $1.34 to $16.36 per share and warrants 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 antidilutive.

For the three and nine months ended September 30, 2009, outstanding options to purchase 6,204,541 shares of common stock with exercise prices ranging from $0.47 to $16.36 per share and warrants 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 antidilutive.

4. Inventories

Net inventories are stated at the lower of cost (first-in, first-out) or market value. The following is a summary of net inventories (in thousands):

	December 31, 2008	September 30, 2009
Purchased parts and materials	$ 2,637	$ 1,495
Finished goods	11,490	3,543
Total inventory	$ 14,127	$ 5,038

Inventories are net of an allowance for excess and obsolete inventory of approximately $1.8 million and $2.3 million as of December 31, 2008 and September 30, 2009, respectively.

5. Intangible Assets

All of our identified intangible assets are considered to have finite lives and are being amortized over their remaining useful lives. Our identified intangible assets consist of the following (in thousands):

	December 31, 2008		
	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (5,000)	$
RaidCore technology	4,256	(287)	3,969
NAS technology	214	(19)	195
Total intangible assets	$ 9,470	$ (5,306)	$ 4,164

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	September 30, 2009		
	Gross	Accumulated Amortization	Net
RaidCore technology	$ 4,256	$ (1,085)	$ 3,171
NAS technology	214	(72)	142
Total intangible assets	$ 4,470	$ (1,157)	$ 3,313

Amortization expense related to intangible assets totaled $0.3 million and $0.3 million for the three months ended September 30, 2008 and 2009, respectively. Amortization expense related to intangible assets totaled $1.1 million and $0.9 million for the nine months ended September 30, 2008 and 2009, respectively.

Estimated future amortization expense related to intangible assets as of September 30, 2009 is as follows (in thousands):

Years ending December 31,	
2009 (Remaining 3 months)	$ 284
2010	1,136
2011	1,116
2012	777
Total	$ 3,313

6. 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 covered by 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, which could have a material adverse effect on our operating results and financial condition if these warranties are eliminated. Estimated liabilities for product warranties are included in accrued expenses. Our warranty cost activity is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Balance, beginning of period	$ 1,453	$ 1,169	$ 1,381	$ 1,560
Changes in accrual related to warranties issued during the period	120	68	444	355
Changes in accrual related to preexisting warranties	971	233	2,266	823
Deductions for costs incurred	(850)	(545)	(2,397)	(1,813)
Balance, end of period	$ 1,694	$ 925	$ 1,694	$ 925

7. Deferred Revenue

In July 2008, we entered into a long-term fixed price contract with one of our customers. We account for this long-term contract under the completed-contract method due to our inability to forecast reasonably dependable estimates. Under the completed-contract method, during the period of contract performance, billings and costs are accumulated on the balance sheet, but no profit or income is recorded before completion or substantial completion of the work. During the three months ended September 30, 2009, we executed a change order with our customer resulting in the completion of the contract. Both parties agreed to end the contract due to the significant changes in the overall scope of the program. As a result, we recognized $1.5 million in revenue and $0.4 million in associated costs of goods sold for the three and nine months ended September 30, 2009. The recorded costs of goods sold does not include pre-contract costs expensed prior to executing a contract with our customer.

Additionally, deferred revenue consists of our product maintenance revenue activity as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Balance, beginning of period	$ 546	$ 589	$ 695	$ 543
New warranty revenue contracts	287	290	1,197	884
Revenue recognized	(322)	(313)	(1,381)	(861)
Balance, end of period	$ 511	$ 566	$ 511	$ 566

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8. Restructuring Charge

In December 2008, our management approved, committed to and initiated plans to restructure and improve efficiencies in our operations. Costs associated with the restructuring plan totaled $0.8 million, primarily related to severance of $0.3 million and facility costs of $0.5 million. The restructuring charge was included in operating expenses in the consolidated statement of operations for the year ended December 31, 2008. The restructuring was due to a combination of factors, primarily driven by the economic downturn, but also driven by our plan to eventually consolidate our facility in Carlsbad, California into the Longmont, Colorado facility. The facility costs are related to approximately 40% of unused space in our Carlsbad, California facility and severance costs represent costs associated with a reduction in workforce. The facility costs are expected to be paid over the remainder of the lease ending in April 2013. To the extent that we are unable to find a tenant to sub-lease our unused space, we may have additional restructuring charges. The majority of the severance liability is expected to be paid through June 30, 2010.

	Restructuring Accrual at December 31, 2008	Restructuring Charges	Cash Payments	Restructuring Accrual at September 30, 2009
			(in thousands)	
Facility costs	$ 541	$ 221	$ (397)	$ 365
Severance costs	140	720	(500)	360
Total	$ 681	$ 941	$ (897)	$ 725

For the nine months ended September 30, 2009 new restructuring charges were the direct result of current period facility move costs as well as severance and retention costs recognized ratably over the service period.

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9. Income Taxes

We recorded an income tax benefit of $0.1 million for the three months ended September 30, 2009 compared to an income tax benefit of $0.1 million for the three months ended September 30, 2008. Our effective income tax rate of 7.18% for the three months ended September 30, 2009 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.

We recorded an income tax benefit of $0.1 million for the nine months ended September 30, 2009 compared to an income tax expense of $0.3 million for the nine months ended September 30, 2008. Our effective income tax rate of 1.08% for the nine months ended September 30, 2009 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.

At December 31, 2008 we had cumulative unrecognized tax benefits of approximately $4.8 million, of which approximately $0.3 million are included in other long term liabilities that, if recognized, would affect the effective tax rate. The remaining $4.5 million of unrecognized tax benefits will have no impact on the effective tax rate due to the existence of net operating loss carryforwards and a full valuation allowance. Consistent with previous periods, penalties and tax related interest expense are reported as a component of income tax expense. As of December 31, 2008, the total amount of accrued income tax related interest and penalties included in the consolidated balance sheet was less than $0.1 million. We do not expect that our unrecognized tax benefit will change significantly within the next 12 months. There have been no material changes to the unrecognized tax benefit during the three month period ended September 30, 2009.

Due to net operating losses and other tax attributes carried forward, we are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending March 31, 1995 through December 31, 2008. With few exceptions, our state income tax returns are open to audit for the years ended December 31, 2000 through 2008.

We periodically evaluate the likelihood of the realization of deferred tax assets, and adjust the carrying amount of the deferred tax assets by the valuation allowance to the extent the future realization of the deferred tax assets is not judged to be more likely than not. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income or loss, the carryforward periods available to us for tax reporting purposes and other relevant factors.

At December 31, 2008, we had federal and state net operating losses of approximately $165.9 million and $96.7 million, respectively, which begin to expire in the tax years ending 2019 and 2009, respectively. In addition, we had federal tax credit carryforwards of $6.3 million, of which approximately $0.5 million can be carried forward indefinitely to offset future tax liability, and the remaining $5.8 million will begin to expire in the tax year ending 2009. We also had state tax credit carryforwards of $5.5 million, of which $0.2 million will begin to expire in 2009, and the remaining $5.3 million have no expiration date.

At December 31, 2008, based on the weight of available evidence, including cumulative losses in recent years and expectations regarding future taxable income, we determined that it was not more likely than not that our United States deferred tax assets would be realized and have a $75.9 million valuation allowance associated with our United States deferred tax assets.

