DOT HILL SYSTEMS CORP
Form 10-Q
May 10, 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 March 31, 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 45,582,865 shares of common stock, $0.001 par value, outstanding as of May 4, 2007.

DOT HILL SYSTEMS CORP.
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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	March 31, 2007
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 99,663	$ 95,913
Accounts receivable, net of allowance of $629 and $541	39,758	37,632
Inventories	2,210	2,420
Prepaid expenses and other	5,039	3,969
Total current assets	146,670	139,934
Property and equipment, net	9,738	9,559
Goodwill	40,725	40,725
Other intangible assets, net	4,382	3,797
Deferred tax assets		17
Other assets	136	159
Total assets	$ 201,651	$ 194,191
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 31,099	$ 31,348
Accrued compensation	3,231	3,273
Accrued expenses	8,652	6,414
Deferred revenue	521	599
Income taxes payable	226	363
Total current liabilities	43,729	41,997
Other long-term liabilities	2,010	2,478
Total liabilities	45,739	44,475
Commitments and Contingencies (Note 10)		
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 45,236 shares issued and outstanding at December 31, 2006 and March 31, 2007, respectively	45	45
Additional paid-in capital	290,705	291,532
Accumulated other comprehensive loss	(814)	(1,418)
Accumulated deficit	(134,024)	(140,443)

Total stockholders equity		155,912		149,716
Total liabilities and stockholders equity	$	201,651	$	194,191

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 March 31,	
	2006	**2007**
NET REVENUE	$ 58,686	$ 53,441
COST OF GOODS SOLD	47,525	46,767
GROSS PROFIT	11,161	6,674
OPERATING EXPENSES:		
Sales and marketing	4,153	3,908
Research and development	9,712	6,074
General and administrative	6,153	3,670
Total operating expenses	20,018	13,652
OPERATING LOSS	(8,857)	(6,978)
OTHER INCOME:		
Interest income, net	1,312	1,308
LOSS BEFORE INCOME TAXES	(7,545)	(5,670)
INCOME TAX EXPENSE (BENEFIT)	(2,570)	292
NET LOSS	$ (4,975)	$ (5,962)
NET LOSS PER SHARE:		
Basic	$ (0.11)	$ (0.13)
Diluted	$ (0.11)	$ (0.13)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:		
Basic	44,518	45,157
Diluted	44,518	45,157
COMPREHENSIVE LOSS:		
Net loss	$ (4,975)	$ (5,962)
Foreign currency translation adjustments	(40)	(604)
Net unrealized gain on short-term investments	26	
Comprehensive loss	$ (4,989)	$ (6,566)

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)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007
Cash Flows From Operating Activities:		
Net loss	$ (4,975)	$ (5,962)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,659	1,775
Loss on disposal of property and equipment	19	
Provision for doubtful accounts	15	
Stock-based compensation expense	1,228	225
Deferred taxes	(2,570)	
Changes in operating assets and liabilities:		
Accounts receivable	(10,240)	2,109
Inventories	(89)	(195)
Prepaid expenses and other assets	(597)	1,042
Accounts payable	7,487	(417)
Accrued compensation and expenses	844	(2,250)
Deferred revenue	(886)	28
Income taxes payable	(33)	158
Restructuring accrual	(34)	
Other long-term liabilities	1,356	16
Net cash used in operating activities	(6,816)	(3,471)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(1,642)	(945)
Sales and maturities of short-term investments	7,775	
Purchases of short-term investments	(8,853)	
Net cash used in investing activities	(2,720)	(945)
Cash Flows From Financing Activities:		
Proceeds from sale of stock to employees	603	508
Proceeds from exercise of stock options and warrants	351	94
Net cash provided by financing activities	954	602
Effect of Exchange Rate Changes on Cash	(3)	64
Net Decrease in Cash and Cash Equivalents	(8,585)	(3,750)
Cash and Cash Equivalents, beginning of period	108,803	99,663
Cash and Cash Equivalents, end of period	$ 100,218	$ 95,913

Supplemental Disclosures of Cash Flow Information:				
Construction in progress costs incurred but not paid	$	1,227	$	481
Cash paid for interest	$		$	
Cash paid for income taxes	$	19	$	125

See accompanying notes to condensed consolidated financial statements.

