DOT HILL SYSTEMS CORP
Form 10-Q
November 09, 2007

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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, 2007

OR

o **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 o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

The registrant had 45,783,269 shares of common stock, $0.001 par value, outstanding as of November 2, 2007.

DOT HILL SYSTEMS CORP.
FORM 10-Q
For the Quarter Ended September 30, 2007
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Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands Except Per Share Amounts)
(Unaudited)

	December 31, 2006	September 30, 2007
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 99,663	$ 84,738
Short-term investments		5,471
Accounts receivable, net of allowance of $629 and $411	39,758	29,185
Inventories	2,210	4,882
Prepaid expenses and other	5,039	4,622
Total current assets	146,670	128,898
Property and equipment, net	9,738	10,322
Goodwill	40,725	40,725
Other intangible assets, net	4,382	2,686
Other assets	136	275
Total assets	$ 201,651	$ 182,906
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 31,099	$ 24,524
Accrued compensation	3,231	3,534
Accrued expenses	8,652	5,754
Deferred revenue	521	1,384
Income taxes payable	226	217
Total current liabilities	43,729	35,413
Long term deferred revenue		1,786
Other long-term liabilities	2,010	2,997
Total liabilities	45,739	40,196
Commitments and Contingencies (Note 11)		
Stockholders Equity:		
Preferred stock, $0.001 par value, 10,000 shares authorized, no shares issued or outstanding		
Common stock, $0.001 par value, 100,000 shares authorized, 45,009 and 45,781 shares issued and outstanding at December 31, 2006 and September 30, 2007, respectively	45	46
Additional paid-in capital	290,705	293,480
Accumulated other comprehensive loss	(814)	(2,508)

Accumulated deficit		(134,024)		(148,308)
Total stockholders equity		155,912		142,710
Total liabilities and stockholders equity	$	201,651	$	182,906

See accompanying notes to condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(In Thousands, Except Per Share Amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2007**	**2006**	**2007**
NET REVENUE	$ 54,846	$ 45,691	$ 179,797	$ 155,331
COST OF GOODS SOLD	47,813	39,166	147,833	135,208
GROSS PROFIT	7,033	6,525	31,964	20,123
OPERATING EXPENSES:				
Sales and marketing	3,607	3,677	11,904	11,456
Research and development	8,221	5,746	30,053	16,617
General and administrative	4,181	2,424	14,305	9,416
Legal settlement	45		3,395	
Total operating expenses	16,054	11,847	59,657	37,489
OPERATING LOSS	(9,021)	(5,322)	(27,693)	(17,366)
OTHER INCOME:				
Interest income, net	1,403	1,255	4,115	3,794
LOSS BEFORE INCOME TAXES	(7,618)	(4,067)	(23,578)	(13,572)
INCOME TAX EXPENSE	52,468	56	48,109	255
NET LOSS	$ (60,086)	$ (4,123)	$ (71,687)	$ (13,827)
NET LOSS PER SHARE:				
Basic	$ (1.34)	$ (0.09)	$ (1.60)	$ (0.30)
Diluted	$ (1.34)	$ (0.09)	$ (1.60)	$ (0.30)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:				
Basic	44,880	45,717	44,678	45,451
Diluted	44,880	45,717	44,678	45,451
COMPREHENSIVE LOSS:				
Net loss	$ (60,086)	$ (4,123)	$ (71,687)	$ (13,827)
Foreign currency translation adjustments	(27)	(1,251)	(227)	(1,692)
Net unrealized gain (loss) on short-term investments	4	(2)	39	(2)
Comprehensive loss	$ (60,109)	$ (5,376)	$ (71,875)	$ (15,521)

See accompanying notes to condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2006	**2007**
Cash Flows From Operating Activities:		
Net loss	$ (71,687)	$ (13,827)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	5,405	5,031
Loss on disposal of property and equipment	75	213
Provision for doubtful accounts	246	(45)
Stock-based compensation expense	2,718	1,647
Deferred taxes	47,141	
Changes in operating assets and liabilities:		
Accounts receivable	(2,007)	10,887
Inventories	457	(2,646)
Prepaid expenses and other assets	138	332
Accounts payable	2,292	(9,076)
Accrued compensation and expenses	1,787	(2,644)
Legal settlement payable	1,475	
Deferred revenue	(989)	783
Income taxes payable	(46)	11
Restructuring accrual	(45)	
Long term deferred revenue		1,786
Other long-term liabilities	1,152	551
Net cash used in operating activities	(11,888)	(6,997)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(3,998)	(3,776)
Sales and maturities of short-term investments	22,575	
Purchases of short-term investments	(10,337)	(5,425)
Net cash provided by (used in) investing activities	8,240	(9,201)
Cash Flows From Financing Activities:		
Proceeds from sale of stock to employees	1,055	967
Proceeds from exercise of stock options and warrants	777	163
Net cash provided by financing activities	1,832	1,130
Effect of Exchange Rate Changes on Cash	219	143
Net Decrease in Cash and Cash Equivalents	(1,597)	(14,925)
Cash and Cash Equivalents, beginning of period	108,803	99,663

Cash and Cash Equivalents, end of period	$ 107,206	$ 84,738
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	$	$
Cash paid for income taxes	$ 1,482	$ 217
Supplemental Disclosure of Non-Cash Investing and Financing Activities:		
Construction in progress costs incurred but not paid	$ 1,464	$ 768

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States, 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, 2006. Operating results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

The preparation of our financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenues are recognized pursuant to applicable accounting standards, including SEC Staff Accounting Bulletin, or SAB, No. 104, *Revenue Recognition.* We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is probable. Revenue is recognized for product sales upon transfer of title to the customer. Reductions to revenue for estimated sales returns are also recorded at that time. These estimates are based on historical sales returns, changes in customer demand and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required. Customer purchase orders and/or contracts are generally used to determine the existence of an arrangement. Shipping documents and the completion of any customer acceptance requirements, when applicable, are used to verify product delivery or that services have been rendered. We assess whether a price is fixed or determinable based upon the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess the collectibility of our accounts receivable based primarily upon the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history. Certain of our sales arrangements include multiple elements. Generally, these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and significantly greater response time in resolving warranty related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts this is typically the price charged when such contracts are sold separately or renewed. Since professional services related to installation and training can be provided by other third party organizations, we allocate revenue related to professional services based on rates that are consistent with other like companies providing similar services, i.e., the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 months. Revenue from installation, training and consulting is recognized as the services are performed.

We primarily sell our products to original equipment manufacturers, or OEM s. Certain of these OEM s accounted for a significant amount of our net revenues. For the three months ended September 30, 2006 and 2007, Sun accounted for approximately 81% and 58%, respectively, of our net revenues. For the nine months ended September 30, 2006 and 2007, Sun accounted for approximately 85% and 67%, respectively, of our net revenues. For the three and nine months ended September 30, 2007, NetApp accounted for approximately 16% and 8%, respectively, of our net revenues, respectively. Net revenues to NetApp were not significant in 2006.

2. Stock-Based Compensation

We account for stock-based compensation in accordance with Statement of Financial Accounting Standard, or SFAS No. 123(R), *Share-Based Payment*, which requires the measurement and recognition of 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 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.

SFAS No. 123(R) requires us to 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, 2006 and 2007.

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As of September 30, 2007, total unrecognized share-based compensation cost related to unvested stock options was $7.2 million, which is expected to be recognized over a weighted average period of approximately 2.8 years. We have included the following amounts for share-based compensation cost, including the cost related to the 2000 EIP, 2000 NEDSOP and 2000 ESPP, in the accompanying unaudited condensed consolidated statements of operations for the three and nine months ended September 30, 2006 and 2007 (amounts in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2007	2006	2007
Cost of goods sold	$ 81	$ 86	$ 221	$ 256
Sales and marketing	66	116	210	341
Research and development	188	230	493	597
General and administrative	322	238	1,700	453
Share-based compensation expense before taxes	657	670	2,624	1,647
Related deferred income tax benefits				
Share-based compensation expense, net of income taxes	$ 657	$ 670	$ 2,624	$ 1,647
Net share-based compensation expense per basic and diluted common share	$ 0.01	$ 0.01	$ 0.06	$ 0.04

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2007	2006	2007
Share-based compensation expense is derived from:				
Stock options	$ 575	$ 549	$ 2,325	$ 1,340
2000 ESPP	82	121	299	307
Share-based compensation expense before taxes	$ 657	$ 670	$ 2,624	$ 1,647

Share-based compensation expense recognized during the three and nine months ended September 30, 2007 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 estimated in accordance with the provisions of SFAS No. 123(R). SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma disclosures required under SFAS No. 123, *Accounting for Stock-based Compensation*, for the periods prior to 2006, we accounted for forfeitures as they occurred. We recognized $0.7 million in share-based compensation expense for the three months ended September 30, 2006 and $2.6 million in share-based compensation expense resulting from adoption of SFAS No. 123(R) for the nine months ended September 30, 2006. We have historically and continue to estimate the fair value of share-based awards using the Black-Scholes option-pricing model. Total unrecognized share-based compensation cost related to unvested stock options as of September 30, 2007 has been adjusted for estimated forfeitures.

To estimate compensation expense under SFAS No. 123(R) for the nine months ended September 30, 2006 and 2007, we used the Black-Scholes option-pricing model with the following weighted-average assumptions for equity awards granted:

	2000 EIP and 2000 NEDSOP	2000 ESPP

	Nine Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2007**	**2006**	**2007**
Risk-free interest rate	4.90%	4.50%	5.00%	4.75%
Expected dividend yield	%	%	%	%
Volatility	68%	68%	68%	68%
Expected life	5.5 years	5.2 years	0.5 years	0.5 years

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 implied volatility of our stock for the related vesting period. The expected life of the equity award is based on historical experience.

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Stock Incentive Plans

2000 EIP. During 2006 and 2007, we primarily granted options to purchase common stock to our employees under the 2000 EIP. These options expire 10 years from the date of grant and typically 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. The number of shares of common stock reserved for issuance under the 2000 EIP is increased annually on the date of our meeting of stockholders by an amount equal to the lesser of (A) two percent of our outstanding shares as of the date of our annual meeting of stockholders, (B) 1,000,000 shares or (C) an amount determined by our board of directors. If an option is surrendered or for any other reason ceases to be exercisable in whole or in part, the shares with respect to which the option was not exercised shall continue to be available under the 2000 EIP. As of September 30, 2007, options to purchase 6,282,528 shares of common stock were outstanding under the 2000 EIP and the options to purchase 870,721 shares of common stock remained available for grant under the 2000 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, 2007, options to purchase 500,000 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 413,124 shares of common stock remained available for grant under the 2000 NEDSOP.

2000 ESPP. 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, as defined in the 2000 ESPP. There were 289,073 and 361,806 shares issued for the 2000 ESPP periods that ended during the nine months ended September 30, 2006 and 2007, respectively.