As a result of our equity transactions, an ownership change, within the meaning of IRC Section 382, occurred on September 18, 2003. As a result, annual use of our federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Dot Hill immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of Section 382 (f) of the IRC) in effect at that time. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the IRC Section 382 limitation for those years.

As a result of our acquisition of Chaparral Network Storage, Inc., or Chaparral, a second ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of Chaparral s federal net operating loss and credit carry forwards may be limited. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the Section 382 limitation for those years.

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We have not provided for any residual U.S. income taxes on the earnings from our foreign subsidiaries because such earnings are intended to be indefinitely reinvested. Such residual U.S. income taxes, if any, would be insignificant.

10. Credit Facilities

Line of Credit

In August 2008, we entered into a credit agreement with Silicon Valley Bank to provide for a revolving credit facility 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. 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 of $55 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. On March 16, 2009, we issued a letter of credit to our contract manufacturer in China in the amount of $5.0 million. As of September 30, 2009, we were in compliance with all financial covenants under the credit agreement. There were no amounts outstanding under this credit facility as of September 30, 2009.

In July 2009, we amended our credit agreement with Silicon Valley Bank. The amendment reduces our obligation to maintain at all times a net worth of $55 million to $50 million (subject to certain increases) and revises the definition of net worth to exclude certain changes such as restructuring expenses and goodwill and long-lived asset impairment charges, subject to certain limitations. The amendment also provides for a cash management services sublimit under the revolving credit line of up to $300,000. All other terms of the credit agreement remain unchanged.

11. Commitments and Contingencies

Dot Hill Securities Class Actions, Derivative Suits and Direct State Securities Action

In late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints allege violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004, and seeking damages therefore. The complaints were consolidated into a single action, and the Court appointed as lead plaintiff a group comprised of the Detroit Police and Fire Retirement System and the General Retirement System of the City of Detroit. The consolidated complaint was filed on August 25, 2006, and we filed a motion to dismiss on October 5, 2006. The Court granted our motion to dismiss on March 15, 2007. Plaintiffs filed their Second Amended Consolidated Complaint on April 20, 2007. We filed a motion to dismiss the Second Amended Consolidated Complaint on May 1, 2008, which the Court granted on September 2, 2008. The plaintiffs subsequently filed a Third Amended Consolidated Complaint on October 10, 2008, and on November 24, 2008 we filed a motion to dismiss. On March 18, 2009, the Court dismissed the Third Amended Consolidated Complaint, but granted plaintiffs leave to amend one more time. On April 17, 2009, plaintiffs filed a Notice of Appeal regarding the Court s September 2, 2008 and March 18, 2009 orders. On May 19, 2009, the Court entered final judgment and dismissed the action with prejudice; the plaintiffs subsequently filed an Amended Notice of Appeal on June 8, 2009. On October 29, 2009, the parties filed a Stipulation of Dismissal of Appeal. On October 30, 2009, the appeal was dismissed.

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In addition, three complaints purporting to be derivative actions were filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. Our demurrers to two of those cases, in which we sought dismissal, were overruled (i.e., denied). We formed a Special Litigation Committee, or SLC, of disinterested directors to investigate the alleged wrongdoing. On January 12, 2007, another derivative action similar to the previous derivative actions with the addition of allegations regarding purported stock option backdating was served on us. In April 2007, the SLC concluded its investigation and based on its findings directed us to file a motion to dismiss the derivative matters. On July 13, 2007, all of the derivative actions were consolidated for pre-trial proceedings. We filed a motion to dismiss the consolidated matters pursuant to the SLC s directive on May 30, 2008. The hearing on this motion is set for February 19, 2010. The outcome of this action is uncertain, and no amounts have been accrued as of September 30, 2009.

In August 2007, a securities lawsuit was filed in California state court by a single former stockholder against us and certain of our directors and executive officers. This complaint is based on the same facts and circumstances described in the federal class action and state derivative complaints, and generally alleges that Dot Hill and the named officers and directors committed fraud and violated state securities laws. The complaint seeks damages, as well as attorneys fees and costs. On November 1, 2007, we filed a motion to dismiss the complaint, which was granted on February 15, 2008. On February 25, 2008, the plaintiff filed his First Amended Complaint. We filed a motion to dismiss the First Amended Complaint on March 6, 2008, which was granted on May 16, 2008. The plaintiff was granted leave to amend. On August 13, 2009, the action was dismissed with prejudice after the parties executed a settlement agreement.

The pending proceedings involve complex questions of fact and law and will require the expenditure of significant funds and the diversion of other resources to prosecute and defend. The results of legal proceedings are inherently uncertain and material adverse outcomes are possible. From time to time the Company may enter into confidential discussions regarding the potential settlement of pending litigation or other proceedings; however, there can be no assurance that any such discussions will occur or will result in a settlement. The settlement of any pending litigation or other proceedings could require Dot Hill to incur substantial settlement payments and costs.

Other Litigation

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

12. Warrant

In January 2008, we amended our Product Purchase Agreement, or the Agreement, originally entered into with HP in September 2007, to allow for sales to additional divisions within HP. In connection with the Agreement, we issued a warrant to HP to purchase 1,602,489 shares of our common stock (approximately 3.5% of our outstanding shares prior to the issuance of the warrant) at an exercise price of $2.40 per share. The warrant was fully vested and exercisable at signing. The fair value of the warrant, determined using the Black-Scholes option-pricing model, was approximately $2.3 million. The Black-Scholes option-pricing model utilized the following assumptions; a risk-free interest rate of 3.18%, expected volatility of 59.5% and a contractual life of five years. The warrant was issued to induce the customer to enter into the Agreement with us. The fair value of the warrant was recorded as a reduction in revenue for the three months ended March 31, 2008, the period the Agreement was signed. At September 30, 2009, there were warrants outstanding to purchase 1,602,489 shares of our common stock at an exercise price of $2.40 per share that expire on January 3, 2013.

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13. Segment Information

Operating segments are components of an enterprise for which separate financial information is available and is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. We operate our business in one reportable operating segment.

Geographic Revenues

Net revenue is recorded in the geographic area in which the sale is originated. Information concerning principal geographic areas in which we operate is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Net revenue:				
United States	$ 69,730	$ 58,450	$ 180,509	$ 155,273
Europe	6,163	4,289	17,366	14,310
Asia	748	861	2,619	2,234
	$ 76,641	$ 63,600	$ 200,494	$ 171,817

14. Fair Value of Financial Instruments

The carrying amounts and fair values of our financial instruments at September 30, 2009 was as follows (in thousands):

	September 30, 2009	
	Carrying Value	Fair Value
Liabilities:		
Note payable	$ 670	$ 670
Other long-term liabilities	$ 1,070	$ 1,005

The carrying values on our balance sheet of our cash and cash equivalents, accounts receivable, accounts payable and income taxes payable approximate their fair values due to their short maturities; thus, we exclude them from the table above.

We estimated the fair value of our note payable and other long-term liabilities using a discounted cash flows approach and incorporated our credit risk for the liability measurement.

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, 2008. 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 elsewhere 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, 2008.