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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 months ended March 31, 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. 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.

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 companies 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 months ended March 31, 2006 and 2007.

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As of March 31, 2007, total unrecognized share-based compensation cost related to unvested stock options was $7.6 million, which is expected to be recognized over a weighted average period of approximately 2.9 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 statement of operations for the three months ended March 31, 2006 and 2007, (amounts in thousands):

	Three Months Ended March 31,	
	2006	2007
Cost of goods sold	$ 51	$ 103
Sales and marketing	87	105
Research and development	180	193
General and administrative	910	(176)
Share-based compensation expense before taxes	1,228	225
Related deferred income tax benefits	(183)	
Share-based compensation expense, net of income taxes	$ 1,045	$ 225
Net share-based compensation expense per basic and diluted common share	$ 0.02	$

Share-based compensation expense recognized under SFAS No. 123(R) for the quarter ended March 31, 2007 included $0.1 million from stock options and $0.1 million from the 2000 ESPP. Share-based compensation expense recognized during the three months ended March 31, 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 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 March 31, 2007 has been adjusted for estimated forfeitures.

To estimate compensation expense that was recognized under SFAS No. 123(R) for the three months ended March 31, 2006 and 2007, we use the Black-Scholes option-pricing model with the following weighted-average assumptions for equity awards granted:

	2000 EIP and 2000 NEDSOP Three Months Ended March 31,		2000 ESPP Three Months Ended March 31,	
	2006	2007	2006	2007
Risk-free interest rate	4.81%	4.46%	4.47%	5.16%
Expected dividend yield	%	%	%	%
Volatility	68%	68%	68%	68%
Expected life	5.6 years	5.4 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.

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 March 31, 2007, options to purchase 5,798,870 shares of common stock were outstanding under the 2000 EIP and the options to purchase 385,300 shares of common stock remained available for grant under the 2000 EIP.

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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 March 31, 2007, options to purchase 440,000 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 473,124 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 121,341 and 191,594 shares issued for the 2000 ESPP periods that ended in the three months ended March 31, 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	980,696	3.57		
Exercised	(35,423)	2.66		
Forfeited	(60,832)	4.35		
Expired	(79,498)	8.76		
Outstanding at March 31, 2007	6,240,873	$ 5.72	7.36	$ 1,303
Vested and expected to vest at March 31, 2007	5,646,457	$ 5.87	7.16	$ 1,250
Exercisable at March 31, 2007	3,417,881	$ 6.79	5.84	$ 1,070

As of March 31, 2006, approximately 3,520,948 options were exercisable at a weighted average exercise price of $6.82.

The weighted average grant-date fair values of options granted during the three months ended March 31, 2006 and 2007 were $4.32 per share and $2.21 per share, respectively. The total intrinsic value of options exercised during each of the three months ended March 31, 2006 and 2007 was approximately $0.1 million.

During the three months ended March 31, 2007, financing cash generated from share-based compensation arrangements amounted to $0.1 million for the purchase of shares upon exercise of options and $0.5 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.

Additional information regarding options outstanding for all plans as of March 31, 2007, is as follows:

	Options Outstanding			Options Exercisable	
	Number	Weighted Average Remaining Contractual	Weighted Average Exercise	Number	Weighted Average Exercise

Range of Exercise Prices	Outstanding	Life (yrs.)	Price	Exercisable	Price
$1.34 3.10	1,053,115	5.94	$ 2.54	813,115	$ 2.39
$3.15 3.57	1,144,195	9.03	3.54	168,499	3.39
$3.59 5.10	1,040,188	8.92	4.10	176,983	4.62
$5.20 6.25	1,160,779	6.60	5.97	895,361	5.94
$6.36 9.94	1,087,225	6.95	7.33	608,552	7.76
$9.98 17.14	755,371	6.44	13.00	755,371	13.00
Total	6,240,873	7.36	$ 5.72	3,417,881	$ 6.79

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The aggregate intrinsic value in the prior table is based on our closing stock price of $3.65 per share as of the last business day of the three months ended March 31, 2007, which amount would have been received by the optionees had all options been exercised on that date. The total fair value of options to purchase common stock that vested during the three months ended March 31, 2006 and 2007 was $1.6 million and $0.8 million, respectively.