Activity and pricing information regarding all options to purchase shares of common stock are summarized as follows:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Outstanding at December 31, 2006	5,435,930	$ 6.12		
Granted	1,786,696	3.42		
Exercised	(66,344)	2.44		
Forfeited	(96,081)	4.31		
Expired	(275,670)	8.67		
Outstanding at September 30, 2007	6,784,531	$ 5.36	7.39	$ 512
Vested and expected to vest at September 30, 2007	6,167,607	$ 5.50	7.22	$ 512
Exercisable at September 30, 2007	3,754,016	$ 6.39	6.08	$ 512

As of September 30, 2006, approximately 3,359,494 options were exercisable at a weighted average exercise price of $6.81.

The weighted average grant-date fair values of options granted during the three months ended September 30, 2006 and 2007 were $1.97 per share and $1.79 per share, respectively.

The weighted average grant-date fair values of options granted during the nine months ended September 30, 2006 and 2007 were $3.30 per share and $2.07 per share, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2007 was $0.2 million and $0.1 million, respectively.

During the nine months ended September 30, 2007, financing cash generated from share-based compensation arrangements amounted to $0.2 million for the purchase of shares upon exercise of options and $1.0 million collected for the purchase of shares through the 2000 ESPP. We issue new shares from the respective plan share reserves upon exercise of options to purchase common stock and for purchases through the 2000 ESPP.

During the first quarter of 2007, we granted performance-based stock options to certain executives, the vesting of which is tied to the achievement of financial and non-financial objectives during 2007. As of September 30, 2007, we estimated that the company will not achieve its 2007 financial goals, as such, we have recognized no stock based compensation expense in relation to these performance based stock options for the nine months ended September 30, 2007.

The total fair value of options to purchase common stock that vested during the three months ended September 30, 2006 and 2007 was $0.3 million and $0.6 million, respectively. The total fair value of options to purchase common stock that vested during the nine months ended September 30, 2006 and 2007 was $2.4 million and $2.3 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 and stock warrants in the weighted average number of common shares outstanding for a period, if dilutive.

The following table sets forth a reconciliation of the basic and diluted number of weighted average shares outstanding used in the calculation of net loss per share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2007**	**2006**	**2007**
Shares used in computing basic net loss per share	44,880	45,717	44,678	45,451
Dilutive effect of warrants and common stock equivalents				
Shares used in computing diluted net loss per share	44,880	45,717	44,678	45,451

For the three months ended September 30, 2006, outstanding options to purchase 5,547,751 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,696,081 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive. For the nine months ended September 30, 2006, outstanding options to purchase 5,396,582 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,702,212 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive.

For the three months ended September 30, 2007, outstanding options to purchase 6,559,539 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 456,554 shares of common stock at prices ranging from $3.25 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive. For the nine months ended September 30, 2007, outstanding options to purchase 6,191,525 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,082,699 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive.

During May 2007, an outstanding warrant to purchase up to 1,239,527 shares of our common stock at $2.97 per share was exercised on a cashless basis. In accordance with the cashless exercise terms, the warrant was exchanged for 343,374 shares of our common stock based on the average closing bid price of our stock for the five days preceding the exercise.

4. Short-Term Investments

We account for and report investments in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. All of our investments are classified as available-for-sale and stated at fair value, with

unrealized gains or losses reported as a component of accumulated other comprehensive loss.

The following table summarizes our short-term investments as of September 30, 2007 (in thousands):

	Cost	Unrealized Gains	Fair Value
Corporate Debt	$ 5,425	$ 46	$ 5,471

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The unrealized gains on short-term investments included $48 thousand in accreted income offset by $2 thousand in unrealized loss due to market fluctuation.

For the three and nine months ending September 30, 2007 we did not recognize any gross realized gains on sale of investments.

Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties. The cost and fair value of short-term investments at September 30, 2007 by contractual maturity are show below (in thousands).

	Cost	Unrealized Gains	Fair Value
Due in one year or less	$ 5,425	$ 46	$ 5,471
Due after one year through five years			
Total	$ 5,425	$ 46	$ 5,471

5. Inventories

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

	December 31, 2006	September 30, 2007
Purchased parts and materials	$ 612	$ 658
Work in process		17
Finished goods	1,598	4,207
Total inventory	$ 2,210	$ 4,882

6. Goodwill and Other Intangible Assets

Under the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets,* goodwill and intangible assets with indefinite lives are not amortized, but instead are tested for impairment at least annually or more frequently if impairment indicators arise. All of our identified intangible assets are considered to have finite lives and are being amortized in accordance with this statement. The Company performed an impairment analysis of goodwill as of September 30, 2007, as a result of impairment indicators arising during the quarter the ended. Based on an independent valuation report and other information, management concluded that there was no impairment of such assets as of September 30, 2007.

Intangible assets that are subject to amortization under SFAS No. 142 consist of the following as of September 30, 2007 (in thousands):

	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (3,982)	$ 1,018
Developed technology	2,600	(2,600)	
Customer relationships	2,500	(2,500)	
Backlog	100	(100)	
Licensed Patent Portfolio	2,570	(902)	1,668
Total other intangible assets	$ 12,770	$ (10,084)	$ 2,686

As of September 30, 2007, the weighted average amortization period for the above intangibles is 2.4 years.

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Estimated future amortization expense related to other intangible assets as of September 30, 2007 is as follows (in thousands):

Years ending December 31,	
2007 (remaining 3 months)	406
2008	1,255
2009	514
2010	511
Total	$ 2,686

7. Product Warranties

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. The changes in our aggregate product warranty liability are as follows for the three and nine months ended September 30, 2007 (in thousands):

	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2007
Balance, beginning of period	$ 1,380	$ 663
Charged to operations	623	2,725
Deductions for costs incurred	(719)	(2,104)
Balance, end of period	$ 1,284	$ 1,284

8. Income Taxes

We recorded income tax expense of $52.5 million and less than $0.1 million for the three months ended September 30, 2006 and 2007, respectively. Our effective income tax rate was (1.4%) for the three months ended September 30, 2007 which differs from the federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

For the nine months ended September 30, 2006 and 2007, we recorded income tax expense of $48.1 million and $0.3 million, respectively. Our effective income tax rate of (1.9%) for the nine months ended September 30, 2007 differs from the federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

On January 1, 2007, we adopted Financial Accounting Standards Board, or FASB, Interpretation No., or FIN, 48 *Accounting for Uncertainty in Income Taxes*. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues.

We had cumulative unrecognized tax benefits of approximately $11.2 million as of January 1, 2007. The cumulative effects of adopting FIN 48 resulted in an increase of $0.5 million to accumulated deficit and an increase in other long term liabilities of $0.5 million. Included in the balance of unrecognized tax benefits at January 1, 2007 are approximately $0.6 million of tax benefits that, if recognized, would affect the effective tax rate. At January 1, 2007 we also had approximately $10.6 million of unrecognized tax benefits that 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 January 1, 2007, the total amount of accrued income tax related interest and penalties included in the condensed consolidated balance sheet was less than $0.1 million. Accrued income tax related interest and penalties recognized during the three and nine months ended September 30, 2007 was not significant. 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 ending September 30, 2007.

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, 1994 through December 31, 2006. With few exceptions, our state income tax returns are open to audit for the years ended December 31, 1999 through 2006.

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

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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 September 30, 2007, based on the weight of available evidence, including cumulative losses in recent years and expectations of 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 $47.1 million valuation allowance associated with our United States deferred tax assets.

As of December 31, 2006, we had federal and state net operating loss carryforwards of approximately $122.4 million and $57.0 million, which begin to expire in the tax years ending 2013 and 2007, respectively. In addition, we had federal tax credit carryforwards of $3.7 million, of which approximately $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $3.2 million began to expire in the tax year ending 2007. We also had state tax credit carryforwards of $3.9 million, of which $3.7 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million began to expire in the tax year ending 2007.

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 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.

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.

9. Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are as follows (in thousands):

	Foreign Currency Items	Short Term Investments Items	Total
Balance, December 31, 2006	$ (814)	$	$ (814)
Quarterly change	(604)		(604)
Balance, March 31, 2007	(1,418)		(1,418)
Quarterly change	163		163
Balance, June 30, 2007	(1,255)		(1,255)
Quarterly change	(1,251)	(2)	(1,253)
Balance, September 30, 2007	$ (2,506)	$ (2)	$ (2,508)

10. Credit Facilities

Effective July 1, 2007, we amended our credit agreement to extend our term for two years with Wells Fargo Bank, National Association, or Wells Fargo, which allows us to borrow up to $30.0 million under a revolving line of credit that expires July 1, 2009. Amounts loaned under the credit agreement bear interest at our option at a fluctuating rate per annum equal to the prime rate in effect from time to time, or at a fixed rate per annum determined by Wells Fargo

to be 0.65% above LIBOR in effect on the first day of the applicable fixed rate term. In connection with the credit agreement, to the extent we have outstanding borrowings, we have granted Wells Fargo a security interest in our investment management account maintained with Wells Capital Management Incorporated. As of December 31, 2006 and September 30, 2007, there were no balances outstanding under this line of credit. The credit agreement limits any new borrowings, loans or advances outside of the credit agreement to an amount less than $1.0 million and annual capital expenditures to an amount less than $10.0 million.

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11. Commitments and Contingencies

Commitments

Consulting Agreement with Former Executive

In March 2006, we entered into a consulting agreement with our former Chief Executive Officer, James L. Lambert. Pursuant to the consulting agreement, Mr. Lambert will perform consulting services for us during a three-year period beginning as of March 1, 2006 for a consulting fee of $16,666 per month. The vesting of 218,125 of Mr. Lambert s stock options, with an average exercise price of $5.63 per share, was accelerated in full in connection with the consulting agreement, and such stock options will continue to be exercisable during the consulting period in accordance with their terms. Mr. Lambert will be restricted from competing with us during the consulting period, and the consulting period will terminate early upon an acquisition of us, Mr. Lambert s election or Mr. Lambert s death or permanent disability. In the event of any such early termination, Mr. Lambert will receive a lump sum payment equal to the amount he would have been eligible to receive if the consulting period continued for the full original three-year period. Based on the terms of this agreement, we recognized a non-cash stock option expense of $0.7 million related to the acceleration of stock options and consulting fees of $0.6 million during the three months ended March 31, 2006.

New Longmont Research and Development Facility Lease

On April 12, 2007, we entered into a lease contract with Circle Capital Longmont LLC, under which we will lease approximately 44,300 square feet of office and laboratory space located at 1351 South Sunset in Longmont, Colorado. We will use this office and laboratory space as our new research and development facility. The lease contract provides for a term of 65 months, commencing in August 2007 and ending December 2012. The lease contract provides for two renewal terms of 5 years each. Rental obligations will be payable on a monthly basis. Future minimum lease payments associated with this lease are as follows:

Year		Minimum Lease Payment
2007 (Remaining 3 months)	$	
2008		382,000
2009		393,000
2010		405,000
2011		417,000
2012		424,000
Total	$	2,021,000

In addition to our rental obligations, we will be responsible for certain costs and charges specified in the contract, including certain operating and utility expenses.

The lease for our current research and development facility located in Longmont, Colorado expired in accordance with the lease terms on July 31, 2007.