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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 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 provide additional layers of data protection options to complement our line of storage disk arrays. Our current mainstream 2000 series of entry-level storage products and newer Just a Bunch of Disks, or JBOD arrays have significantly increased in market share during 2008 and are targeted primarily at mainstream enterprise and small-to-medium business, or SMB, applications. Our legacy SANnet II products have been distinguished by certification as Network Equipment Building System, or NEBS, Level 3 (a telecommunications standard for equipment used in central offices) and are MIL-STD-810F (a military standard created by the U.S. government) compliant based on their ruggedness and reliability, and this legacy is continued in a number of next generation products that we plan to bring to market in 2009. In January 2009, we launched a new line of products to address the growing need for smaller form factor, highly dense storage utilizing SAS or serial ATA, or SATA disks, as well as the newest generation of solid state disks, or SSDs. In September 2008, we made a significant investment through our acquisition of certain assets, namely RAIDCore and Network Attached Software, or NAS, from Ciprico Inc., or Ciprico. We believe this acquisition will open up new markets for us in the enterprise server and workstation markets for data protection internal to the servers and workstations. The acquisition also provided us with a new team of software development professionals located in Minneapolis, Minnesota. We signed our first customer agreement relating to RAIDCore products in May 2009, and began selling to this customer during the third quarter of 2009.

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, Fujitsu Technology Solutions GmbH, or FTS, Motorola, Inc., or Motorola, and Sun Microsystems, or Sun.

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. The agreement does not contain any minimum purchase commitments and the term of the agreement was extended from one to five years. In connection with the agreement, we issued a warrant to HP to purchase 1,602,489 shares of our common stock (approximately 3.5% of our outstanding shares prior to the issuance of the warrant) at an exercise price of $2.40 per share. The warrant was fully vested and exercisable at signing. The fair value of the warrant, determined using the Black-Scholes option-pricing model, was approximately $2.3 million. The Black-Scholes option-pricing model utilized the following assumptions; a risk-free interest rate of 3.18%, expected volatility of 59.5% and a contractual life of five years. The warrant was issued to induce the customer to enter into the agreement with us. The fair value of the warrant was recorded as a reduction in revenue for the three months ended March 31, 2008, the period the agreement was signed.

We have been shipping our products to Sun for resale to Sun s customers since October 2002 and continue to do so. However, we have experienced a decline in net revenue from Sun primarily due to the products nearing the end of their lifecycle and the lack of development of follow-on products for the ST-3000 line to date. We expect net revenue from Sun to continue to decline over future periods. Pursuant to our Development and OEM Supply Agreement with NetApp, we are designing and developing 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. Pursuant to our Master Purchase Agreement with FTS, we jointly developed with FTS storage solutions utilizing key components and patented technologies from us. We began shipping products to FTS under the agreement in July 2006.

Our agreements with our channel partners do not contain any minimum purchase commitments and may be terminated at any time upon notice from the applicable partner. Our ability to achieve profitability will depend on, among other things, the level and mix of orders we actually receive from our channel partners, 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 channel partners and the economic environment.

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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; and

- the timing, rescheduling or cancellation of significant customer orders and our ability, as well as the ability of our customers, to manage inventory.

For these and other reasons, our net revenue and results of operations in 2009 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. Since 2002, we outsourced substantially all of our manufacturing operations to Flextronics International Limited, or Flextronics. In February 2007, we entered into a manufacturing agreement with MiTAC International Corporation, or MiTAC, a leading provider of contract manufacturing and original design manufacturing services, and SYNNEX Corporation, or SYNNEX, a leading global information technology, or IT, supply chain services company. We began shipping products for general availability under the MiTAC and SYNNEX agreement in 2007. Substantially all of our Series 2000 and Series 5000 R/Evolution products were manufactured by these partners through September 30, 2009.

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.

We derive net revenues primarily from sales of our Series 2000 and SANnet II family of products and we are in the process of transitioning SANnet II customers to our Series 2000 and Series 5000 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, cash equivalents and other miscellaneous income and expense items.

In September 2008, we acquired certain identified RAIDCore and NAS assets of Ciprico for approximately $4.5 million, consisting of cash consideration of $2.3 million, an unsecured non-interest bearing promissory note in the amount of $0.9 million and contingent consideration in the amount of $1.1 million. Additionally, we incurred $0.2 million in acquisition related costs, primarily

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consisting of legal fees. Payments under the promissory note are due in equal monthly installments over a 42-month period that commenced October 1, 2008. We are also required to pay Ciprico earn-out payments of up to $2.0 million over the 42 months following the date of acquisition. The earn-out payments are payable on a quarterly basis and are equal to 6.67% of RAIDCore and NAS net revenue for the quarterly period. The contingent consideration liability fair value, as of the acquisition date, was $1.1 million and is included in other long-term liabilities. The purchase price was allocated to the assets acquired based on estimated fair values on the transaction date, resulting in the recording of RAIDCore technology of $4.3 million and NAS technology of $0.2 million. The RAIDCore and NAS assets are being amortized on a straight-line basis over four years and three years, respectively. Our primary reasons for the acquisition were to allow us to broaden our product portfolio in the RAID market while allowing us to sell into the Band 1 market, and to pursue opportunities at current and target OEM customers.

In December 2008, our management approved, committed to, and initiated plans to restructure and improve efficiencies in our operations. Costs associated with the restructuring plan totaled $0.8 million, primarily related to severance and facility costs. The restructuring was due to a combination of factors, primarily driven by the economic downturn, but also driven by our eventual plan to consolidate our facilities in Carlsbad, California into the Longmont, Colorado facility. We anticipate the move to be substantially completed by June 30, 2010.

As a result of our ongoing strategic development, planning and evaluation, we have identified sustainable higher margin business that will greatly compliment our current product offerings. Accordingly, we have decided to expand our current focus to include two new initiatives; channel sales and software. We will leverage our current products and technology to pursue selling through alternative distribution channels, such as Value Added Resellers. Additionally, we will increase our investments in software that will both be embedded in our RAID Controller and will also be available to run stand alone on servers. Both initiatives will require investment and development on our part.

Critical Accounting Policies and Estimates

There have been no significant changes in our critical accounting policies to those presented in our Form 10-K for the year ended December 31, 2008.

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 September 30,		**Nine Months Ended September 30,**	
	2008	**2009**	**2008**	**2009**
Net revenue	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	88.3	81.7	89.9	83.2
Gross profit	11.7	18.3	10.1	16.8
Operating expenses:				
Sales and marketing	3.9	4.4	5.4	4.6
Research and development	9.1	11.4	10.7	12.4
General and administrative	4.3	3.7	5.1	4.4
Restructuring charge		0.8		0.6
Legal settlement	(0.3)		(2.0)	
Total operating expenses	17.0	20.2	19.3	21.9
Operating loss	(5.3)	(1.9)	(9.1)	(5.1)
Other income, net	0.4		0.7	0.1
Loss before income taxes	(4.9)	(1.9)	(8.4)	(5.1)
Income tax expense (benefit)	(0.1)	(0.1)	0.1	0.1

Net loss	(4.8)%	(1.8)%	(8.6)%	(5.0)%

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Three Months Ended September 30, 2008 Compared to the Three Months Ended September 30, 2009

Net Revenue

	Three Months Ended September 30,			
	2008	2009	Decrease	% Change
	(in thousands, except percentages)			
Net Revenue	$ 76,641	$ 63,600	$ (13,041)	(17.0)%