3. Net Loss Per Share

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

Diluted net loss per share reflects the potential dilution by including common stock equivalents, such as stock options 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 March 31,	
	2006	**2007**
Shares used in computing basic net loss per share	44,518	45,157
Dilutive effect of warrants and common stock equivalents		
Shares used in computing diluted net loss per share	44,518	45,157

For the three months ended March 31, 2006, outstanding options to purchase 5,001,319 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,714,679 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 March 31, 2007, outstanding options to purchase 6,240,873 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.

4. 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	March 31, 2007
Purchased parts and materials	$ 612	$ 568
Finished goods	1,598	1,852
Total inventory	$ 2,210	$ 2,420

5. 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 remaining identified intangible assets are considered to have finite lives and are being amortized in accordance with this statement.

Intangible assets that are subject to amortization under SFAS No. 142 consist of the following as of March 31, 2007 (in thousands):

	Gross	Accumulated Amortization	Net

Core technology	$ 5,000	$ (3,426)	$ 1,574
Developed technology	2,600	(2,600)	
Customer relationships	2,500	(2,202)	298
Backlog	100	(100)	
Licensed Patent Portfolio	2,570	(645)	1,925
Total other intangible assets	$ 12,770	$ (8,973)	$ 3,797

As of March 31, 2007, the weighted average amortization period for the above intangibles is 2.6 years.

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Estimated future amortization expense related to other intangible assets as of March 31, 2007 is as follows (in thousands):

Years ending December 31,	
2007 (remaining 9 months)	1,517
2008	1,255
2009	514
2010	511
Total	$ 3,797

6. 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 months ended March 31, 2007 (in thousands):

	Three Months Ended March 31, 2007	
Balance, beginning of period	$	663
Charged to operations		1,044
Deductions for costs incurred		(674)
Balance, end of period	$	1,033

7. Income Taxes

We recorded an income tax benefit of $2.6 million and an income tax expense of $0.3 million for the three months ended March 31, 2006 and 2007, respectively. Our effective income tax rate was (5.1)% for the three months ended March 31, 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.

On January 1, 2007, we adopted Financial Accounting Standards Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48). 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 derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues.

We have cumulative unrecognized tax benefits of approximately $11.2 million as of January 1, 2007. The cumulative effects of adopting FIN 48 resulted in a decrease of $0.5 million to retained earnings 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 the Company also has approximately $10.6 million of unrecognized tax benefits that will have no impact on the effective tax rate due to the existence of a 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 months ended March 31, 2007 was not significant. During the three months ended March 31, 2007, we reduced our unrecognized tax benefit, and correspondingly reduced income tax expense by $0.1 million as a result of the expiration of a state tax statute of limitations. We do not reasonably estimate that the unrecognized tax benefit will change significantly within the next twelve months.

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 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.

As of December 31, 2006, we have 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 have 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 will begin to expire in the tax year ending 2007. We also have 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 will begin 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.

8. Accumulated Other Comprehensive Loss

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

	Foreign Currency Items
Balance, December 31, 2006	$ (814)
Quarterly change	(604)
Balance, March 31, 2007	$ (1,418)

9. Credit Facilities

Effective July 1, 2006, we amended our credit agreement 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, 2007. 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 March 31, 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.

10. 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.

Contingencies

Crossroads Systems Litigation

On October 17, 2003, Crossroads Systems, Inc., or Crossroads, filed a lawsuit against us 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 storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of Small Computer Systems Interface, or SCSI, storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004.