Contingencies

Crossroads Systems Litigation

On October 27, 2003, we were served with a lawsuit filed by Crossroads in the United States District Court in Austin, Texas, alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. The patents involve the use of access controls in storage routers. The court has interpreted storage routers to include RAID controllers.

On June 28, 2006, we entered into a Settlement and License Agreement with Crossroads that settled the lawsuit and licenses to us the family of patents from which it stemmed. We concurrently entered into an Agreement between Dot Hill Systems and Infortrend Re Settlement of Crossroads Lawsuit with Infortrend Technology, Inc., or Infortrend. In accordance with the Crossroads and Infortrend agreements, on July 14, 2006, we paid $3.35 million to Crossroads for alleged past damages and Crossroads agreed to dismiss, with prejudice, all patent claims against us. In addition, Infortrend was expected to pay Crossroads an additional $7.15 million on our behalf. However, Infortrend withheld

$1.43 million from that payment for the payment of Taiwan taxes. This withholding is included

in income tax expense on our statement of operations. Going forward, Crossroads will receive a running royalty of 2.5% based on a percentage of net sales of RAID products sold by us, but only those with functionality that is covered by licensed patents. For RAID products that use a controller sourced by Infortrend, we will pay 0.8125% of the 2.5% royalty, and Infortrend will be responsible for the remainder. For RAID products that use our proprietary controller, we alone will be paying the 2.5% running royalty. No royalty payments will be required with respect to the sale of storage systems that do not contain RAID controllers, known as JBOD systems, or systems that use only the SCSI protocol end-to-end, even if those perform RAID. Further, royalty payments with respect to the sale of any products that are made, used and sold outside of the United States will only be required if and when Crossroads is issued patents that cover the products and that are issued by countries in which the products are manufactured, used or sold.

In July 2006, Crossroads filed two lawsuits against us in the United States District Court for the Western District of Texas based on the alleged breach of the June 28, 2006 Settlement and License Agreement due to the withholding of the $1.43 million for Taiwanese taxes. On September 28, 2006 the Court indicated that it would grant Crossroads Motion to Enforce. Therefore, on October 5, 2006, Crossroads and Dot Hill amended the original Settlement and License Agreement to state that Dot Hill would pay to Crossroads the $1.43 million, plus $45,000 in late fees, and would not make deductions based on taxes on royalty payments in the future. The payment of the $1.475 million was made on October 5, 2006. As required by the amended settlement, Crossroads has dismissed with prejudice the original patent action as well as the second lawsuit based on the enforcement of the original settlement.

Thereafter, we gave notice to Infortrend of our intent to bring a claim alleging breach of the settlement agreement seeking reimbursement of the $1.475 million from Infortrend. On November 13, 2006, Infortrend filed a lawsuit in the Superior Court of California, County of Orange for declaratory relief. The complaint seeks a court determination that Infortrend is not obligated to reimburse Dot Hill for the $1.475 million. On December 12, 2006, we answered the complaint and filed a cross complaint alleging breach of contract, fraud, breach of implied covenant of good faith and fair dealing, breach of fiduciary duty and declaratory relief. Infortrend demurred to the cross complaint. The Court denied the demurrer as to the fraud cause of action and sustained the demurrer as to the claims for breach of the covenant of good faith and fair dealing and breach of fiduciary duty. The Court granted Dot Hill leave to amend the cross complaint as to those two causes of action. No trial date has been scheduled.

Chaparral Securities Class Action

In August 2004, a class action lawsuit was filed against, among others, Chaparral and a number of its former officers and directors in the United States District Court for the Central District of California. The lawsuit, among other things, alleges violations of federal and state securities laws and purports to seek damages on behalf of a class of shareholders who held interests in limited liability companies that had purchased, among other securities, Chaparral stock during a defined period prior to our acquisition of Chaparral. In May 2005, the Second Amended Complaint was dismissed with leave to amend. Plaintiffs filed a Third Amended Complaint, which the Court again dismissed with leave to amend in November of 2005 as to Chaparral and certain other defendants. Plaintiffs declined to amend within the proscribed period, and final judgment was entered in February 2006. Plaintiffs filed a notice of appeal in the United States District Court of Appeals for the Ninth Circuit, though they have not filed their opening papers.

Plaintiffs filed a related action in the Superior Court of the State of California, Orange County, in December of 2005, alleging many of the same claims. That action was stayed pending the outcome of the federal appeal. The parties have reached a settlement of the securities class actions. That settlement was preliminarily approved by the Orange County Superior Court on March 19, 2007. At the final settlement approval hearing on October 1, 2007, the court approved the final settlement, pending non-material changes to the terms of the settlement agreement. We expect the final settlement order to issue shortly.

Dot Hill Securities Class Actions and Derivative Suits

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 our motion to dismiss on May 29, 2007 and are still waiting for a ruling from the judge.

In addition, three complaints purporting to be derivative actions have been 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 demurrer to two of those cases, in which we sought dismissal, was 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. On April 16, 2007, the SLC concluded its investigation and based on its findings directed us to file a motion to dismiss the derivative matters. On June 27, 2007, the parties stipulated to consolidate all of the derivative matters for pre-trial proceedings. We expect to file a motion to dismiss the consolidated matters pursuant to the SLC s directive in the next few months. The outcome of these actions is uncertain, and no amounts have been accrued as of September 30, 2007.

In August 2007, a securities lawsuit was filed in California state court by a single former stockholder against 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 $500,000 in damages, as well as attorneys fees and costs. On November 1, 2007, we demurred to dismiss the complaint. The outcome of this action is uncertain, and no amounts have been accrued as of September 30, 2007.

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 result 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 are involved in certain other legal actions and claims arising in the ordinary course of business. Management believes that the outcome of such other litigation and claims will not have a material adverse effect on our financial condition or operating results.

12. Segments Information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by our chief operating decision-maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-maker is our Chief Executive Officer. Our operating segments are managed separately because each segment represents a strategic business unit that offers different products or services.

Our operating segments are organized on the basis of products and services. We have identified operating segments that consist of our SANnet® family of systems, legacy and other systems, and services. We currently evaluate performance based on stand-alone segment revenue and gross margin. Because we do not currently maintain information regarding operating income at the operating segment level, such information is not presented.

Information concerning revenue and gross profit by product and service is as follows (in thousands):

	SANnet Family	Legacy and Other	Services	Total
Three months ended:				
September 30, 2006:				
Net revenue	$53,473	$ 513	$ 860	$54,846
Gross profit	$ 6,389	$ 49	$ 595	$ 7,033
September 30, 2007:				
Net revenue	$42,953	$ 528	$2,210	$45,691
Gross profit	$ 4,998	$ 129	$1,398	$ 6,525

	SANnet Family	Legacy and Other	Services	Total
Nine months ended:				
September 30, 2006:				
Net revenue	$174,394	$2,801	$2,602	$179,797
Gross profit	$ 30,377	$ 366	$1,221	$ 31,964
September 30, 2007:				
Net revenue	$149,566	$ 768	$4,997	$155,331
Gross profit	$ 17,390	$ 196	$2,537	$ 20,123

Information concerning operating assets by product and service, derived by specific identification for assets related to specific segments and an allocation based on segment volume for assets related to multiple segments, is as follows (in thousands):

	SANnet Family	Legacy and Other	Services	Total
As of:				
December 31, 2006	$195,332	$3,024	$3,295	$201,651
September 30, 2007	$180,274	$ 532	$2,100	$182,906

13. Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather it eliminates inconsistencies in the guidance found in various prior accounting pronouncements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Although we are still evaluating the potential effects of this standard, we do not expect the adoption of SFAS No. 157 to have a material impact on our financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115*, which allows measurement at fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. If the fair value option for an eligible item is elected, unrealized gains and losses for that item shall be reported in current earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between the different measurement attributes the company elects for similar types of assets and liabilities. This statement is effective for fiscal years beginning after November 15, 2007. We are in the process of evaluating the application of the fair value option and its effect on our financial condition and results of operations.

14. Stock Option Expense related to Historical Grant Practices

In response to recently reported industry issues around option pricing in July 2006, our Audit Committee, which is comprised of independent directors initiated a review of our historical stock option grant practices and related accounting dating back to our merger with Artecon, Inc. in 1999. As a result, we recognized $0.1 million of cost of goods sold and sales and marketing expenses for the three months ended September 30, 2006 associated with the errors identified by our Audit Committee s review that was not recognized in prior periods. The expenses associated with the errors were not material in any of the prior periods during which the expenses should have been recognized nor was the cumulative adjustment material to the three or nine months ended September 30, 2006.

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, 2006. 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 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, 2006.

Overview

We are a provider of storage systems 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 and software products employing a modular system that allows end-users to add capacity as needed. Our products provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our new product family based on our R/Evolution architecture provides high performance and large capacities for a broad variety of environments. Our SANnet ® 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.

Our products and services are sold worldwide to end-users primarily through our channel partners, including original equipment manufacturers, or OEMs, systems integrators, or SIs, and value added resellers, or VARs. We have been shipping our products to Sun Microsystems, or Sun, for resale to Sun s customers since October 2002 and continue to do so, having shipped over 143,000 units to date. We have developed products for Fujitsu Siemens and Network Appliance, or NetApp. We began shipping products to Fujitsu Siemens in July 2006 and to NetApp in June 2007.

In February 2004, we acquired all the outstanding shares of Chaparral Network Storage, Inc., or Chaparral, a privately held storage system provider. This acquisition provided us with a core of redundant array of independent disks, or RAID, hardware and software technology and a team of hardware and software professionals located in Longmont, Colorado.

As part of our focus on indirect sales channels, we have historically outsourced substantially all of our manufacturing operations to Solectron Corporation, or Solectron. Our agreement with Solectron allowed us to reduce sales cycle times and our manufacturing infrastructure, enhance working capital and improve margins by taking advantage of Solectron s manufacturing and procurement economies of scale.

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 IT supply chain services company. Under the terms of the agreement, MiTAC is supplying Dot Hill with manufacturing, assembly and test services from its facilities in China, and SYNNEX is providing Dot Hill with final assembly, testing and configure-to-order services through its facilities in Fremont,

California and Telford, United Kingdom. We believe that the agreement with MiTAC and SYNNEX will help to expand our global capabilities and reduce our manufacturing costs. We began to selectively ship products under the MiTAC and SYNNEX agreement in April 2007, and expect that in Q4 2007 we will start to ship all of our series 2000 and 5000 products from MiTAC and SYNNEX.

We derive a portion of our revenue from services associated with the maintenance service we provide for our installed products. Earlier this year, we entered into an agreement with GAVS Information Services, LLC, or GAVS, to provide telephonic warranty and non-warranty support for customers for either our more mature SANnet product family or products designed under our new R/Evolution platform. We also entered into an agreement earlier in the year with Glasshouse Technologies Inc., to become an authorized service provider of on-site support on a global basis for customers who purchase maintenance agreements for either our mature SANnet product family or products designed under our new R/Evolution platform.

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

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, 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 short-term investments and other miscellaneous income and expense items.