The decrease in net revenue is primarily attributable to a decrease in net revenue from Sun, which sells our SANnet II family of products under the ST-3000 brand product line. Our net revenue from Sun decreased 96% from the three months ended September 30, 2008 as compared to the three months ended September 30, 2009. For the three months ended September 30, 2008, net revenue from Sun totaled 16.3% of our total net revenue, compared to 0.8% of our total net revenue for the three months ended September 30, 2009. The decline in Sun net revenue is primarily due to the Sun products nearing the end of their lifecycle. This decrease in net revenue from Sun was partially offset by an increase in net revenue from HP, who sells a version of our Series 2000 family of products within their MSA 2000 product family. For the three months ended September 30, 2008, HP net revenue totaled 44.0% of total net revenue as compared to 58.8% of total net revenue for the three months ended September 30, 2009. The increase in HP net revenue is due to the successful launch and market acceptance of the HP MSA 2000 product in 2008, which continued in 2009, as well as the successful launch of follow-on products in 2009. Total net revenue from our other major customer, NetApp, decreased during the same comparable periods. For the three months ended September 30, 2008, net revenue from NetApp totaled 20.7% of our total net revenue, compared to 19.5% of our total net revenue for the three months ended September 30, 2009. The decrease in net revenue from NetApp, as well as decreases from some of our other customers, is due to a reduction in the number of units sold and is primarily attributable to the economic downturn. In July 2008 we entered into a long-term fixed price contract with one of our customers. We accounted for this long-term contract under the completed-contract method due to our inability to forecast reasonably dependable estimates. Under the completed-contract method, during the period of contract performance, billings and costs are accumulated on the balance sheet, but no profit or income is recorded before completion or substantial completion of the work. During the three months ended September 30, 2009, we executed a change order with our customer resulting in the completion of the contract. Both parties agreed to end the contract due to the significant changes in the overall scope of the program. As a result, we recognized $1.5 million in revenue for the three months ended September 30, 2009.

Cost of Goods Sold and Gross Profit

	Three Months Ended September 30, 2008		Three Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease) Increase	% Change
	(in thousands, except percentages)					
Cost of Goods Sold	$ 67,700	88.3%	$ 51,969	81.7%	$ (15,731)	(23.2)%
Gross Profit	$ 8,941	11.7%	$ 11,631	18.3%	$ 2,690	30.1%

The decrease in cost of goods sold and increase in gross profit as percentages of net revenue was primarily attributable to the success of our product cost reduction and value engineering initiatives over the past year which has significantly reduced cost of goods sold as a percentage of net revenue for both our Series 2000 products that we sell to HP and other customers as well as the products we sell to NetApp. Additionally, gross profit was positively impacted by $1.1 million as a result of the recognition of revenue and costs of goods sold associated with the completion of our long-term contract accounted for under the completed contract method. These positive impacts were partially offset by a decrease in net revenue from our higher margin products sold to SANnet II customers; primarily Sun. Manufacturing overhead and variances associated with manufacturing and supporting our customers declined from the three months ended September 30, 2008 to the three months ended September 30, 2009 by $0.9 million due to a reduction in payroll related costs and improved management of the manufacturing process and supply chain. Furthermore, the decrease in costs of goods sold was due to depreciation and amortization decreasing due to the fourth quarter 2008 impairment and write off of certain long-lived assets, as well as an intangible asset fully amortizing in the third quarter of 2008.

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Sales and Marketing Expenses

	Three Months Ended September 30, 2008		Three Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Sales and Marketing Expenses	$ 2,990	3.9%	$ 2,772	4.4%	$ (218)	(7.3)%

The decrease in sales and marketing expenses in absolute dollars was primarily attributable to a work force reduction which resulted in a decrease in salaries, bonuses, commissions and other employee related costs.

Research and Development Expenses

	Three Months Ended September 30, 2008		Three Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Research and Development Expenses	$ 6,940	9.1%	$ 7,241	11.4%	$ 301	4.3%

The increase in research and development expense in absolute dollars and as a percentage of net revenue was primarily due to an increase in salaries and other payroll related expenses of approximately $0.2 million, an increase in consultant expenses of approximately $0.2 million and an increase in intangible amortization of approximately $0.3 million. These increases were partially offset by a decrease in project materials, test equipment and non-recurring engineering of approximately $0.3 million. The increase in salaries and other payroll related expenses was a direct result of the hiring of new employees to support development activities related to the September 2008 acquisition of assets from Ciprico. The increase in consultant expenses are directly related to the ongoing development activities. The increase in intangible amortization is due to the amortization of certain intangible assets acquired from Ciprico. The decrease in project materials, test equipment and non-recurring engineering occurred because we were still incurring development costs associated with the ramp up of the HP product line during the three months ended September 30, 2008. These costs were not as significant during the three months ended September 30, 2009.

General and Administrative Expenses

	Three Months Ended September 30, 2008		Three Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
General and Administrative Expenses	$ 3,309	4.3%	$ 2,320	3.7%	$ (989)	(29.9)%

The decrease in general and administrative expenses in absolute dollars and as a percentage of net revenue is primarily due to a decrease in professional fees of $0.8 million, Oracle implementation costs of $0.2 million, and insurance fees of $0.1 million. These decreases were partially offset by an increase in board fees of $0.1 million. The decreases in professional fees, other professional fees and insurance fees are due to our ability to renegotiate lower fees with our service providers. IT consulting costs decreased due to the consultants being replaced with full-time employees.

Restructuring Charge

	Three Months Ended September 30, 2008		Three Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Restructuring Charge	$		$ 530	0.8%	$ 530	100%

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In December 2008, our management approved, committed to and initiated plans 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 our facility in Carlsbad, California into our Longmont, Colorado facility. The restructuring plan consists of 40% of our facility costs relating to unused space in our Carlsbad, California facility and severance costs that are related to a reduction in workforce. As of September 30, 2009, the majority of our Carlsbad operations has been moved to our Longmont facility. We anticipate the move to be completed by June 30, 2010.

Restructuring charges incurred during the third quarter of 2009 were the direct result of current period facility move costs as well as severance and retention costs recognized ratably over the service period.

Legal Settlement

	Three Months Ended September 30, 2008		Three Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Legal settlement	$ (200)	(0.3)%	$		$ (200)	(100.0)%

During the three months ended September 30, 2008 we received legal settlement proceeds of $0.2 million related to a claim we filed in December 2006 against Infortrend for breach of the settlement agreement with Crossroads whereby Infortrend withheld $1.475 million for Taiwanese taxes. Such amount is reported as a reduction in operating expenses.

Other Income, net

	Three Months Ended September 30, 2008		Three Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Other Income, net	$ 290	0.4%	$ 7	0.0%	$ (283)	(97.6)%

The decrease in other income, net is primarily attributable to a decrease in interest income of $0.3 million. The decrease in interest income is primarily attributable to declining interest rates and implementing a more conservative investment policy.

Income Taxes

We recorded an income tax benefit of $0.1 million for the three months ended September 30, 2008 and for the three months ended September 30, 2009. Our effective income tax rate of 7.18% for the three months ended September 30, 2009 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.