On June 28, 2006, we entered into a Settlement and License Agreement with Crossroads that settles 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 paid Crossroads an additional $7.15 million on our behalf, from which $1.43 million was withheld for Taiwan taxes and 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 United States Patents No. 5,941,972 and No. 6,425,035 and other patents in the patent family. 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 those that 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.

On July 24, 2006, Crossroads filed another lawsuit against us in the United States District Court for the Western District of Texas, and on July 25, 2006 Crossroads filed a Motion to Enforce in the aforementioned lawsuit. Both the new lawsuit and motion alleged that Dot Hill had breached the June 28, 2006 Settlement and License Agreement by deducting $1.43 million of the lump sum payment of $10.50 million as withholding against any potential Taiwan tax liability arising out of Dot Hill s indemnification by Infortrend, a Taiwan company. 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.

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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, and the final settlement approval hearing is set for June 18, 2007. We expect the case to be dismissed following final approval of settlement.

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 Consolidated Complaint on April 20, 2007. We expect to file our motion to dismiss on May 29, 2007 and expect it to be heard on August 20, 2007.

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 one 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. We have filed a Notice of Related case informing the Court that the latest case should be consolidated with the previously filed derivative actions. We have a motion to consolidate these matters currently set for July 13, 2007. The outcome of these actions is uncertain, and no amounts have been accrued as of March 31, 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.

11. Segments and Geographic 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.

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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:				
March 31, 2006:				
Net revenue	$57,146	$ 639	$ 901	$58,686
Gross profit	$10,598	$ 62	$ 501	$11,161
March 31, 2007:				
Net revenue	$51,948	$ 177	$1,316	$53,441
Gross profit	$ 6,195	$ 42	$ 437	$ 6,674

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
March 31, 2007	$188,550	$1,159	$4,482	$194,191

Information concerning principal geographic areas in which we operate is as follows (in thousands):

	Three Months Ended March 31,	
	2006	2007
Net revenue:		
United States	$ 55,019	$ 45,613
Europe	2,234	6,593
Asia	1,433	1,235
	$ 58,686	$ 53,441
Operating income (loss):		
United States	$ (8,724)	$ (3,671)
Europe	(135)	(3,402)
Asia	2	95
	$ (8,857)	$ (6,978)

	As of December 31, 2006	As of March 31, 2007
Assets:		
United States	$ 192,539	$ 180,610

Europe		6,358		11,243
Asia		2,754		2,338
	$	201,651	$	194,191

Net revenue is recorded in the geographic area in which the sale is originated.

12. 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 results of operations or financial condition.

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 its financial position and results of operations.

13. Subsequent Events

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, tentatively commencing in August 2007 and ending December 2012. 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 9 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 faculty located in Longmont, Colorado expires in accordance with the lease terms on July 31, 2007.

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 broad range of products, from medium capacity stand-alone storage units to complete multi-terabyte storage area networks, provides 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. In May 2002, we entered into a three-year OEM agreement with Sun Microsystems, or Sun, to provide our storage hardware and software products for private label sales by Sun, which was subsequently extended until January 2011. The OEM agreement now provides for automatic renewals for additional one-year periods, unless either party notifies the other of its intent not to renew within a specified time period. We have been shipping our products to Sun for resale to Sun s customers since October 2002 and continue to do so, having shipped over 129,000 units to date.

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.

In July 2005, we entered into a Development and OEM Supply Agreement with Network Appliance, Inc. and Network Appliance B.V., collectively, NetApp. Under the agreement, we are designing and developing general purpose disk arrays for a variety of products to be sold under private label by NetApp. The agreement does not contain any minimum purchase commitments by NetApp. The initial term of the agreement is three years after first general availability customer shipment and renews automatically for a subsequent 12 months unless terminated by either party. We expect to begin shipping products under this agreement over the next several months.

