

DOT HILL SYSTEMS CORP
Form 10-K
March 15, 2012
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the Fiscal Year Ended December 31, 2011

or

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

For the Transition Period From to

Commission file number 1-13317

DOT HILL SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

Delaware
(State of Incorporation)

13-3460176
(I.R.S. Employer Identification No.)

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

1351 S. Sunset Street,

Longmont, CO
(Address of principal executive offices)

80501
(Zip Code)

Registrant's telephone number, including area code:

(303) 845-3200

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common stock, \$0.001 par value	The Nasdaq Stock Market

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold as of June 30, 2011 was \$161,008,055.

The number of shares of the registrant's common stock outstanding as of February 29, 2012 was 57,866,406

Documents Incorporated by Reference

Portions of the registrant's definitive proxy statement for its 2012 annual meeting of stockholders are incorporated by reference into Part III of this Form 10-K.

Table of Contents

**DOT HILL SYSTEMS CORP.
INDEX TO ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2011**

		Page
PART I		
Item 1.	<u>Business</u>	3
Item 1A.	<u>Risk Factors</u>	20
Item 1B.	<u>Unresolved Staff Comments</u>	37
Item 2.	<u>Properties</u>	37
Item 3.	<u>Legal Proceedings</u>	38
Item 4.	<u>Mine Safety Disclosures</u>	38
PART II		
Item 5.	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	39
Item 6.	<u>Selected Financial Data</u>	41
Item 7.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	43
Item 7A.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	64
Item 8.	<u>Financial Statements and Supplementary Data</u>	65
Item 9.	<u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	65
Item 9A.	<u>Controls and Procedures</u>	65
Item 9B.	<u>Other Information</u>	68
PART III		
Item 10.	<u>Directors, Executive Officers and Corporate Governance</u>	68
Item 11.	<u>Executive Compensation</u>	68
Item 12.	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	68
Item 13.	<u>Certain Relationships and Related Transactions, and Director Independence</u>	69
Item 14.	<u>Principal Accounting Fees and Services</u>	69
PART IV		
Item 15.	<u>Exhibits, Financial Statement Schedules</u>	70

Table of Contents

Forward-Looking Statements

Certain statements contained in this annual report on Form 10-K, including, but not limited to, 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, or the Securities Act, 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. Future filings with the Securities and Exchange Commission, or SEC, future press releases and future oral or written statements made by us or with our approval, which are not statements of historical fact, may also contain forward-looking statements. Because such statements include 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 are set forth in the section entitled Risk Factors and in the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere throughout this annual report on Form 10-K.

Readers are cautioned not to place undue reliance on these forward-looking statements. The forward-looking statements speak only as of the date on which they are made, and, except as required by applicable law, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events.

In this annual report on Form 10-K, Dot Hill, Dot Hill Systems Corp., we, us and our refer to Dot Hill Systems Corporation, and our wholly owned subsidiaries on a consolidated basis, unless the context otherwise provides.

PART I

Item 1. Business

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

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

Table of Contents

AssuredSAN 3000 series of storage arrays that provide high speed interface options including 8 gigabyte, or GB, Fibre Channel, 1GB and 10GB iSCSI over Ethernet and 6GB SAS connectivity.

Our standalone storage software operating segment in 2010 and 2011 consisted of our AssuredUVS and AssuredVRA product lines.

Our AssuredUVS product line, formerly known as the intelligent storage networking system, or iSN TM, is based on the technology we acquired in January 2010 from Cloverleaf Communications, Inc., or Cloverleaf, a privately held software company focused on heterogeneous storage virtualization and unified storage technologies. Such technology was marketed as standalone host-based software, and also included an appliance product consisting of a standard off-the-shelf x86 server combined with the proprietary software that delivers the unified virtual storage feature set. Our storage arrays are also available bundled with this appliance. Sales of AssuredUVS products were not significant in 2011. On February 2, 2012 we decided to re-align our software strategy to focus on accelerating the development of software that will be embedded in our AssuredSAN product line to better enable us to launch a set of mid-range storage products in 2012, provide more differentiated entry level products over time and help position us to win new OEM and channel customers that may be looking for new or alternative suppliers resulting from industry consolidation. Since we do not expect to utilize the Cloverleaf based software in these mid-range product offerings, we have decided to discontinue our investment and development efforts in the Cloverleaf based products, and recently began to market the Cloverleaf asset to prospective acquirers and while there have been indications of interest, there is no assurance we will find a suitable buyer on a timely basis. We have determined that the ongoing cash investment in this operation could outweigh the potential consideration from the sale of this business, and thus, we plan to substantially close down our Israeli software development group by March 31, 2012. Consequently, we do not expect sales of AssuredUVS to be a significant percentage of our total net revenue in the future.