Nine Months Ended September 30, 2008 Compared to the Nine Months Ended September 30, 2009

Net Revenue

Nine Months Ended September 30,

	2008	2009	Decrease	% Change
	(in thousands, except percentages)			
Net Revenue	$ 200,494	$ 171,817	$ (28,677)	(14.3)%

The decrease in net revenue is primarily attributable to a decrease in net revenue from Sun, which sells our SANnet II family of products under the ST-3000 brand product line. Our net revenue from Sun decreased 83% from the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2009. For the nine months ended September 30, 2008, net revenue from

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Sun totaled 27.9% of our total net revenue, compared to 5.7% of our total net revenue for the nine months ended September 30, 2009. The decline in Sun net revenue is primarily due to the Sun products nearing the end of their lifecycle. This decrease in net revenue from Sun was partially offset by an increase in net revenue from HP, who sells a version of our Series 2000 family of products within their MSA 2000 product family. For the nine months ended September 30, 2008, HP net revenue totaled 29.8% of total net revenue. For the nine months ended September 30, 2009, HP net revenue totaled 51.1% of total net revenue. The increase in HP net revenue is due to the successful launch and market acceptance of the HP MSA 2000 product in 2008, which continued in 2009, as well as the successful launch of follow-on products in 2009. Total net revenue from our other major customer, NetApp, decreased in absolute dollars during the same comparable periods. For the nine months ended September 30, 2008, net revenue from NetApp totaled 21.9% of our total net revenue, compared to 22.2% of our total net revenue for the nine months ended September 30, 2009. The decrease in net revenue from NetApp, as well as decreases from some of our other customers is due to a reduction in the number of units sold and is primarily attributable to the economic downturn. In July 2008 we entered into a long-term fixed price contract with one of our customers. We accounted for this long-term contract under the completed-contract method due to our inability to forecast reasonably dependable estimates. Under the completed-contract method, during the period of contract performance, billings and costs are accumulated on the balance sheet, but no profit or income is recorded before completion or substantial completion of the work. During the three months ended September 30, 2009, we executed a change order with our customer whereby the deliverables under the contract were revised resulting in the completion of the contract. Both parties agreed to end the contract due to the significant changes in the overall scope of the program. As a result, we recognized $1.5 million in revenue for the nine months ended September 30, 2009.

Cost of Goods Sold and Gross Profit

	Nine Months Ended September 30, 2008		Nine Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease) Increase	% Change
	(in thousands, except percentages)					
Cost of Goods Sold	$ 180,165	89.9%	$ 142,955	83.2%	$ (37,210)	(20.7)%
Gross Profit	$ 20,329	10.1%	$ 28,862	16.8%	$ 8,533	42.0%

The decrease in cost of goods sold and increase in gross profit as percentages of net revenue was primarily attributable to the success of our product cost reduction and value engineering initiatives over the past year which has significantly reduced cost of goods sold as a percentage of net revenue for both our Series 2000 products that we sell to HP and other customers as well as the products we sell to NetApp. Additionally, gross profit was positively impacted by $1.1 million as a result of the recognition of revenue and costs of goods sold associated with the completion of our long-term contract accounted for under the completed contract method. These positive impacts were partially offset by a decrease in net revenue from our higher margin products sold to SANnet II customers; primarily Sun. Manufacturing overhead and variances associated with manufacturing and supporting our customers declined from the nine months ended September 30, 2008 to the nine months ended September 30, 2009 by $4.0 million due to a reduction in payroll related costs and tighter management of the manufacturing process and supply chain. Furthermore, the decrease in costs of goods sold was due to depreciation and amortization decreasing due to the fourth quarter 2008 impairment and write off of certain long-lived assets, as well as an intangible asset fully amortizing in the third quarter of 2008. These reductions to costs of goods sold were partially offset by a $0.9 million inventory reserve charge primarily associated with Sun end of life inventory and to a lesser degree certain component parts of our Series 2000 products.

Sales and Marketing Expenses

	Nine Months Ended September 30, 2008		Nine Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Sales and Marketing Expenses	$ 10,909	5.4%	$ 7,856	4.6%	$ (3,053)	(28.0)%

The decrease in sales and marketing expenses in both absolute dollars and as a percentage of net revenue was primarily attributable to lower salaries, bonuses, commissions and other employee related expenses of approximately $1.4 million, a decrease in various marketing expenses amounting to $0.6 million, a decrease in other professional fees of $0.2 million, a decrease in allocated common costs of $0.4 million, a decrease in depreciation expense of $0.1 million and a decrease in severance of $0.3 million. Lower overall headcount contributed to the decrease in salaries, commissions and other employee-related expenses including travel. The reduction in allocated common costs was a direct result of our 2008 restructuring charge, as well as our 2008 long-lived asset impairment charge, which resulted in lower facility costs and depreciation expense for the nine months ended September 30, 2009. The decrease in marketing expenses is due to our cost containment initiatives. Other professional fees decreased due to lower net revenue resulting in lower outside commissions. Severance decreased due to fewer headcount reductions for the nine months ended September 30, 2009. During the nine months ended September 30, 2008, our Senior Vice President of Sales and Operations left the company and was not replaced.

Research and Development Expenses

	Nine Months Ended September 30, 2008		Nine Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Research and Development Expenses	$ 21,489	10.7%	$ 21,327	12.4%	$ (162)	(0.8)%

The decrease in research and development expense in absolute dollars was primarily due to a decrease in project materials, tooling, outside testing, test equipment and non-recurring engineering of $2.2 million, a decrease in depreciation of $0.1 million and a decrease in allocated common costs of $0.2 million. These decreases were partially offset by an increase in salaries and other payroll related expenses of $1.8 million, an increase in intangible asset amortization of $0.8 million, an increase in consultant expenses of $0.2 million. During the nine months ended September 30, 2008, there was a significant amount of development costs associated with the ramp up of the HP product line. This development activity resulted in significant project materials, tooling, outside testing, test equipment and non-recurring engineering. These costs were not incurred to the same degree during the nine months ended September 30, 2009. The reduction in allocated common costs was a direct result of our 2008 restructuring charge, as well as our 2008 long-lived asset impairment charge, which resulted in lower facility costs and depreciation expense during the nine months ended September 30, 2009. The increase in salaries and other payroll related expenses was a direct result of hiring engineers to support HP and other development projects as well as the hiring of new employees to support development activities related to the September 2008 acquisition of assets from Ciprico. The increase in intangible amortization is due to the amortization of certain intangible assets acquired from Ciprico. The increase in consultant expenses are directly related to the ongoing development activities.

General and Administrative Expenses

	Nine Months Ended September 30, 2008		Nine Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
General and Administrative Expenses	$ 10,291	5.1%	$ 7,562	4.4%	$ (2,729)	(26.5)%

The decrease in general and administrative expenses in absolute dollars and as a percentage of net revenue is partially mitigated by a $0.1 million foreign currency loss for the nine months ended September 30, 2009 compared to a $0.2 million foreign currency gain for the nine months ended September 30, 2008. Other general and administrative expenses decreased $3.0 million primarily due to a decrease in professional fees of $1.4 million, recruiting fees of $0.4 million, IT consulting costs of $0.4 million, consultant fees of $0.3 million, allocated common costs of $0.2 million, salaries of $0.2 million, insurance fees of $0.2 million and building rent of $0.1 million. These decreases were slightly offset by increases in board fees of $0.2 million. The decreases in professional fees, consultant fees, and insurance fees are due to our ability to renegotiate lower fees with our service providers. Recruiting costs decreased due to limited recruiting activity for the nine months ended September 30, 2009. IT consulting costs decreased due to the consultants being replaced with full-time employees. Salaries decreased as a result of our 2008 reduction in headcount. The reduction in allocated common costs was a direct result of our 2008 restructuring charge, as well as our 2008 long-lived asset impairment charge, which resulted in lower facility costs and depreciation expense during the nine months ended September 30, 2009. Building rent decreased as a direct result of closing our Netherlands office during the first quarter of 2008.