In January 2006, we entered into a Master Purchase Agreement with Fujitsu Siemens Computers GmbH and Fujitsu Siemens Computers (Holding) B.V., collectively, Fujitsu. Under the agreement, Dot Hill and Fujitsu are jointly developing storage solutions utilizing key components and patented technologies from Dot Hill. The agreement does not contain any minimum purchase commitments by Fujitsu. The initial agreement term is five years. We began shipping products under this agreement in July 2006.

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 allows 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 will supply Dot Hill with manufacturing, assembly and test services from its facilities in China, and SYNNEX will provide 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 facilitate our strategic product initiatives, help to expand our global capabilities and reduce our manufacturing costs. We expect to begin shipping products under the MiTAC and SYNNEX agreement over the next several months.

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 warranty and non-warranty services for customers who purchase new maintenance agreements for our prior generation SANnet product family as well as our new R/Evolution platform. Anacomp Inc., or Anacomp, our current service provider will manage our SANnet I support for non-warranty customer.

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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 and expenditures for legal and accounting services. Restructuring expenses consist primarily of employee severance, lease termination costs and other office closure expenses related to the consolidation of excess facilities.

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.

In August 1999, Box Hill Systems Corp. merged with Artecon, Inc. and we changed our name to Dot Hill Systems Corp. We reincorporated in Delaware in 2001. Our headquarters are located in Carlsbad, California, and we maintain 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. 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.

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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 perform periodic valuation assessments based on projected sales forecasts and analyzing upcoming changes in future configurations of our products and record inventory write-downs for excess and obsolete inventory. Although we strive to ensure the accuracy of our forecasts, we periodically are faced with uncertainties. The outcomes of these uncertainties are not within our control, and may not be known for prolonged periods of time. Any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventories and commitments, and consequently, on our operating results. If actual market conditions become less favorable than those forecasted, additional inventory write-downs might be required, adversely affecting operating results.

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 consolidated financial statements. We determine the fair value of our reporting units using the income approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. 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.

The income approach is dependent on a number of factors including estimates of future market growth and trends, forecasted revenue and costs, expected periods the assets will be utilized, appropriate discount rates and other variables. We base our fair value estimates on assumptions we believe to be reasonable, but which are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

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.

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.

As of March 31, 2007, total unrecognized share-based compensation cost related to unvested stock options was $7.6 million, which is expected to be recognized over a weighted average period of approximately 2.9 years.

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 10 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 March 31,	
	2006	**2007**
Net revenue:	100.0%	100.0%
Cost of goods sold	81.0	87.5
Gross profit	19.0	12.5
Operating expenses:		
Sales and marketing	7.1	7.3
Research and development	16.5	11.4
General and administrative	10.5	6.9
Total operating expenses	34.1	25.5
Operating loss	(15.1)	(13.1)
Other income, net	2.2	2.4
Income tax expense (benefit)	(4.4)	0.5
Net loss	(8.5)%	(11.2)%

(percentages may not aggregate due to rounding)

Three Months Ended March 31, 2007 Compared to Three Months Ended March 31, 2006

Net Revenue

Net revenue decreased $5.3 million, or 9.0%, to $53.4 million for the three months ended March 31, 2007 from $58.7 million for the three months ended March 31, 2006. The decrease in net revenue was primarily attributable to decreased orders for our products from our largest OEM customer, Sun, which accounted for 76.1% of our net revenue for the three months ended March 31, 2007, as compared to 87.7% of our revenue for the three months ended March 31, 2006. Fibre Channel units shipped were 2,217 for the three months ended March 31, 2007 compared to 2,284 units for the three months ended March 31, 2006. Small Computer Systems Interface, or SCSI, units shipped were 2,848 for the three months ended March 31, 2007 compared to 3,265 units for the three months ended March 31, 2006. Blade units shipped were 2,743 for the three months ended March 31, 2007 compared to 1,958 units for the three months ended March 31, 2006. SATA units shipped were 133 for the three months ended March 31, 2007 compared to 674 units for the three months ended March 31, 2006. We shipped 1,040 units of our 2730 product for the three months ended March 31, 2007 compared to none for the three months ended March 31, 2006. Non-Sun revenue was $12.8 million for the three months ended March 31, 2007 compared to $7.2 million for the three months ended March 31, 2006.