Our headquarters are located in Carlsbad, California. We primarily maintain a research and development facility in Longmont, Colorado and international offices in Germany, Japan, the Netherlands, China and the United Kingdom.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and use judgment that may impact the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingent assets and liabilities. As a part of our on-going internal processes, we evaluate our estimates, including those related to inventory write-downs, warranty cost accruals, revenue recognition, bad debt allowances, long-lived assets valuation, goodwill and intangible assets valuation, income taxes, including deferred income tax asset valuation, stock based compensation, litigation and contingencies. We base these estimates upon both historical information and other assumptions that we believe are valid and reasonable under the circumstances. These assumptions form the basis for making judgments and determining the carrying values of assets and liabilities that are not apparent from other sources. Actual results could vary from those estimates under different assumptions and conditions.

We believe that the policies set forth below may involve a higher degree of judgment and complexity in their application than our other accounting policies and represent the critical accounting policies used in the preparation of our financial statements.

Revenue Recognition

Revenues are recognized pursuant to applicable accounting standards, including SEC Staff Accounting Bulletin, or SAB, No. 104, *Revenue Recognition.*

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is probable. We recognize revenue for product sales upon transfer of title to the customer. Reductions to revenue for estimated sales returns are also recorded at that time. These estimates are based on historical sales returns, changes in customer demand and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required. Customer purchase orders and/or contracts are generally used to determine the existence of an arrangement. Shipping documents and the completion of any customer acceptance requirements, when applicable, are used to verify product delivery or that services have been rendered. We assess whether a price is fixed or determinable based upon the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess the collectibility of our accounts receivable based primarily upon the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history. Certain

of our sales arrangements include multiple elements. Generally, these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and faster response time in resolving warranty related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts this is typically the price charged when such contracts are sold separately or renewed. Because professional services related to installation and training can be provided by other third party organizations, we allocate revenue related to professional services based on rates that are consistent with other like companies providing similar services, i.e., the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 months. Revenue from installation, training and consulting is recognized as the services are performed.

We maintain inventory, or hubbing arrangements with certain of our 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 reports that it has removed our product from the warehouse to incorporate into its end products. If a customer does not take our product under a hubbing arrangement in accordance with the schedule it originally provided to us, our future revenue stream could vary substantially from our forecasts and our results of operations could be materially and adversely affected.

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 unmarketable 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. As a result, our ability to effectively manage inventory levels may be impaired, which would cause our total inventory turns to decrease. In that event, our expenses associated with excess and obsolete inventory could increase and our cash flow could be negatively impacted.

Valuation of Goodwill

We review goodwill for impairment annually and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable in accordance with Statement of Financial Accounting Standards, or SFAS, No. 142, *Goodwill and Other Intangible Assets.* The provisions of SFAS No. 142 require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of each reporting unit to its carrying value. Our reporting units are consistent with the reportable segments identified in the notes to our condensed consolidated financial statements. We determine the fair value of our reporting units using a combination of the income approach and market capitalization approach. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then we must perform the second step in order to determine the implied fair value of the reporting unit s goodwill and compare it to the carrying value of the reporting unit s goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, then we must record an impairment charge equal to the difference.

Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future discounted cash flows. Under the market capitalization approach, valuation multiples are calculated based on operating data from publicly traded companies within our industry. Multiples derived from companies within our industry provide an indication of how much a knowledgeable investor in the marketplace would be willing to pay for a company. These multiples are applied to the operating data for the reporting unit to arrive at an indicated fair value. Significant management judgment is required in the forecasts of future operating results that are used in the estimated future discounted cash flow method of valuation. The estimates we have used are consistent with the plans and estimates that we use to manage our business. We base our fair value estimates on forecasted revenue and operating costs along with the business plan for fiscal 2007 through fiscal 2015. Our forecasts consider the effect of a number of factors including, but not limited to, the effect of the roll out of new products, securing new customers, the effect of

the transition to a new contract manufacturer, the ability to reduce product costs and the impact of continued cost savings measures within operating expenses. It is possible, however, that the plans may change and estimates used may prove to be inaccurate. If our actual results, or the plans and estimates used in future impairment analyses, are lower than the original estimates used to assess the recoverability of these assets, we could incur an impairment charge. If in the future the multiples derived from companies within our industry declines significantly we could also incur an impairment charge.

We performed a valuation of our SANnet reporting unit as of September 30, 2007. Based upon the results of our valuation, management concluded that the fair value of the reporting unit exceeded the carrying value, and therefore step two was not required. We determined that a blending of both the income approach at 20% and the market capitalization approach at 80% was reasonable. Our valuation, using the methods described above, indicated a fair value of $146.0 million compared to our book value of $139.8 million. A combined reduction in either our discounted cash flow or market capitalization approaches in total of more than 4.0% of our current fair value would result in a failure of step one and would require us to perform a step two analysis. Additionally, a further reduction in our market capitalization could be an indicator of impairment. Given the volatility of our stock price a continued decline in market capitalization could result in an impairment of our goodwill.

Deferred Income Taxes

We account for income taxes under the asset and liability method, under which deferred tax assets, including net operating loss carryforwards, and liabilities are determined based on temporary differences between the book and tax basis of assets and liabilities. 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 we believe a portion will be realized, or not realized. 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, the carryforward periods available to us for tax reporting purposes, and other relevant factors.

At September 30, 2007, based on the weight of available evidence, including cumulative losses in recent years and expectations of 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 $47.1 million valuation allowance associated with our United States deferred tax assets.

Due to our equity transactions, an ownership change, within the meaning of Internal Revenue Code, or 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 IRC Section 382 (f)) 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 Section 382 limitation for those years.

As a result of our acquisition of Chaparral, a second ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of the acquired 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.

Stock-Based Compensation

We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment*, which requires us to record stock compensation expense for equity based awards granted, including stock options, for which expense will be recognized over the service period of the equity based award based on the fair value of the award, at the date of grant. The estimation of stock option fair value requires management to make complex estimates and judgments about, among other things, employee exercise behavior, forfeiture rates, and the volatility of our common stock. These judgments directly affect the amount of compensation expense that will ultimately be recognized. We currently use the Black-Scholes option pricing model to estimate the fair value of our stock options. The Black-Scholes model meets the requirements of SFAS 123R but the fair values generated by the model may not be indicative of the actual fair values of our stock options as it does not consider certain factors important to those awards to employees, such as continued employment and periodic vesting requirements as well as limited transferability. The determination of the fair value of share-based payment awards utilizing the Black-Scholes model is affected by our stock price and a number of assumptions, including expected volatility, expected life, risk-free interest rate and expected dividends. We use the implied volatility for traded options on our stock as the expected volatility assumption required in the Black-Scholes model. Our selection of the implied volatility approach is based on the availability of data regarding actively traded options on our stock as well as we believe that implied volatility is more representative than historical volatility. The expected life of the stock options is based on historical and other economic data trended into the future. The risk-free interest rate assumption is based on observed interest rates appropriate for the terms of our stock options. The dividend yield assumption is based on our history and expectation of dividend payouts. We will evaluate the assumptions used to value stock options on a quarterly basis. If factors change and we employ different assumptions, stock-based compensation expense may differ significantly from what we have recorded in the past. If there are any modifications or cancellations of the underlying unvested securities, we may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense. To the extent that we grant additional stock options to employees our stock-based compensation expense will be increased by the additional unearned compensation resulting from those additional grants or acquisitions.

As of September 30, 2007, total unrecognized share-based compensation cost related to unvested stock options was $7.2 million, which is expected to be recognized over a weighted average period of approximately 2.8 years.

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Contingencies

We are subject to various legal proceedings and claims and tax matters, the outcomes of which are subject to significant uncertainty. SFAS No. 5, *Accounting for Contingencies*, requires that an estimated loss from a loss contingency should be accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. We evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial position or our results of operations. See Note 11 to our condensed consolidated financial statements for further information regarding contingencies.

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:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2007**	**2006**	**2007**
Net revenue:	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	87.2	85.7	82.2	87.0
Gross profit	12.8	14.3	17.8	13.0
Operating expenses:				
Sales and marketing	6.6	8.0	6.6	7.4
Research and development	15.0	12.6	16.7	10.7
General and administrative	7.6	5.3	8.0	6.0
Legal settlement			1.9	
Total operating expenses	29.2	25.9	33.2	24.1
Operating loss	(16.4)	(11.6)	(15.4)	(11.1)
Other income, net	2.6	2.7	2.3	2.4
Income tax expense	95.7	0.1	26.8	0.2
Net loss	(109.6)%	(9.0)%	(39.9)%	(8.9)%

(percentages may not aggregate due to rounding)

Three Months Ended September 30, 2007 Compared to Three Months Ended September 30, 2006

Net Revenue

Net revenue decreased $9.1 million, or 16.6%, to $45.7 million for the three months ended September 30, 2007 from $54.8 million for the three months ended September 30, 2006. The decrease in net revenue was primarily attributable to decreased orders for our products from our largest OEM customer, Sun, which accounted for 58.0% of our net revenue for the three months ended September 30, 2007, as compared to 81% of our net revenue for the three months ended September 30, 2006. The decrease in net revenue from Sun was partially offset by an increase in orders from our second largest OEM customer, NetApp, which accounted for 15.7% of our net revenue for the three months ending September 30, 2007, along with an increase in sales of our Series 2000 products, a new family of products introduced during the third quarter of 2006. Fibre Channel units shipped were 1,453 for the three months ended September 30, 2007 compared to 2,473 units for the three months ended September 30, 2006. Small Computer Systems Interface, or SCSI, units shipped were 1,894 for the three months ended September 30, 2007 compared to 2,774 units for the three months ended September 30, 2006. Blade units shipped were 1,582 for the three months ended September 30, 2007 compared to 2,921 units for the three months ended September 30, 2006. SATA units

shipped were 69 for the three months ended September 30, 2007 compared to 431 units for the three months ended September 30, 2006. We shipped 906 units of our Series 2000 products for the three months ended September 30, 2007 compared to 655 for the three months ended September 30, 2006. Net revenue not related to Sun or NetApp was $12.0 million for the three months ended September 30, 2007 compared to $9.5 million for the three months ended September 30, 2006.

Cost of Goods Sold

Cost of goods sold decreased $8.6 million, or 18.0%, to $39.2 million for the three months ended September 30, 2007 from $47.8 million for the three months ended September 30, 2006. As a percentage of net revenue, cost of goods sold decreased to 85.7% for the three months ended September 30, 2007 from 87.2% for the three months ended September 30, 2006. The decrease in the dollar amount of cost of goods sold was primarily attributable to a decrease in net revenue. The decrease in the cost of goods sold as a percentage of net revenue for the three months ended September 30, 2007 compared to the three months ended September 30, 2006 was largely due to several factors. First, we significantly reduced manufacturing overhead as a result of more efficiently managing our internal costs and supply chain. Second, costs of goods sold associated with our Series 2000 products in the quarter ending September 30, 2007, decreased significantly over quarter ended September 30, 2006, as the Series 2000 first started shipping in the latter quarter and were manufactured in a largely soft tooled environment resulting in higher costs of goods sold on the Series 2000 products shipped in that quarter. These factors which had the impact of reducing costs of goods sold as a percentage of net revenue were partially offset by changes in the product sales mix. Net revenue to our largest OEM customer, Sun, declined as a percentage of total net revenue. On the other hand, net revenue of our Series 2000 products and net revenue to our second largest OEM customer which have a higher cost of goods sold as a percentage of net revenue than net revenue to our largest OEM customer, increased as a percentage of total net revenue.