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Restructuring Charge

	Nine Months Ended September 30, 2008		Nine Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Restructuring Charge	$		$ 941	0.6%	$ 941	100%

In December 2008, our management approved, committed to and initiated plans 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 our facility in Carlsbad, California into our Longmont, Colorado facility. The restructuring plan consists of 40% of our facility costs relating to unused space in our Carlsbad, California facility and severance costs that are related to a reduction in workforce. As of September 30, 2009, the majority of our Carlsbad operations has been moved to our Longmont facility. We anticipate the move to be completed by June 30, 2010.

Restructuring charges incurred during the nine months ended September 30, 2009 were the direct result of current period facility move costs as well as severance and retention costs recognized ratably over the service period.

Legal Settlement

	Nine Months Ended September 30, 2008		Nine Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Legal settlement	$ (4,036)	(2.0)%	$		$ (4,036)	(100.0)%

During the nine months ended September 30, 2008, legal settlement proceeds were received from two cases. The proceeds from the first legal settlement of $3.8 million reflects a February 2007 claim we filed for arbitration in Denver, Colorado alleging that the representative of the Chaparral Network Storage, Inc., or Chaparral, shareholders was wrongfully withholding escrow funds due to us as a result of damages incurred by us relating to a completed patent infringement lawsuit filed by Crossroads. The proceeds from the second legal settlement of $0.2 million reflects a claim we filed in December 2006 against Infortrend for breach of the settlement agreement with Crossroads whereby Infortrend withheld $1.475 million for Taiwanese taxes. Such amounts are reported as a reduction in operating expenses.

Other Income, net

	Nine Months Ended September 30, 2008		Nine Months Ended September 30, 2009			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Other Income, net	$ 1,435	0.7%	$ 115	0.1%	$ (1,320)	(92.0)%

The decrease in other income, net is primarily attributable to a decrease in interest income of $1.2 million. The decrease in interest income is primarily attributable to declining interest rates, and the implementation of a more conservative investment policy during the third quarter of 2008.

Income Taxes

We recorded an income tax expense of $0.3 million for the nine months ended September 30, 2008 compared to a $0.1 million income tax benefit for the nine months ended September 30, 2009.

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Liquidity and Capital Resources

The primary drivers affecting liquidity and cash are working capital requirements, net profits or losses, legal settlement gains or losses, asset acquisition costs, restructuring charges and capital expenditures. Historically, the payment terms we have had to offer our customers have been relatively similar to the terms received from our creditors and suppliers. We typically bill customers on an open account basis subject to our standard credit quality and payment terms ranging between net 30 and net 45 days. If in the longer term 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 September 30, 2009, we had $59.2 million of cash and cash equivalents and $67.2 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.

For the nine months ended September 30, 2009, net cash provided by operating activities was $4.5 million compared to cash used in operating activities of $23.1 million for the nine months ended September 30, 2008. The operating activities that affected cash consisted primarily of higher gross profit, resulting largely from lower contract manufacturing costs, an overall decrease in operating expenses largely as a result of the company-wide restructuring initiative undertaken during the fourth quarter of 2008 which was comprised of our initiative to lower overall operating expenses by reducing travel company wide and reducing headcount in 2009. These cost reductions were offset by lower interest income due primarily to lower reinvestment rates and a more conservative investing strategy and lower average cash balances. The non-cash operating activities included in the net loss that did not affect cash consisted of the following: depreciation and amortization of $2.1 million; share-based compensation expense of $2.2 million; and the provision for doubtful accounts of $0.3 million. Cash flows from operations reflects the positive impact of $5.6 million related to an overall decrease in accounts receivables, which was primarily due to lower net revenues during the three months ended September 30, 2009 as compared to the three months ended December 31, 2008, and a $9.1 million decrease in net inventory, which was the direct result of a 2009 management initiative to negotiate to reduce or eliminate finished goods inventory at two of the three customers for whom we held such inventory. Cash flows from operations was negatively impacted by a $2.1 million decrease in accounts payable due to the timing of payments to our vendors. Additionally, a significant amount of accounts payable was outstanding at December 31, 2008 due to higher net revenue during the three months ended December 31, 2008 compared to lower net revenue during the three months ended September 30, 2009, resulting in lower inventory purchases. Cash flows from operations were further negatively impacted by a $2.0 million increase in prepaid expenses and other assets which was primarily due to a $1.7 million increase in other receivables representing component parts procured by us and sold to our contract manufacturers, and a $0.3 million increase in various other vendor prepayments; a $1.2 million decrease in deferred revenue that was primarily attributable to our recognizing $1.5 million of deferred revenue due to the completion of our long-term firm fixed price contract during the third quarter of 2009; a $0.4 million decrease in accrued compensation and other expenses which was primarily due to the reversal of a marketing developing fund accrual for one of our European customers; and a $0.4 million decrease in other long-term liabilities due to the amortization of our deferred rent and amortization of our NetApp deferred revenue.

Cash used in investing activities for the nine months ended September 30, 2009 was $2.4 million, compared to $4.0 million for the nine months ended September 30, 2008. Cash used during the nine months ended September 30, 2009 was primarily for the addition of equipment to support our data center colocation, leasehold improvements and furniture associated with the expansion of our Longmont, Colorado facility and tooling and equipment at our contract manufacturer locations.

Cash provided by financing activities for the nine months ended September 30, 2009 was $0.3 million, compared to cash provided by financing activities of $1.2 million for the nine months ended September 30, 2008. Cash provided by financing activities is primarily attributable to the proceeds received from the sale of common stock to employees under our employee stock purchase plan of $0.5 million, partially offset by a decrease of $0.2 million due to the ongoing pay-down of our note payable which is associated with our 2008 acquisition of certain intangible assets from Ciprico.

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We presently expect cash, cash equivalents and cash generated from operations to be sufficient to meet our operating and capital requirements for the next 12 months and for operating periods in excess of 12 months. In addition, this will enable us to pursue acquisitions, business investments or capital improvements. 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 amount and timing of the receipt of net revenue from continued operations, 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 HP and NetApp, the status of our relationships with key customers, partners and suppliers, the timing and extent of the introduction of new products and services, growth in operations and the economic environment.

In August 2008, we entered into a credit agreement with Silicon Valley Bank to provide for a revolving credit facility 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. 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 for us to maintain at all times a net worth of $55 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. On March 16, 2009 we issued a letter of credit to one of our contract manufacturers in the amount of $5.0 million. There were no amounts outstanding under this credit facility as of September 30, 2009.

In July 2009, we amended our credit agreement with Silicon Valley Bank. The amendment reduces our obligation to maintain at all times a net worth of $55 million to $50 million (subject to certain increases) and revises the definition of net worth to add back restructuring expenses and goodwill and long-lived asset impairment charges, subject to certain limitations. The amendment also provides for a cash management services sublimit under the revolving credit line of up to $300,000. All other terms of the credit agreement remain unchanged.