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Cost of Goods Sold

Cost of goods sold decreased $0.7 million, or 1.5%, to $46.8 million for the three months ended March 31, 2007 from $47.5 million for the three months ended March 31, 2006. As a percentage of net revenue, cost of goods sold increased to 87.5% for the three months ended March 31, 2007 from 81.0% for the three months ended March 31, 2006. The increase in cost of goods sold was attributable primarily to the composition of product sales during the three months ended March 31, 2007 compared to the three months ended March 31, 2006. The shift in product sales mix for the three months ended March 31, 2007 was due to the sale of the 2730 modular enterprise storage platform, a new product introduced during the third quarter of 2006, which is shipping at depressed margins until we migrate manufacturing to a hard tooled offshore environment. In addition to the shift in product sales mix, we incurred costs related to the anticipated transition of certain manufacturing services to MiTAC, a $0.5 million increase in warranty reserves related to the new 2730 modular enterprise storage platform, a $0.4 million increase in inventory reserves primarily associated with end of life products and $0.2 million of royalty payments related to the Crossroads Systems, Inc., or Crossroads, agreement entered into in June 2006.

Gross Profit

Gross profit decreased $4.5 million, or 40.2%, to $6.7 million for the three months ended March 31, 2007 from $11.2 million for the three months ended March 31, 2006. As a percentage of net revenue, gross profit decreased to 12.5% for the three months ended March 31, 2007 from 19.0% for the three months ended March 31, 2006. The decrease in the dollar amount of gross profit is attributable to lower total sales and sales of the 2730 product which is currently shipping at depressed margins until we migrate manufacturing to a hard tooled offshore environment. In addition, there were costs associated with the anticipated transition of certain manufacturing services to MiTAC, a $0.5 million increase in warranty reserves related to the new 2730 modular enterprise storage platform, a $0.4 million increase in inventory reserves primarily associated with end of life products and $0.2 million of royalty payments related to the Crossroads agreement entered into in June 2006.

The decrease in gross profit as a percentage of our net revenue for the three months ended March 31, 2007 when compared to the three months ended March 31, 2006 is attributed principally to a difference in our product mix.

Sales and Marketing Expenses

Sales and marketing expenses decreased $0.3 million, or 7.1%, to $3.9 million for the three months ended March 31, 2007 from $4.2 million for the three months ended March 31, 2006. As a percentage of net revenue, sales and marketing expenses increased to 7.3% for the three months ended March 31, 2007 from 7.1% for the three months ended March 31, 2006. The decrease in sales and marketing expenses is primarily attributable to a decrease in headcount at our subsidiaries in Japan and Europe. 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 $3.6 million, or 37.1%, to $6.1 million for the three months ended March 31, 2007 from $9.7 million for the three months ended March 31, 2006. As a percentage of net revenue, research and development expenses decreased to 11.4% for the three months ended March 31, 2007 from 16.5% for the three months ended March 31, 2006. The decrease in research and development expenses is primarily due to the reduced investment in prototypes and project materials for products under development for our new OEM customers of $3.1 million and a decrease of $0.4 million in testing expense. We expect research and development expenses for the year ending December 31, 2007 will 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 $2.5 million, or 40.3%, to $3.7 million for the three months ended March 31, 2007 from $6.2 million for the three months ended March 31, 2006. As a percentage of net revenue, general and administrative expenses decreased to 6.9% for the three months ended March 31, 2007 from 10.5% for the three months ended March 31, 2006. The decrease is primarily attributable to a $1.3 million expense associated with the acceleration of vesting of stock options of our former chief executive officer and his consulting agreement which occurred during the three months ended March 31, 2006, $0.4 million decrease in share-based compensation expense, $0.3 million decrease in pay related costs due to reduction in headcount at our subsidiary in Japan, and $0.2 million decrease in bad debt expense at our European subsidiary.