Gross Profit

Gross profit decreased less than $0.5 million, or 7.1%, to $6.5 million for the three months ended September 30, 2007 compared to $7.0 million for the three months ended September 30, 2006. As a percentage of net revenue, gross profit increased to 14.3% for the three months ended September 30, 2007 from 12.8% for the three months ended September 30, 2006. The decrease in the dollar amount of gross profit was primarily attributable to lower total net revenue. The increase in gross profit as a percentage of net revenue for the three months ended September 30, 2007 compared to the three months ended September 30, 2006 was largely due to several factors. First, we significantly reduced manufacturing overhead as a result of more efficiently managing our internal costs and supply chain. Second, gross profit as a percentage of net revenue associated with our Series 2000 products in the quarter ending September 30, 2007 increased significantly over quarter ended September 30, 2006. The Series 2000 first started shipping in the quarter ended September 30, 2006 and was manufactured in a soft tooled environment resulting in a negative gross profit as a percentage of net revenue on the Series 2000 products shipped in that quarter. These gains in gross profit as a percentage of net revenue were partially offset by the impact of changes in the product sales mix. Net revenue to our largest OEM customer declined as a percentage of total net revenue. On the other hand, net revenue of our Series 2000 products and to our second largest OEM customer which have a lower gross profit as a percentage of net revenue than net revenue to our largest OEM customer, increased as a percentage of total net revenue.

Sales and Marketing Expenses

Sales and marketing expenses were relatively flat at $3.7 million for the three months ended September 30, 2007 and 2006. As a percentage of net revenue, sales and marketing expenses increased to 8.0% for the three months ended September 30, 2007 from 6.6% for the three months ended September 30, 2006. Although in total sales and marketing expenses were relatively flat there were changes within certain expense categories. These changes were primarily attributable to an increase in salaries offset by a decrease in advertising costs. The increase in sales and marketing expenses as a percentage of net revenue was primarily due to a decrease in revenue for the three months ended September 30, 2007 compared to the three months ended September 30, 2006. We expect sales and marketing expenses for the year ending December 31, 2007 to remain consistent with spending levels incurred during 2006.

Research and Development Expenses

Research and development expenses decreased $2.5 million, or 30.5%, to $5.7 million for the three months ended September 30, 2007 from $8.2 million for the three months ended September 30, 2006. As a percentage of net revenue, research and development expenses decreased to 12.6% for the three months ended September 30, 2007 from 15.0% for the three months ended September 30, 2006. The decrease in research and development expenses was primarily due to a reduction of $2.3 million in investment in prototypes and project materials, and a reduction of $0.1 million in payroll and travel related expenses. We expect research and development expenses for the year ending

December 31, 2007 will continue to decrease from spending levels incurred during 2006 as much of our investment in prototypes and project materials for our new products has been completed.

General and Administrative Expenses

General and administrative expenses decreased $1.8 million, or 42.9%, to $2.4 million for the three months ended September 30, 2007 from $4.2 million for the three months ended September 30, 2006. As a percentage of net revenue, general and administrative expenses decreased to 5.3% for the three months ended September 30, 2007 from 7.6% for the three months ended September 30, 2006. The decrease was primarily attributable to a $1.0 million gain due to currency revaluation of intercompany transactions, $0.4 million reduction in tax and accounting fees, a $0.4 million reduction in legal expenses, and a decrease of $0.2 million in bad debt expense.

Legal Settlement Expense

On June 28, 2006, we entered into a Settlement and License Agreement with Crossroads Systems, Inc., or Crossroads, that settles Crossroads lawsuit against us and licenses to us the family of patents from which it stemmed. We concurrently entered into an Agreement between Dot Hill Systems and Infortrend Re Settlement of Crossroads Lawsuit with Infortrend Technology Inc., or Infortrend. In accordance with the Crossroads and Infortrend agreements, on July 14, 2006, we paid $3.35 million to Crossroads for alleged past damages and Crossroads agreed to dismiss all patent claims against us. As part of the agreement between Dot Hill and Infortrend, Infortrend paid Crossroads $5.72 million on behalf of Dot Hill on July 17, 2006. $1.43 million was paid by Dot Hill for Taiwan taxes and is included in income tax expense on our statement of operations. Please refer to Note 11 in the accompanying condensed consolidated financial statements.

Income Taxes

We recorded income tax expense of less than $0.1 million for the three months ended September 30, 2007 compared to $52.5 million for the three months ended September 30, 2006. Our effective income tax rate of (1.4)% for the three months ended September 30, 2007 differs from the U.S. federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes. For the three months ended September 30, 2006, we recorded tax expense of $52.5 million, reflecting an effective tax rate of (688.7%). Our effective tax rate for the three months ended September 30, 2006 differs from the U.S. federal statutory rate primarily due to our valuation allowance against deferred tax assets in foreign jurisdictions, state taxes and the impact of share-based compensation expense recognized under SFAS No. 123(R).

At September 30, 2007, based on the weight of available evidence, including cumulative losses in recent years and expectations of 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 $47.1 million valuation allowance associated with our United States deferred tax assets.

As of December 31, 2006, we had federal and state net operating losses of approximately $122.4 million and $57.0 million, which begin to expire in the tax years ending 2013 and 2007, respectively. In addition, we had federal tax credit carryforwards of $3.7 million, of which approximately $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $3.2 million began to expire in the tax year ending 2007. We also had state tax credit carryforwards of $3.9 million, of which $3.7 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million began to expire in the tax year ending 2007.

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 Section 382 limitation for those years.

As a result of our acquisition of 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.

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.

Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006

Net Revenue

Net revenue decreased $24.5 million, or 13.6%, to $155.3 million for the nine months ended September 30, 2007 from $179.8 million for the nine months ended September 30, 2006. The decrease in net revenue was primarily attributable to decreased orders for our products from our largest OEM customer, Sun, which accounted for 66.9% of our net revenue for the nine months ended September 30, 2007, as compared to 85% of our net revenue for the nine months ended September 30, 2006. The decrease in net revenue from Sun was partially offset by sales of our Series 2000 products, a new family of products introduced during the third quarter of 2006, and sales to another large OEM customer, NetApp. Fibre Channel units shipped were 5,887 for the nine months ended September 30, 2007 compared to 7,726 units for the nine months ended September 30, 2006. SCSI units shipped were 7,334 for the nine months ended September 30, 2007 compared to 9,853 units for the nine months ended September 30, 2006. Blade units shipped were 8,041 for the nine months ended September 30, 2007 compared to 8,729 units for the nine months ended September 30, 2006. SATA units shipped were 239 for the nine months ended September 30, 2007 compared to 1,848 units for the nine months ended September 30, 2006. We shipped 3,826 units of our series 2000 products for the nine months ended September 30, 2007 compared to 655 for the nine months ended September 30, 2006. Net revenue not related to Sun or NetApp was $38.6 million for the nine months ended September 30, 2007 compared to $24.2 million for the nine months ended September 30, 2006.

Cost of Goods Sold

Cost of goods sold decreased $12.6 million, or 8.5%, to $135.2 million for the nine months ended September 30, 2007 from $147.8 million for the nine months ended September 30, 2006. As a percentage of net revenue, cost of goods sold increased to 87.0% for the nine months ended September 30, 2007 from 82.2% for the nine months ended September 30, 2006. The decrease in the dollar amount of cost of goods sold was primarily attributable to a decrease in net revenue. The increase in cost of goods sold as a percentage of net revenue for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006 was primarily due to a change in the product sales mix. Net revenue to our largest OEM customer declined as a percentage of total net revenue. On the other hand, net revenue of our Series 2000 products and net revenue to our second largest OEM customer that have a higher costs of goods sold as a percentage of net revenue compared to net revenue to our largest OEM customer increased as a percentage of total net revenue. The net effect of this change in product sales mix was to increase costs of goods sold as a percentage of net revenue. In addition, manufacturing overhead and variances for the nine months ending September 30, 2007 increased compared to the nine months ending September 30, 2006. This increase was largely due to transferring production of our Series 2000 products from Solectron to MITAC and SYNNEX as well as for start up costs associated with production for our second largest customer.

Gross Profit

Gross profit decreased $11.9 million, or 37.2%, to $20.1 million for the nine months ended September 30, 2007 from $32.0 million for the nine months ended September 30, 2006. As a percentage of net revenue, gross profit decreased to 13.0% for the nine months ended September 30, 2007 from 17.8% for the nine months ended September 30, 2006. The decrease in the dollar amount of gross profit as percentage of net revenue for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006 was primarily due to a change in the product sales mix. Net revenue to our largest OEM customer declined as a percentage of total net revenue. On the other hand, net revenue of our Series 2000 products and to our second largest OEM customer that have lower gross profit as a percentage of net revenue compared to net revenue to our largest OEM customer increased as a percentage of total net revenue. The net effect of this change in product sales mix was to decrease gross profit dollars and gross profit as a percentage of net revenue. In addition, manufacturing overhead and variances for the nine months ended September 30, 2007 increased over levels for the nine months ending September 30, 2006. This increase was largely due to transferring production of our Series 2000 products from Solectron to MITAC and SYNNEX as well as for start up costs associated with production for our second largest customer.

Sales and Marketing Expenses

Sales and marketing expenses decreased $0.4 million, or 3.4%, to $11.5 million for the nine months ended September 30, 2007 from $11.9 million for the nine months ended September 30, 2006. As a percentage of net

revenue, sales and marketing expenses increased to 7.4% for the nine months ended September 30, 2007 from 6.6% for the nine months ended September 30, 2006. The decrease in the dollar amount of sales and marketing expenses was primarily attributable to a decrease in headcount at our subsidiaries in Japan and Europe. The increase in sales and marketing expenses as a percentage of net revenue was primarily due to a decrease in

net revenue for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006. We expect sales and marketing expenses for the year ending December 31, 2007 to remain consistent with spending levels incurred during 2006.

Research and Development Expenses

Research and development expenses decreased $13.5 million, or 44.9%, to $16.6 million for the nine months ended September 30, 2007 from $30.1 million for the nine months ended September 30, 2006. As a percentage of net revenue, research and development expenses decreased to 10.7% for the nine months ended September 30, 2007 from 16.7% for the nine months ended September 30, 2006. The decrease in research and development expenses both in dollar amounts and as a percentage of net revenue was primarily due to a reduction of $11.5 million in investment in prototypes and project materials, a reduction of $0.9 million in test related expenses, a reduction of $0.3 million in payroll and travel related expenses and a reduction of $0.3 million in third party professional and consulting fees. We expect research and development expenses for the year ending December 31, 2007 will continue to decrease from spending levels incurred during 2006 as much of our investment in prototypes and project materials for our new products has been completed.