The following table summarizes our contractual obligations as of September 30, 2009 (in thousands).

Contractual Obligations	Total	2009	2010	2011	2012	2013
Operating lease obligations	$ 6,035	$ 429	$ 1,769	$ 1,773	$ 1,673	$ 391
Inventory related purchase obligations	4,430	425	4,005			
Restructuring obligations	841	367	474			
Note payable	714	71	286	286	71	
Total	$ 12,020	$ 1,292	$ 6,534	$ 2,059	$ 1,744	$ 391

For purposes of the table above, the operating lease obligations exclude common area maintenance, real estate taxes and insurance expenses.

Inventory related purchase obligations represent purchase commitments to our suppliers and contract manufacturers for certain raw material components that either went end of life with suppliers or are deemed excess at contract manufacturers.

Our restructuring obligations represent future severance payments as part of our December 2008 restructuring plan.

We maintain indemnification agreements with certain of our OEM customers related to intellectual property and product liability.

In addition to the amounts shown in the table above, $0.3 million of unrecognized tax benefits have been recorded as liabilities and we are uncertain as to if or when such amounts may be settled.

Off Balance Sheet Arrangements

At September 30, 2009, 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

In September 2009, the Financial Accounting Standards Board, or FASB, reached a consensus on Accounting Standards Update, or ASU, No. 2009-13, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements*, or ASU 2009-13 and ASU No. 2009-14, *Software (Topic 985) Certain Revenue Arrangements That Include Software Elements,* or ASU 2009-14. ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: i) VSOE or ii) third-party evidence, or TPE, before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity s estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product s essential functionality. These new updates are effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. We are currently evaluating the impact that the adoption of these ASUs will have on our future consolidated financial statements.

In August 2009, the FASB, issued Accounting Standards Update No. 2009-05, *Measuring Liabilities at Fair Value*, which provides clarification that in circumstances where a quoted market price in an active market for an identical liability is not available, a reporting entity must measure fair value of the liability using one of the following techniques: 1) the quoted price of the identical liability when traded as an asset; 2) quoted prices for similar liabilities or similar liabilities when traded as assets; or 3) another valuation technique, such as a present value technique or the amount that the reporting entity would pay to transfer the identical liability or would receive to enter into the identical liability that is consistent with the provisions of Topic 820. This statement becomes effective for the first reporting period (including interim periods) beginning after issuance. We will adopt this statement beginning in the fourth quarter of fiscal 2009. Based on the current nature of our operations, we do not expect the adoption of this requirement will have a material impact on our consolidated financial statements.

In June 2009, the FASB issued Accounting Standards Codification, or ASC, No. 810-10-05 which changes the approach to determining the primary beneficiary of a variable interest entity, or VIE and requires companies to more frequently assess whether they must consolidate VIEs. ASC No. 810-10-05 is effective for annual periods beginning after November 15, 2009. Based on the current nature of our operations, we do not expect the adoption of this requirement will have a material impact on our consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate and Credit Risk

Our exposure to market rate risk for changes in interest rates relates to our investment portfolio. Our primary investment strategy is to preserve the principal amounts invested, maintain liquidity and maximize investment yields subject to other investment objectives. Accordingly, we primarily invest in instruments such as money market funds that meet high credit quality standards, as specified in our investment policy guidelines. Our investment policy also limits the amount of credit exposure to any one issue, issuer and type of instrument. Our cash and cash equivalents are not subject to significant interest rate risk due to their short terms to maturity. As of September 30, 2009, the carrying value of our cash and cash equivalents approximated fair value. We do not currently use derivative financial instruments in our investment portfolio and we do not enter into market risk sensitive instruments for trading purposes.

The following table provides information about our investment portfolio at December 31, 2008 and September 30, 2009. For investment securities, the table presents carrying values, and as applicable, related weighted average interest rates at December 31, 2008 and September 30, 2009 (in thousands).

	December 31, 2008	September 30, 2009
	(amounts in thousands)	
Cash equivalents	$ 32,375	$ 51,024
Average interest rate	1.13%	0.09%

We have a line of credit agreement that accrues interest on any outstanding balances at a variable rate. As of September 30, 2009, we had no balance under this line. On March 16, 2009 we issued a letter of credit to one of our contract manufacturers in the amount of $5.0 million.

Foreign Currency Exchange Rate Risk

A portion of our international business is presently conducted in currencies other than the United States dollar. Foreign currency transaction gains and losses arising from normal business operations are credited to or charged against earnings in the period incurred. As a result, fluctuations in the value of the currencies in which we conduct our business relative to the United States dollar will cause currency transaction gains and losses, which we have experienced in the past and continue to experience. Due to the substantial volatility of currency exchange rates, among other factors, we cannot predict the effect of exchange rate fluctuations upon future operating results. There can be no assurances that we will not experience currency losses in the future. We have not previously undertaken hedging transactions to cover currency exposure and we currently do not intend to engage in hedging activities in the near future. A 10% unfavorable change in the exchange rate would not materially impact our September 30, 2009 balance sheet.

As we sell products or services in foreign currencies, we are regularly required to convert the payments received into United States dollars or utilize such foreign currencies as payments for expenses of our business, which gives rise to foreign exchange gains and losses. Given the uncertainty as to when and what specific foreign currencies we may be required or decide to accept as payment from our international customers, we cannot predict the ultimate impact that such a decision would have on our business, gross profits and results of operations. While we monitor our foreign currency exposures, we do not currently maintain an active foreign currency hedging program.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)), as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and the Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report on Form 10-Q.

Changes in Internal Controls

There was no change 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

Dot Hill Securities Class Actions, Derivative Suits and Direct State Securities Action

In late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints allege violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004, and seeking damages therefore. The complaints were consolidated into a single action, and the Court appointed as lead plaintiff a group comprised of the Detroit Police and Fire Retirement System and the General Retirement System of the City of Detroit. The consolidated complaint was filed on August 25, 2006, and we filed a motion to dismiss on October 5, 2006. The Court granted our motion to dismiss on March 15, 2007. Plaintiffs filed their Second Amended Consolidated Complaint on April 20, 2007. We filed a motion to dismiss the Second Amended Consolidated Complaint on May 1, 2008, which the Court granted on September 2, 2008. The plaintiffs subsequently filed a Third Amended Consolidated Complaint on October 10, 2008, and on November 24, 2008 we filed a motion to dismiss. On March 18, 2009, the Court dismissed the Third Amended Consolidated Complaint, but granted plaintiffs leave to amend one more time. On April 17, 2009, plaintiffs filed a Notice of Appeal regarding the Court s September 2, 2008 and March 18, 2009 orders. On May 19, 2009, the Court entered final judgment and dismissed the action with prejudice; the plaintiffs subsequently filed an Amended Notice of Appeal on June 8, 2009. On October 29, 2009, the parties filed a Stipulation of Dismissal of Appeal. On October 30, 2009, the appeal was dismissed.

In addition, three complaints purporting to be derivative actions were filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. Our demurrers to two of those cases, in which we sought dismissal, were overruled (i.e., denied). We formed a Special Litigation Committee, or SLC, of disinterested directors to investigate the alleged wrongdoing. On January 12, 2007, another derivative action similar to the previous derivative actions with the addition of allegations regarding purported stock option backdating was served on us. In April 2007, the SLC concluded its investigation and based on its findings directed us to file a motion to dismiss the derivative matters. On July 13, 2007, all of the derivative actions were consolidated for pre-trial proceedings. We filed a motion to dismiss the consolidated matters pursuant to the SLC s directive on May 30, 2008. The hearing on this motion is set for February 19, 2010. The outcome of this action is uncertain, and no amounts have been accrued as of September 30, 2009.