Income Taxes

We recorded an income tax expense of $0.3 million for the three months ended March 31, 2007 compared to an income tax benefit of $2.6 million for the three months ended March 31, 2006. Our effective income tax rate of (5.1)% for the three months ended March 31, 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. At March 31, 2006, we recorded a tax benefit of $2.6 million, reflecting an effective tax rate of 34.1%. Our effective tax rate for the three months ended March 31, 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).

As of December 31, 2006, we have 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 have 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 will begin to expire in the tax year ending 2007. We also have 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 will begin 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 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 IRC 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.

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 March 31, 2007, we had $95.9 million of cash and cash equivalents. We had $97.9 million of working capital as of March 31, 2007.

For the three months ended March 31, 2007, cash used in operating activities was $3.5 million compared to cash used in operating activities of $6.8 million for the three months ended March 31, 2006. The net cash used in operating activities is primarily attributable to the net loss of $6.0 million offset by depreciation and amortization of $1.8 million and share-based compensation expense of $0.2 million. Cash flow from operations reflects the positive impact of $2.1 million related to a decrease in accounts receivable due to the timing of cash receipts, a $1.0 million decrease in prepaid and other assets and a $0.2 million increase in income taxes payable. Cash provided from operations was negatively impacted by a $2.3 million decrease in accrued compensation and expenses, a $0.4 million reduction in accounts payable and a $0.2 million increase in inventory.

Cash used in investing activities for the three months ended March 31, 2007 was $1.0 million compared to $2.7 million for the same period in 2006. The cash used in the three months ended March 31, 2007 was attributable to purchases of property and equipment.

Cash provided by financing activities for the three months ended March 31, 2007 was $0.6 million compared to cash provided by financing activities of $1.0 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 $0.1 million, and the proceeds received from the sale of common stock to employees under our employee stock purchase plan of $0.5 million.

We presently expect cash, cash equivalents and cash generated from operations to be sufficient to meet our operating and capital requirements for at least the next 12 months and to enable us to pursue acquisitions or significant 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 revenues 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 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, tentatively 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 current research and development faculty located in Longmont, Colorado expires in accordance with the lease terms on July 31, 2007.

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 results of operations or financial condition.

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 its financial position 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 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 March 31, 2007. For investment securities, the table presents carrying values at December 31, 2006 and March 31, 2007 and, as applicable, related weighted average interest rates by expected maturity dates.

	December 31, 2006	**March 31, 2007**
	(amounts in thousands)	
Cash equivalents	$95,845	$ 88,750
Average interest rate	5.3%	5.3%

We have a line of credit agreement, which accrues interest at a variable rate. As of March 31, 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.

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 March 31, 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.

Part II. Other Information

Item 1. Legal Proceedings

Crossroads Systems Litigation

On October 17, 2003, Crossroads filed a lawsuit against us 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 storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of Small Computer Systems Interface, or SCSI, storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004.

On June 28, 2006, we entered into a Settlement and License Agreement with Crossroads that settles 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 paid Crossroads an additional $7.15 million on our behalf, from which $1.43 million was withheld for Taiwan taxes and 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 United States Patents No. 5,941,972 and No. 6,425,035 and other patents in the patent family. 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 those that 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.

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On July 24, 2006, Crossroads filed another lawsuit against us in the United States District Court for the Western District of Texas, and on July 25, 2006, Crossroads filed a Motion to Enforce in the aforementioned lawsuit. Both the new lawsuit and motion alleged that Dot Hill had breached the June 28, 2006 Settlement and License Agreement by deducting $1.43 million of the lump sum payment of $10.50 million as withholding against any potential Taiwan tax liability arising out of Dot Hill s indemnification by Infortrend, a Taiwan company. 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, and the final settlement approval hearing is set for June 18, 2007. We expect the case to be dismissed following final approval of settlement.