General and Administrative Expenses

General and administrative expenses decreased $4.9 million, or 34.0%, to $9.4 million for the nine months ended September 30, 2007 from $14.3 million for the nine months ended September 30, 2006. As a percentage of net revenue, general and administrative expenses decreased to 6.0% for the nine months ended September 30, 2007 from 8.0% for the nine months ended September 30, 2006. The decrease in both dollar amounts and as a percentage of net revenue was primarily attributable to $1.2 million in expense associated with the acceleration of vesting of stock options of our former chief executive officer and his consulting agreement which occurred during the nine months ended September 30, 2006, a $1.4 million decrease in legal expenses, a $0.9 million reduction in third party professional and consulting fees, and a $1.1 million gain due to currency revaluation of intercompany transactions.

Legal Settlement Expense

On June 28, 2006, we entered into a Settlement and License Agreement with Crossroads that settles Crossroads lawsuit against us and licenses to us the family of patents from which it stemmed. We concurrently entered into an Agreement between Dot Hill Systems and Infortrend Re Settlement of Crossroads Lawsuit with Infortrend. In accordance with the Crossroads and Infortrend agreements, on July 14, 2006, we paid $3.35 million to Crossroads for alleged past damages and Crossroads agreed to dismiss all patent claims against us. As part of the agreement between Dot Hill and Infortrend, Infortrend paid Crossroads $5.72 million on behalf of Dot Hill on July 17, 2006. $1.43 million was paid by Dot Hill for Taiwan taxes and is included in income tax expense on our statement of operations. Please refer to Note 11 in the accompanying condensed consolidated financial statements.

Income Taxes

We recorded income tax expense of $0.3 million for the nine months ended September 30, 2007 compared to income tax expense of $48.1 million for the nine months ended September 30, 2006. Our effective income tax rate of (1.9)% for the nine months ended September 30, 2007 differs from the U.S. federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes. For the nine months ended September 30, 2006, we recorded a tax expense of $48.1 million, reflecting an effective tax rate of (204.0)%. Our effective tax rate for the nine months ended September 30, 2006 differs from the U.S. federal statutory rate primarily due to our valuation allowance against deferred tax assets in foreign jurisdictions, state taxes and the impact of share-based compensation expense recognized under SFAS No. 123(R).

At September 30, 2007, based on the weight of available evidence, including cumulative losses in recent years and expectations of 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 $47.1 million valuation allowance associated with our United States deferred tax assets.

As of December 31, 2006, we had federal and state net operating losses of approximately $122.4 million and $57.0 million, which begin to expire in the tax years ending 2013 and 2007, respectively. In addition, we had federal tax credit carryforwards of $3.7 million, of which approximately $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $3.2 million began to expire in the tax year ending 2007. We also had

state tax credit carryforwards of $3.9 million, of which $3.7

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million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million began to expire in the tax year ending 2007.

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 Section 382 limitation for those years.

As a result of our acquisition of 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.

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.

Liquidity and Capital Resources

As of September 30, 2007, we had $90.2 million of cash, cash equivalents and short-term investments and $93.5 million of working capital.

For the nine months ended September 30, 2007, cash used in operating activities was $7.0 million compared to cash used in operating activities of $11.9 million for the nine months ended September 30, 2006. The net cash used in operating activities in 2007 is primarily attributable to the net loss of $13.8 million offset by depreciation and amortization of $5.0 million, share-based compensation expense of $1.6 million and loss on disposition of property and equipment of $0.2 million. Cash flow from operations reflects the positive impact of $10.8 million related to a decrease in accounts receivable due to the timing of payments from our customers and lower sales over the comparable period, a $0.3 million decrease in prepaid and other assets, a $0.7 million and $1.8 million increase in short-term and long-term deferred revenues, respectively, as a result of a $2.5 million customer deposit. Additionally, other long-term liabilities increased $0.6. Cash provided from operations was negatively impacted by an $9.1 million reduction in accounts payable due to the timing of payments to our vendors as well as lower sales volume, a $2.6 million decrease in accrued compensation and expenses, and a $2.6 million increase in inventory primarily due to the creation of hub inventory locations for certain of our customers.

Cash used in investing activities for the nine months ended September 30, 2007 was $9.2 million compared to $8.2 million provided by investing activities for the same period in 2006. The cash used in the nine months ended September 30, 2007 was attributable to a $5.4 million purchase of short-term investments with the remainder being used for the purchase of property and equipment.

Cash provided by financing activities for the nine months ended September 30, 2007 was $1.1 million compared to cash provided by financing activities of $1.8 million for the same period in 2006. The cash provided by financing activities is attributable to the proceeds received from the exercises of stock options under our equity incentive plans and warrants of $0.2 million, and the proceeds received from the sale of common stock to employees under our employee stock purchase plan of $1.0 million.

We presently expect cash, cash equivalents, short term investments and cash generated from operations to be sufficient to meet our operating and capital requirements for at least the next 12 months and for operating periods in excess of 12 months. In addition, this will enable us to pursue acquisitions 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, our ability to manage our relationships with third party manufacturers, the status of our relationships with key customers, partners and suppliers, the timing and extent of the introduction of new products and services and growth in personnel and operations.

On April 12, 2007, we entered into a lease contract with Circle Capital Longmont LLC, under which we lease approximately 44,300 square feet of office and laboratory space located at 1351 South Sunset in Longmont, Colorado.

We use this office and

laboratory space as our new research and development facility. The lease contract provides for a term of 65 months, commencing in August 2007 and ending December 2012. Our operating lease commitments will increase by $0.4 million per year for each of the years ended December 31, 2008 through 2012.

The lease for our previous research and development faculty located in Longmont, Colorado expired in accordance with the lease terms on July 31, 2007.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board, or FASB, issued SFAS No. 157, *Fair Value Measurements*, which establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather it eliminates inconsistencies in the guidance found in various prior accounting pronouncements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Although we are still evaluating the potential effects of this standard, we do not expect the adoption of SFAS No. 157 to have a material impact on our financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115*, which allows measurement at fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. If the fair value option for an eligible item is elected, unrealized gains and losses for that item shall be reported in current earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between the different measurement attributes the company elects for similar types of assets and liabilities. This statement is effective for fiscal years beginning after November 15, 2007. We are in the process of evaluating the application of the fair value option and its effect on our financial condition and results of operations.

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, maximize investment yields subject to other investment objectives and maintain liquidity to meet projected cash requirements. Accordingly, we invest in instruments such as money market funds, certificates of deposit, United States government/agencies bonds, notes, bills and municipal bonds 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. 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. We do not expect to incur any material losses with respect to our investment portfolio.

The following table provides information about our investment portfolio at December 31, 2006 and September 30, 2007. For investment securities, the table presents carrying values at December 31, 2006 and September 30, 2007 and, as applicable, related weighted average interest rates by expected maturity dates.

	December 31, 2006	September 30, 2007
	(amounts in thousands)	
Cash equivalents	$95,845	$ 80,966
Average interest rate	5.3%	5.3%
Short-term investments		$ 5,471
Average interest rate		5.4%
Total Portfolio	$95,845	$ 86,437
Average Interest Rate	5.3%	5.3%

We have a line of credit agreement, which accrues interest on any outstanding balances at a variable rate. As of September 30, 2007, we had no balance under this line. Were we to incur a balance under this line of credit, we would be exposed to interest rate risk on such debt.

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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.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We conducted an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of 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 September 30, 2007. Based upon that evaluation, the 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.

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Part II. Other Information

Item 1. Legal Proceedings

Crossroads Systems Litigation

On October 27, 2003, we were served with a lawsuit filed by Crossroads in the United States District Court in Austin, Texas, alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. The patents involve the use of access controls in storage routers. The court has interpreted storage routers to include RAID controllers.

On June 28, 2006, we entered into a Settlement and License Agreement with Crossroads that settled the lawsuit and licenses to us the family of patents from which it stemmed. We concurrently entered into an Agreement between Dot Hill Systems and Infortrend Re Settlement of Crossroads Lawsuit with Infortrend Technology, Inc., or Infortrend. In accordance with the Crossroads and Infortrend agreements, on July 14, 2006, we paid $3.35 million to Crossroads for alleged past damages and Crossroads agreed to dismiss, with prejudice, all patent claims against us. In addition, Infortrend was expected to pay Crossroads an additional $7.15 million on our behalf. However, Infortrend withheld $1.43 million from that payment for the payment of Taiwan taxes. This withholding is included in income tax expense on our statement of operations. Going forward, Crossroads will receive a running royalty of 2.5% based on a percentage of net sales of RAID products sold by us, but only those with functionality that is covered by licensed patents. For RAID products that use a controller sourced by Infortrend, we will pay 0.8125% of the 2.5% royalty, and Infortrend will be responsible for the remainder. For RAID products that use our proprietary controller, we alone will be paying the 2.5% running royalty. No royalty payments will be required with respect to the sale of storage systems that do not contain RAID controllers, known as JBOD systems, or systems that use only the SCSI protocol end-to-end, even if those perform RAID. Further, royalty payments with respect to the sale of any products that are made, used and sold outside of the United States will only be required if and when Crossroads is issued patents that cover the products and that are issued by countries in which the products are manufactured, used or sold.

In July, 2006, Crossroads filed two lawsuits against us in the United States District Court for the Western District of Texas based on the alleged breach of the June 28, 2006 Settlement and License Agreement due to the withholding of the $1.43 million for Taiwanese taxes. On September 28, 2006 the Court indicated that it would grant Crossroads Motion to Enforce. Therefore, on October 5, 2006, Crossroads and Dot Hill amended the original Settlement and License Agreement to state that Dot Hill would pay to Crossroads the $1.43 million, plus $45,000 in late fees, and would not make deductions based on taxes on royalty payments in the future. The payment of the $1.475 million was made on October 5, 2006. As required by the amended settlement, Crossroads has dismissed with prejudice the original patent action as well as the second lawsuit based on the enforcement of the original settlement.

Thereafter, we gave notice to Infortrend of our intent to bring a claim alleging breach of the settlement agreement seeking reimbursement of the $1.475 million from Infortrend. On November 13, 2006, Infortrend filed a lawsuit in the Superior Court of California, County of Orange for declaratory relief. The complaint seeks a court determination that Infortrend is not obligated to reimburse Dot Hill for the $1.475 million. On December 12, 2006, we answered the complaint and filed a cross complaint alleging breach of contract, fraud, breach of implied covenant of good faith and fair dealing, breach of fiduciary duty and declaratory relief. Infortrend demurred to the cross complaint. The Court denied the demurrer as to the fraud cause of action and sustained the demurrer as to the claims for breach of the covenant of good faith and fair dealing and breach of fiduciary duty. Dot Hill filed an amended cross complaint, and Infortrend has answered. Discovery is ongoing. No trial date has been scheduled.