In August 2007, a securities lawsuit was filed in California state court by a single former stockholder against us and certain of our directors and executive officers. This complaint is based on the same facts and circumstances described in the federal class action and state derivative complaints, and generally alleges that Dot Hill and the named officers and directors committed fraud and violated state securities laws. The complaint seeks damages, as well as attorneys fees and costs. On November 1, 2007, we filed a motion to dismiss the complaint, which was granted on February 15, 2008. On February 25, 2008, the plaintiff filed his First Amended Complaint. We filed a motion to dismiss the First Amended Complaint on March 6, 2008, which was granted on May 16, 2008. The plaintiff was granted leave to amend. On August 13, 2009, the action was dismissed with prejudice after the parties executed a settlement agreement.

The pending proceedings involve complex questions of fact and law and will require the expenditure of significant funds and the diversion of other resources to prosecute and defend. The results of legal proceedings are inherently uncertain and material adverse outcomes are possible. From time to time the Company may enter into confidential discussions regarding the potential settlement of pending litigation or other proceedings; however, there can be no assurance that any such discussions will occur or will result in a settlement. The settlement of any pending litigation or other proceedings could require Dot Hill to incur substantial settlement payments and costs.

Other Litigation

We may be involved in certain other legal actions and claims from time to time arising in the ordinary course of business. Management believes that the outcome of such other litigation and claims will likely not have 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 ending December 31, 2008. 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.

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 recession could reduce 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.

Recently, the credit markets and the financial services industry have been experiencing a period of unprecedented turmoil and upheaval characterized by the bankruptcy, failure, collapse or sale of various financial institutions and other industries and an unprecedented level of intervention from the United States federal government. While the ultimate outcome of these events cannot be predicted, they may have a material adverse effect on our liquidity and financial condition if our ability to borrow money to finance our operations from our existing lender under our bank credit agreement or obtain credit from trade creditors were to be impaired. 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.

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 32.6% and 51.1% of our net revenues for the year ended December 31, 2008 and for the nine months ended September 30, 2009, respectively. In addition, sales to NetApp accounted for 23.2% and 22.2% of our net revenues for the year ended December 31, 2008 and for the nine months ended September 30, 2009, respectively. Furthermore, sales to Sun accounted for 24.6% and 5.7% of net revenues for the year ended December 31, 2008 and for the nine months ended September 30, 2009, respectively. We expect HP and NetApp will each represent greater than 10% of our overall revenues for the year ending December 31, 2009. If our relationships with HP and NetApp or certain of our other OEM customers were disrupted, 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, Sun, or our other OEM customers will expand or not otherwise be disrupted. In fact, sales to Sun have continued to decrease compared to earlier levels and Sun has informed us that they intend to phase out our products over the next several quarters. Factors that could influence our relationship with our significant OEM customers, including HP and NetApp, include:

- our ability to maintain our products at prices that are competitive with those of other 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 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.

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, Sun, 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.

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We sell on a purchase order basis, making us subject to uncertainties and variability in demand by our customers, and our component suppliers may 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 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, we may have an inadequate supply of products, or we may have excess inventory, 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.

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, Sun and Dell, some of whom are our customers, as well as smaller storage companies. The server companies and independent storage systems suppliers are also potential customers as well and as indicated we have established a relationship with Sun, NetApp and HP. 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. If we are unable to lower production costs to be consistent with our projections

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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.

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 and Series 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.

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Manufacturing and supplier disruptions could harm our business.

We rely on third parties to manufacture 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.

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 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.

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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 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 costs and expenses in line with our net revenue, such as the fact that our expense levels are based in part on our expectations as to future sales, and that a significant percentage of our expenses are fixed, which limits our ability to reduce expenses quickly in response to any shortfalls in net revenue or gross margin. As a result, if net revenue, product margin or gross margin do not meet our projections, operating results may be negatively affected.

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

For the three months ended September 30, 2009, we incurred a net loss of $1.1 million. For the remainder of 2009, 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. 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 affect our financial results for 2009. 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 new contract manufacturing partner;
- the success of our sales and marketing efforts;
- the amount of field failures resulting in product replacements or recalls;
- the extent and terms of any development, marketing or other arrangements;

changes in economic, regulatory or competitive conditions, including the current worldwide economic crisis;

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

costs of litigating and defending law suits.

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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.

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 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.

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, 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, or a loss or delay in market acceptance, 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, manufacturing defects or from our own design deficiencies. 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.

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. Significant warranty costs, particularly those that exceed reserves, 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. None of our customers have thus far asserted claims, but may in the future 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.

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 WorldWide 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.

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.

We may face difficulties retaining key employees and attracting new employees in connection with our consolidation of operations and facilities in Longmont, Colorado.

We have decided to consolidate our Longmont, Colorado and our Carlsbad, California operations and facilities into a single facility in Longmont, Colorado. We may face difficulties retaining key employees in Carlsbad, California and Longmont, Colorado, and attracting new employees in Longmont, Colorado, in connection with the consolidation, which may adversely affect our operations and the transfer of knowledge and processes to the consolidated facility in a timely manner.

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.

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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 September 30, 2009 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 September 30, 2009 exceeds the trading price of our common stock. The warrant is exercisable for a period of five years from the date of issuance. 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 Dot Hill s 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 has 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.

As of September 30, 2009, 36% of our common stock was owned by five 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 facilities and the facilities of our suppliers and customers are located in regions that are subject to natural disasters.

Our California facilities, including our principal executive offices, are located near major earthquake faults, and close to areas that have recently been impacted by wildfires. Any bodily injury or property damage to the facilities or the surrounding infrastructure as a result of such occurrences could have a material adverse effect on our business, results of operations or financial condition. Additionally, some of our products are manufactured, sold or transported in regions which have historically experienced natural disasters. Any earthquake or other natural disaster, including a hurricane or tsunami, affecting a country in which our products are manufactured or sold could adversely affect our business, results of operations and financial condition.

Item 6. Exhibits

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

Exhibit Number	**Description**
3.1	Certificate of Incorporation of Dot Hill Systems Corp. (1)
3.2	Amended and Restated Bylaws of Dot Hill Systems Corp. (2)
4.1	Certificate of Incorporation of Dot Hill Systems Corp. (1)
4.2	Amended and Restated Bylaws of Dot Hill Systems Corp. (2)
4.3	Form of Common Stock Certificate. (3)
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. (4)
4.5	Form of Rights Certificate. (4)
4.6	Warrant to Purchase Shares of Common Stock dated January 4, 2008. (5)
10.1	Amendment to Loan and Security Agreement dated July 30, 2009 by and between Dot Hill Systems Corp. and Silicon Valley Bank. (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.

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(1) 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.

(2) 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.

(3) 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.

(4) 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.

(5) 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.

(6) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on August 4, 2009 and incorporated herein by reference.

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SIGNATURES

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

Dot Hill Systems Corp.

Date: November 6, 2009

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

Date: November 6, 2009

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