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 expect to file our motion to dismiss on May 29, 2007 and expect it to be heard on August 20, 2007.

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 one 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. We have filed a Notice of Related case informing the Court that the latest case should be consolidated with the previously filed derivative actions. We have a motion to consolidate these matters currently set for July 13, 2007. The outcome of these actions is uncertain, and no amounts have been accrued as of March 31, 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. Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. The risks described below are not the only ones we face. 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-K, including our financial statements and related notes.

We are dependent on sales to a relatively small number of customers.

Our business is highly dependent on a limited number of OEM customers. For example, sales to Sun accounted for 82% and 76% of our net revenue for the year ended December 31, 2006 and three months ended March 31, 2007, respectively. As a result, if our relationships with Sun, NetApp or Fujitsu were disrupted, we would lose substantially all of our anticipated net revenue and our business could be materially harmed. We cannot guarantee that our relationship with Sun, NetApp, Fujitsu or other OEM customers will expand or not otherwise be disrupted. Factors that could influence our relationship with significant OEM customers, including Sun, NetApp and Fujitsu include:

- our ability to maintain our products at prices that are competitive with those of other storage system suppliers;
- our ability to maintain quality levels for our products sufficient to meet the expectations of our OEM customers;
- our ability to produce, ship and deliver a sufficient quantity of our products in a timely manner to meet the needs of our OEM customers;
- our ability to continue to develop and launch new products that our OEM customers feel meet their needs and requirements, with respect to cost, timeliness, features, performance and other factors; and
- the ability of Sun, NetApp, Fujitsu 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 OEM customers, including Sun, NetApp and Fujitsu, contain any minimum purchasing commitments and our customers may cancel purchase orders at any time. Further, we do not expect that future contracts with OEM 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 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.

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

For the three months ended March 31, 2007, we incurred a net loss of $5.9 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 provider and continued investment in research and development. We may be able to mitigate these losses as we transition manufacturing of our 2730 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.

Our available cash and cash equivalents as of March 31, 2007 totaled $95.9 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;
- 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 2730 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 being able to 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. 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.

In addition, while we do not expect our new relationship with MiTAC and SYNNEX to 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.

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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 2730 product 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 customarily 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 of storage products supplied by us 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.

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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)

* 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.

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 issues;

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;

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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 OEM customers;

slowing sales of the products of our OEM 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.

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 six 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;

our engineering work necessary to integrate a storage solution with a customer s system;

the complexity of technical challenges that need to be overcome during the development process;

meeting unique customer specifications and requirements; and

difficulties by our customers in integrating our products and technologies into their own products.

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

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. 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.

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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. 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. In addition, consolidation among our competitors, suppliers and customers may harm our business by increasing the resources of our competitors, reducing the number of suppliers available to us for our product components and increasing competition for customers by reducing the number of customer-purchasing decisions.

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 settles 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.

Although we have taken a number of steps to reduce operating costs, 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 has continued and 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 March 31, 2007, our executive officers, directors and their affiliates beneficially owned approximately 9.4% 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.

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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 March 31, 2007 there were outstanding warrants to purchase 1,696,081 shares of our common stock. The warrants have exercise prices ranging from $2.97 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.

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.

In the past, securities class action litigation has often been 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 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. 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.

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	Manufacturing Agreement by and among Dot Hill Systems Corp., MiTAC International Corporation and SYNNEX Corporation dated February 20, 2007.*
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.

* Confidential treatment has been requested with respect to certain portions of this exhibit. Omitted portions have been filed separately with the SEC.

(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: May 10, 2007	By /s/ DANA W. KAMMERSGARD Dana W. Kammersgard *Chief Executive Officer, President and Director (Principal Executive Officer)*
Date: May 10, 2007	By /s/ HANIF I. JAMAL Hanif I. Jamal *Chief Financial Officer, and Treasurer (Principal Financial and Accounting Officer)*

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