Chaparral Securities Class Action

In August 2004, a class action lawsuit was filed against, among others, Chaparral and a number of its former officers and directors in the United States District Court for the Central District of California. The lawsuit, among other things, alleges violations of federal and state securities laws and purports to seek damages on behalf of a class of shareholders who held interests in limited liability companies that had purchased, among other securities, Chaparral stock during a defined period prior to our acquisition of Chaparral. In May 2005, the Second Amended Complaint was dismissed with leave to amend. Plaintiffs filed a Third Amended Complaint, which the Court again dismissed with leave to amend in November of 2005 as to Chaparral and certain other defendants. Plaintiffs declined to amend within the proscribed period, and final judgment was entered in February 2006. Plaintiffs filed a notice of appeal in the

United States District Court of Appeals for the Ninth Circuit, though they have not filed their opening papers.

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Plaintiffs filed a related action in the Superior Court of the State of California, Orange County, in December of 2005, alleging many of the same claims. That action was stayed pending the outcome of the federal appeal. The parties have reached a settlement of the securities class actions. That settlement was preliminarily approved by the Orange County Superior Court on March 19, 2007. At the final settlement approval hearing on October 1, 2007, the court approved the final settlement, pending non-material changes to the terms of the settlement agreement. We expect the final settlement order to issue shortly.

Dot Hill Securities Class Actions and Derivative Suits

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 our motion to dismiss on May 29, 2007 and are still waiting for a ruling from the judge.

In addition, three complaints purporting to be derivative actions have been 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 demurrer to two of those cases, in which we sought dismissal, was overruled (i.e., denied). We have 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 option backdating was served on us. On April 16, 2007, the SLC concluded its investigation and based on its findings directed us to file a motion to dismiss the derivative matters. On June 27, 2007, the parties stipulated to consolidate all of the derivative matters for pre-trial proceedings. We expect to file a motion to dismiss the consolidated matters pursuant to the SLC s directive in the next few months. The outcome of these actions is uncertain, and no amounts have been accrued as of September 30, 2007.

In August 2007, a securities lawsuit was filed in California state court by a single former stockholder against 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 $500,000 in damages, as well as attorneys fees and costs. On November 1, 2007, we demurred to dismiss the complaint. The outcome of this action is uncertain, and no amounts have been accrued as of September 30, 2007.

Other Litigation

We are involved in certain other legal actions and claims arising in the ordinary course of business. Management believes that the outcome of such other litigation and claims will not have a material adverse effect on our financial condition or operating results.

Item 1A. Risk Factors

The following sets forth risk factors that may affect our future results, including certain revisions to the risk factors included in our annual report on Form 10-K for the fiscal year ended December 31, 2006 and subsequent filings with the SEC. Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. We face risks described but not limited to those detailed below. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The trading price of our common stock could decline due to any of these risks. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this quarterly report on Form 10-Q, including our financial statements and related notes.

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

Our business is highly dependent on a limited number of OEM customers. For example, sales to Sun accounted for 82% and 67% of our net revenue for the year ended December 31, 2006 and nine months ended September 30, 2007, respectively. If our relationships with Sun, NetApp, Fujitsu Siemens or certain other OEM customers of ours were disrupted, we would lose a significant portion, if not substantially all, of our anticipated net revenue and our business could be materially harmed. We cannot guarantee that our relationship with Sun, NetApp, Fujitsu Siemens or other OEM customers will expand or not otherwise be disrupted. Factors that could influence our relationship with our significant OEM customers, including Sun, NetApp and Fujitsu Siemens 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 meet our OEM customers needs and requirements with respect to cost, timeliness, features, performance and other factors; and
- the ability of Sun, NetApp, Fujitsu Siemens or our other OEM customers to effectively launch, ramp, ship, sell and market their own products 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 Sun, NetApp and Fujitsu Siemens, contain any minimum purchasing commitments and our customers may cancel purchase orders at any time. Further, we do not expect that future contracts with customers, if any, will include any minimum purchasing commitments. Changes in the timing or volume of purchases by our major customers could result in lower revenue. For example, we cannot be certain that our sales to Sun will continue at historical levels. In fact, sales to Sun have decreased recently compared to earlier 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, our OEM customers may sell the products of our competitors. For example, on April 25, 2006, we were informed by Sun of its decision to move potential future supply of a new, low-end, entry-level storage product to another party. The project had previously been directed solely to Dot Hill. We cannot be certain if, when or to what extent any customer might cancel purchase orders, cease making purchases or elect not to renew the applicable contract upon the expiration of the current term. The decision by any of our OEM customers to cancel purchase orders, cease making purchases or terminate their respective contracts could cause our revenues to decline substantially, and our business and results of operations could be significantly harmed.

We may continue to experience losses in the future, and may require additional capital.

For the nine months ended September 30, 2007, we incurred a net loss of $13.8 million. We expect to incur a loss for the year ended December 31, 2007, primarily as a result of high new product production costs pending transition of our supply chain to a lower cost contract manufacturer and continued investment in research and development. We may be able to mitigate these losses as we transition manufacturing of our Series 2000 and Series 5000 products to a hard-tooled environment, change the mix of product sales and continue to focus on internal cost controls. However, we cannot assure you that we will be profitable in any future period or that these attempts at mitigation will be successful.

Our available cash, cash equivalents and short term investments as of September 30, 2007 totaled $90.2 million. We presently expect cash, cash equivalents, short term investments and cash generated from operations to be

sufficient to meet our operating and capital requirements through at least the next 12 months. However, unanticipated events may require us to raise additional funds. Our future capital requirements will depend on, and could increase substantially as a result of many factors, including:

- our plans to maintain and enhance our engineering, research, development and product testing programs;
- our ability to achieve acceptable gross profit margins;

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the success of our manufacturing strategy;

the success of our sales and marketing efforts;

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;

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

costs of litigating and defending law suits.

We may not be able to raise additional funds on commercially reasonable terms or at all. Any sales of convertible debt or equity securities in the future may have a substantial dilutive effect on our existing stockholders. If we are able to borrow funds, we may be required to grant liens on our assets to the provider of any source of financing or enter into operating, debt service or working capital covenants with any provider of financing that could hinder our ability to operate our business in accordance with our plans. As a result, our ability to further borrow money on a secured basis may be impaired, and we may not be able to issue secured debt on commercially reasonable terms or at all.

Our inability to successfully transition manufacturing of our Series 2000 and successor products from Solectron to MiTAC and SYNNEX could significantly impact our operating results.

Our decision to enter into a manufacturing agreement with MiTAC and SYNNEX was partly based upon our belief that we can achieve lower manufacturing and product transformation costs. As this is a new relationship for both companies, we will need to establish new processes, tooling and manufacturing infrastructure. Consequently, there could be a delay in migrating production to MiTAC and SYNNEX which could negatively impact expected gross margins. We could also have surplus raw materials or finished goods at Solectron which could result in writedowns or lower margins. In addition, if we experience any product quality or manufacturing capacity issues, we could impact revenues from customers as well as their satisfaction with our products.

If however, we are unable to give any of our contract manufacturers sufficient volumes of products to manufacture on our behalf, our contract manufacturers are likely to become less responsive to us and seek to increase prices.

In addition, our new relationship with MiTAC and SYNNEX may negatively impact our relationship with Solectron, we cannot be assured that there will not be any strains on the relationship between the two companies that could impact product cost or quality.

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

Our gross margins are determined in large part based on our manufacturing costs, our component costs and our ability to bundle RAID controllers, software and low cost value added features into our products, as well as the prices at which we sell our products. If we are unable to lower production costs to be consistent with any decline in selling prices, our gross margins and operating results will suffer. Several of the new products we are currently shipping or expect to begin shipping are at the early launch phase. Until our manufacturing processes for these new products are more fully developed, product costs for these new products will be higher than for more mature products. Our strategy to offset gross margin erosion includes shifting our manufacturing to lower cost suppliers such as MiTAC and SYNNEX and transitioning the manufacturing of our Series 2000 products to a hard-tooled production environment. We cannot assure you that we will be successful or that we will not experience unforeseen delays in effecting that transition, nor can we be certain as to the magnitude of any cost savings. In addition, as we begin to derive a greater portion of our net revenues from sales of products to customers other than Sun, a greater percentage of products may be sold without RAID controllers, software or other margin enhancing features. All of these factors, together with increasing pricing pressures, could further adversely affect our gross margins and operating results.

The market for our products is subject to substantial pricing pressure that may harm our net revenues, gross margins and operating results.

Pricing pressures exist in the data storage market and have harmed and may, in the future, continue to harm our net revenues, gross margin and operating results. These pricing pressures are due, in part, to continuing decreases in component prices, such as those of disks 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. In addition, because we expect to continue to make most of our sales to a small number of customers, we are subject to continued pricing pressures from our customers, particularly our OEM customers.

Pricing pressures are also due, in part, to the highly competitive nature of our industry, the narrowing of functional differences among competitors, which forces companies to compete more on price rather than product features, and the introduction of new technologies, which leaves older technology more vulnerable to pricing pressures. To the extent we are forced to reduce the prices of our products sold as a result of these pressures, our net revenues, gross margins and operating results will decline.

Our operating results are subject to substantial quarterly and annual fluctuations, our period to period comparisons are not necessarily meaningful and we may not meet the expectations of public market analysts and investors.

Our revenues in any quarter are substantially dependent upon customer orders in that quarter. We attempt to project future orders based in part on estimates from our OEM customers. For this purpose, arrangements with OEM customers will usually include the estimated future volume requirements of that customer. Our OEM customers estimated requirements are not always accurate and we therefore cannot predict our quarterly revenues with any degree of certainty. Moreover, we cannot predict or control our customers product launch dates, volume ramps and other factors that may result in substantial fluctuations on a quarterly or annual basis. In addition, Sun s quarterly operating results typically fluctuate downward in the first quarter of their fiscal year when compared with the immediately preceding fourth quarter. It is likely that NetApp s sales as well as sales of our other new OEM customers will fluctuate on a quarterly or seasonal basis as well, and these fluctuations will affect our financial results. Due to the infancy of the NetApp relationship, we cannot be certain of what affect these fluctuations will have on our quarterly results, if any.

Our quarterly operating results have fluctuated significantly in the past as shown in the following table and are not a good indicator of future performance (in millions).

Quarter	Net Revenue	Net Income (Loss)
First Quarter 2003	$ 30.5	$ (1.5)
Second Quarter 2003	48.4	2.6
Third Quarter 2003	51.0	4.3
Fourth Quarter 2003	57.5	6.6
First Quarter 2004	47.9	(2.6)
Second Quarter 2004	69.0	6.7
Third Quarter 2004	57.0	3.5
Fourth Quarter 2004	65.5	4.0
First Quarter 2005	58.0	2.1
Second Quarter 2005	65.9	3.3
Third Quarter 2005	53.6	(1.3)
Fourth Quarter 2005*	56.3	22.5
First Quarter 2006	58.7	(5.0)
Second Quarter 2006	66.3	(6.6)
Third Quarter 2006**	54.8	(60.1)
Fourth Quarter 2006	59.4	(9.1)
First Quarter 2007	53.4	(6.0)

Second Quarter 2007	56.2	(3.7)
Third Quarter 2007	45.7	(4.1)

* Includes deferred tax benefit from reversal of valuation allowance of $25.3 million.