In September 2008, we acquired certain assets, namely RAIDCore from Ciprico Inc., or Ciprico. These products are marketed to OEM accounts as the AssuredVRA product line. This acquisition opened up new markets for us in the enterprise server and workstation markets for data protection internal to the servers and workstations. In particular, the RAIDCore acquisition allows us to broaden our product portfolio in the redundant array of independent disks, or RAID, market while allowing us to sell into the Band 1 market and to pursue opportunities at current and target OEM customers. We signed our first customer agreement relating to RAIDCore products in May 2009 and began selling to this customer during the third quarter of 2009. Sales of AssuredVRA products were not significant in 2010 and 2011. Although we expect sales of our AssuredVRA products to increase in 2012, we do not expect such sales to represent a significant percentage of our total net revenue in 2012.

We decided to expand our routes to market beyond our focus on original equipment manufacturers, or OEMs, and in October of 2009, we launched a Dot Hill channel program targeted at selling through distributors and resellers. We continued to expand our channel program through 2011 and believe this will provide Dot Hill with additional sales channels for all of our products. The majority of sales to our channel partners were represented by our AssuredSAN line of products in 2011. We expect sales to our channel partners of our AssuredSAN products will increase in 2012.

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

Our products and services are sold worldwide to facilitate server and SAN storage implementations, primarily through OEMs as private label products, and supplemented by Dot Hill branded products sold through

Table of Contents

distributors to resellers and in turn to end customers. Our storage system operating segment OEM partners currently include, among others, Hewlett-Packard, or HP, Sony Ericsson, or Ericsson, Motorola, Inc., or Motorola, General Dynamics Government Systems Corporation, or General Dynamics, Lockheed Martin Corporation, or Lockheed Martin, NEC Corporation, or NEC, Tektronix Inc., or Tektronix, Samsung Electronics, or Samsung, Stratus Technologies, or Stratus, Fujitsu Technology Solutions GmbH, or FTS, and Concurrent Computer Corporation, or Concurrent. Our standalone storage software operating segment OEM partners currently include, among others, Dell Inc., or Dell. Although our products and services are sold worldwide, the majority of our net revenue is derived from our U.S. operations. See Note 14 of the Notes to Consolidated Financial Statements for information regarding our operating segments and a breakout of our net revenue by geographical regions.

We began shipping products to HP in the fourth quarter of 2007. In January 2008, we amended our agreement with HP to allow for sales of additional products to additional divisions within HP. Our products are primarily sold as HP's MSA 2000/P2000 product family. Sales to HP increased significantly during 2008 and increased again in 2009 primarily as a result of the successful launch and market acceptance of the HP MSA 2000 products. HP launched its third generation product line, now called the P2000 product line, in February 2010. Sales to HP increased again in 2010 as we began selling our next generation host interfaces across the HP P2000 product line. The agreement with HP does not contain any minimum purchase commitments. In October 2011, we extended our supply agreement with HP by five years to expire in October 2016 and also extended the expiration of 1.6 million warrants originally granted to HP in March 2008 to expire concurrently with the supply agreement in October 2016 the extension resulted in a contra-revenue charge of approximately \$1.0 million. Net revenue from HP approximated 73% of our total net revenue in 2011. We expect sales to HP to continue to represent a substantial percentage of our total net revenue in 2012.

We previously designed and developed general purpose disk arrays for a variety of products that were sold under private label by NetApp, Inc., or NetApp. In the fourth quarter of 2010, we decided to exit our low margin business with NetApp and amended our agreement with NetApp to allow them to manufacture and sell on a royalty-free basis all of the products we previously manufactured and sold to them beginning on or about December 1, 2010. As a result, we did not generate any material revenue from NetApp in 2011 nor do we anticipate generating any additional revenue from NetApp in 2012.

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

our ability to maintain and enhance relationships with our customers, in particular our OEM customers, as well as our ability to win new business;

our ability to source critical components such as integrated circuits, hard disk drives, memory and other components on a timely basis;

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

our ability to launch new products in accordance with OEM schedules and milestones;

general economic and political conditions and specific conditions in the markets we address, including the continuing volatility in the technology sector, current general economic volatility and trends in the data storage markets in various geographic regions;

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

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

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

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

Table of Contents

Our manufacturing strategy includes outsourcing substantially all of our manufacturing to third-party manufacturers in order to reduce sales cycle times and manufacturing infrastructure, enhance working capital and improve margins by taking advantage of the third parties manufacturing and procurement economies of scale. In September 2008, we entered into a manufacturing agreement with Foxconn Technology Group, or Foxconn. Under the terms of the agreement, Foxconn supplies us with manufacturing, assembly and test services from its facilities in China and final integration services including final assembly, testing and configure-to-order services through its worldwide facilities. In November 2011 we amended our agreement with Foxconn to extend the manufacturing agreement for a period of three years. In addition, Foxconn agreed to waive the requirement for a letter of credit and improved our payment terms. Foxconn began manufacturing products for us in July 2009 and we began shipping products for general availability under the Foxconn agreement during the second half of 2009. The majority of our products sold in 2010 and 2011 were manufactured by Foxconn. We expect Foxconn to manufacture substantially all of our products in 2012.