** Includes income tax expense related to establishing valuation allowance of $47.1 million.

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Accordingly, comparisons of our quarterly results of operations or other period to period comparisons are not necessarily meaningful and should not be relied on as an indication of our future performance. In addition, the announcement of financial results that fall short of the results anticipated by public market analysts and investors could have an immediate and significant negative effect on the trading price of our common stock in any given period.

We may have difficulty predicting future operating results due to both internal and external factors affecting our business and operations, which could cause our stock price to decline.

Our operating results may vary significantly in the future depending on a number of factors, many of which are out of our control, including:

- the size, timing, cancellation or rescheduling of significant customer orders;
- our ability to reduce product costs and improve operating margins;
- market acceptance of our new products and product enhancements and new product announcements or introductions by our competitors;
- product configuration, mix and quality issues;
- changes in pricing by us or our competitors;
- the cost of litigation and settlements involving intellectual property and other matters;
- deferrals of customer orders in anticipation of new products or product enhancements;
- our ability to develop, introduce and market new products and product enhancements on a timely basis;
- hardware component costs and availability, particularly with respect to hardware components obtained from sole-source providers and major component suppliers such as disk drives, memory and legacy RAID controllers;
- our success in creating brand awareness and in expanding our sales and marketing programs;
- the level of competition;
- our ability to win business with new customers;
- potential reductions in inventories held by customers;
- slowing sales of the products of our customers;
- technological changes in the open systems storage market;
- levels of expenditures on research, engineering and product development;
- levels of expenditures in our manufacturing and support organization and our ability to manage variances in component costs and inventory levels of components held by our manufacturing partners;
- the quality of products being manufactured by Solectron, MiTAC and SYNNEX;
- changes in our business strategies;

personnel changes; and

general economic trends and other factors.

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Our sales cycle varies substantially 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 nine 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. We have shifted our business strategy to focus primarily on OEM customers, with whom sales cycles are generally lengthier and less certain than direct sales to end-users, or sales through VARs.

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;
- 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 process; and
- meeting unique customer specifications and requirements.

Our net revenue is difficult for us to predict since it is directly affected by the timing of large orders, the closing of lengthy sales cycles and the launch of our products as part of our customers product lines. Due to the unpredictable timing of customer orders, we may ship products representing a significant portion of our net sales for a quarter during the last month of that quarter. We may also expect a customer to launch its sale of our products on a certain date, but later learn that the customer has delayed the launch of the product. 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 requirement of a few of our larger OEM customers to locate finished goods inventory in their hubs could result in a reduction in working capital and cash*.**

A few of our larger customers deploy Vendor Managed Inventory or VMI hubs, whereby vendors including Dot Hill are required to provide for up to several weeks of finished goods inventory. This inventory is typically located at hubs close to our customer s final assembly facilities. As our business grows with these customers, we expect inventory levels at these hubs to grow thus increasing inventory obsolescence risk and reducing cash.

Our business and operating results may suffer if we encounter significant product defects due to the introduction of our new storage systems.

Our new integrated storage systems, as well as our legacy products, may contain undetected errors or failures, which may be discovered after shipment, resulting in a loss of revenue or a loss or delay in market acceptance, which could harm our business. 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 or a substantial decrease in 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. Significant warranty costs, particularly those that exceed reserves, could adversely impact our business. In addition, defects in our products could result in our customers claiming property damages, consequential damages, or personal injury, which could also result in our loss of customers and goodwill. 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.

The loss of one or more suppliers could slow or interrupt the production and sales of our products.

Our third party manufacturers rely on other third parties to supply key components of our storage products. Many of these components are available only from limited sources in the quantities and quality we require. From time to time there is significant market demand for disk drives, RAID controllers, 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 controllers become available, incorporating substitute components into our products could delay our ability to deliver our products in a timely manner. For example, 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.

Manufacturing and supplier disruptions could harm our business.

We rely on third parties to manufacture substantially all of our products. If our agreements with Solectron, 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. In addition, Flextronics International Ltd., or Flextronics, recently announced that it has entered into a definitive agreement to acquire Solectron, and the acquisition is expected to close by the end of calendar year 2007. In the event Flextronics successfully acquires Solectron, there is no assurance that the combined company will not terminate, or otherwise seek to modify the terms of, our agreement with Solectron, and any such termination or modification may also require us to establish and qualify alternative manufacturing for our products. Any such transition would also require a significant amount of our management s attention. Under our OEM agreements with Sun and NetApp, Sun and NetApp have the right to require that we use a third party to manufacture our products. Such an external manufacturer must meet the engineering, qualification and logistics requirements of both Sun and NetApp. If our agreements with Solectron, 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 that is cost competitive. Failure to identify a suitable alternative manufacturing partner could impact our customer relationships and our financial condition.

With 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 effect 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 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.

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.

Demand for disk drives and memory has at times surpassed supply, forcing drive and memory manufacturers, 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

or memory 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.

The market for storage systems is intensely competitive and our results of operations, pricing and business could be harmed if we fail to maintain or expand our market position.

The storage market is intensely competitive and is characterized by rapidly changing technology. We compete primarily against independent storage system suppliers, including EMC, Hitachi, Engenio and Xyratex, but also against server companies such as HP, IBM and Dell as well as smaller storage companies. 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 any 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. Consolidation among our competitors, suppliers and customers, or the establishment of cooperative relationships among them, 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. 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 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.

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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, 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. 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.

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 licenses 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. In addition to the formal claims brought against us by Crossroads, 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.

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

We may have to take further measures to reduce expenses if revenue declines and we experience greater operating losses or do not achieve a stable net income. 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. As a result, if net revenue does not meet our projections, operating results may be negatively affected. We may experience shortfalls in net revenue for various reasons, including:

- significant pricing pressures that occur because of declines in selling prices over the life of a product or because of increased competition;

sudden shortages of raw materials or fabrication, test or assembly capacity constraints that lead our suppliers and manufacturers to allocate available supplies or capacity to our competitors, which, in turn, may harm our ability to meet our sales obligations;

the reduction, rescheduling or cancellation of customer orders; and

our inability to market products with competitive features, or the inability to market certain products in any form, due to the patents or other intellectual property rights of third parties.

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. 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.

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 Chief Financial Officer, Phil Davis, our Executive Vice President of Worldwide Field Operations, James Kuenzel, our Senior Vice President of Engineering, and Robert Finley, our Vice President of Manufacturing Operations. 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 is 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.

Our executive officers and directors and their affiliates own a significant percentage of our outstanding shares, which could prevent us from being acquired and adversely affect our stock price.

As of September 30, 2007, our executive officers, directors and their affiliates beneficially owned approximately 9.8% of our outstanding shares of common stock. These individuals may be able to influence matters requiring approval by our stockholders, including the election of a majority of our directors. The voting power of these stockholders under certain circumstances could have the effect of delaying or preventing a change in control of us. This concentration of ownership may also make it more difficult or expensive for us to obtain financing. Further, any substantial sale of shares by these individuals could depress the market price of our common stock and impair our ability to raise capital in the future through the sale of our equity securities.

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.

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, 2007 there were outstanding warrants to purchase 456,554 shares of our common stock. The warrants have exercise prices ranging from $3.25 to $4.50 per share and expire at various dates through March 14, 2008. When the exercise price of the warrants is less than the trading price of our common stock, exercise of the warrants would have a dilutive effect on our stockholders. The possibility of the issuance of shares of our common stock upon exercise of the warrants could cause the trading price of our common stock to decline.

Our stock price may be highly volatile and could decline substantially and unexpectedly, which has resulted in litigation and may result in additional claims filed against us in the future.

The trading price of our shares of common stock has been affected by the factors disclosed in this section as well as prevailing economic and financial trends and conditions in the public securities markets. Share prices of companies in technology-related industries, such as ours, tend to exhibit a high degree of volatility. The announcement of financial results that fall short of the results anticipated by the public markets could have an immediate and significant negative effect on the trading price of our shares in any given period. Such shortfalls may result from events that are beyond our immediate control, can be unpredictable and, since a significant proportion of our sales during each fiscal quarter tend to occur in the latter stages of the quarter, may not be discernible until the end of a financial reporting period. These factors may contribute to the volatility of the trading value of our shares regardless of our long-term prospects. The trading price of our shares may also be affected by developments, including reported financial results and fluctuations in trading prices of the shares of other publicly held companies, in our industry generally and our business segment in particular, which may not have any direct relationship with our business or prospects.

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. For example, 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 seek damages based on alleged 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. In addition, four complaints purporting to be derivative actions have been 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. Securities litigation could result in the expenditure of substantial funds, divert management s attention and resources, harm our reputation in the industry and the securities markets and reduce our profitability.

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

A substantial number of shares of our common stock may become available for resale. If 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.

Geopolitical military conditions, including terrorist attacks and other acts of war, may materially and adversely affect the markets on which our common stock trades, the markets in which we operate, our operations and our profitability.

Terrorist attacks and other acts of war, and any response to them, may lead to armed hostilities and such developments would likely cause instability in financial markets. Armed hostilities and terrorism may directly impact our facilities, personnel and operations that are located in the United States and internationally, as well as those of our OEM customers, suppliers, third party manufacturer and customers. Furthermore, severe terrorist attacks or acts of war may result in temporary halts of commercial activity in the affected regions, and may result in reduced demand for our products. These developments could have a material adverse effect on our business and the trading price of our common stock.

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Compliance with Sarbanes-Oxley Act of 2002.

We are exposed to significant costs and risks associated with complying with increasingly stringent and complex regulations of corporate governance and disclosure standards. Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ Stock Market rules require growing expenditure of management time and external resources. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management s annual review and evaluation of our internal controls, and attestations of the effectiveness of our internal controls by our independent registered public accounting firm. This process has required us to hire additional personnel and outside advisory services and has resulted in significant accounting, audit and legal expenses. We expect to continue to incur significant expense in future periods to comply with regulations pertaining to corporate governance as described above. In addition, we have recently implemented an ERP system, which was an extremely complicated, time consuming and expensive process.

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	Bylaws of Dot Hill Systems Corp. (1)
4.1	Certificate of Incorporation of Dot Hill Systems Corp. (1)
4.2	Bylaws of Dot Hill Systems Corp. (1)
4.3	Form of Common Stock Certificate. (2)
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. (3)
4.5	Form of Rights Certificate. (3)
10.1	Revolving Line of Credit Note dated July 1, 2007 issued by Dot Hill Systems Corp. to Wells Fargo Bank, National Association.
31.1	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on

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 January 14, 2003 and incorporated herein by reference.

(3) 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.

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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 9, 2007

By: /s/ DANA W. KAMMERSGARD

Dana W. Kammersgard
Chief Executive Officer, President and Director
(Principal Executive Officer)

Date: November 9, 2007

By: /s/ HANIF I. JAMAL

Hanif I. Jamal
Chief Financial Officer, and Treasurer
(Principal Financial and Accounting Officer)