We have also historically outsourced our manufacturing to Flextronics International Limited, or Flextronics, MiTAC International Corporation, or MiTAC, a leading provider of contract manufacturing and original design manufacturing services, and SYNnex Corporation, or SYNnex, a leading global information technology, or IT, supply chain services company. We do not expect to outsource much of our manufacturing to Flextronics, SYNnex or MiTAC in 2012.

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan included severance and related costs for the reduction of approximately 10% of our workforce, and fees associated with the acceleration of the closure of our Carlsbad, California facility. Substantially all of our 2010 Plan workforce reductions were completed by December 31, 2010 and we completely exited our Carlsbad facility as of June 30, 2010. The costs related to the 2010 Plan are \$0.7 million and have been entirely recorded in our financial statements as of and through December 31, 2011.

We were formed in 1999 by the combination of Box Hill Systems Corp., or Box Hill, and Artecon, Inc., or Artecon. We reincorporated in Delaware in 2001. Our website address is <http://www.dothill.com>. Information contained on our website does not constitute a part of this annual report on Form 10-K. Our annual reports on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K and all amendments to those reports that we file with the SEC are currently available free of charge to the general public through our website promptly after being filed with the SEC and are also accessible through the SEC's website which may be found at <http://www.sec.gov>. In addition, you may read and copy the materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330.

Industry Background

Growth of Data Storage

The efficient generation, storage, management and retrieval of digital data and content has become increasingly strategic and mission-critical to organizations. In essence, we believe storage is becoming a non-discretionary purchase. The volume of this data continues to grow rapidly, driven by several factors, including, among others:

the proliferation of different types of data, especially unstructured data such as digital graphics, video, text and audio;

the emergence of Internet-based communication protocols which enable users to rapidly duplicate, change and re-communicate data;

new regulations and corporate policies requiring additional storage requirements imposed on healthcare companies and evolving regulatory requirements for financial services companies;

the implementation of enterprise-wide databases containing business management information;

Table of Contents

gains in network bandwidth and the technology for managing and classifying large volumes of data;

the development of the information lifecycle management and the growing use of RAID systems in the backup market in place of, or in addition to, automated tape libraries, due to new applications of technologies that offer improved alternatives in the trade-off between performance and cost of ownership; and

the emergence of cloud based computing and storage as well as the growth of unstructured data analysis.

While research of worldwide external disk storage systems shipped is not yet completely available, the industry continued to report an overall capacity growth in 2011 despite economic conditions. A further trend that is expected to benefit us is faster growth in entry-level storage and mid-range storage markets as IT budgets are adjusted downwards. We expect this trend to continue into 2012 and potentially beyond as entry-level and mid-range storage starts to offer an increasing number of traditional enterprise level features.

The data storage industry has experienced significant consolidation through mergers and acquisitions over the past several years. Numerous smaller independent storage companies have been acquired by larger storage and server companies. Companies such as EqualLogic, Inc., LeftHand Networks, Inc., 3PAR, Inc., Compellent Technologies, Inc., Greenplum, Inc., Pillar Data Systems, Inc., BlueArc Corporation, Isilon Systems, Inc., XIV, Exanet Limited and LSI Corporation's Engenio Division, have all been absorbed by larger entities. These transactions have altered the competitive landscape in the data storage industry which has resulted in new business opportunities for us with both our reseller and OEM customers.

Traditionally, storage vendors have designed products for markets differentiated by capacity, performance, price and feature set. These storage markets are typically identified as:

Entry-level. Entry-level storage products are designed for lower capacity, standalone data storage needs. OEMs and server companies address this market primarily through an indirect sales channel approach employing distributors, retailers and VARs that assist IT managers in identifying, purchasing and installing the product.

Mid-range. Mid-range or departmental/workgroup storage products are designed for higher capacity and performance than entry-level products, but still feature ease of use and manageability, and are attached to a local server or a network of servers tailored to the needs of the local users. In this market, storage providers, OEMs and server companies primarily sell their products to local IT managers either direct or through distributors, VARs and regional SIs.

High-end. High-end or data center storage products are designed for use by larger organizations where data storage and management is critical. These organizations require large capacity storage systems that feature high-performance, automation, extreme reliability, continuous availability, operating systems interoperability and global service and support. In this market, storage providers, OEMs and server companies sell their products with a combination of a direct sales force and indirect channels, including OEMs, large SIs, VARs and managed services providers.

Historically, we have primarily competed for customers for entry-level storage products. In more recent years we have increased our investments in embedded software and other technologies, and we expect to launch mid-range products in 2012.

Industry Trends and Customer Needs

Migration to Networked, Clustered Computing and Unified Storage

Computing processes and architectures have evolved from mainframe computing systems toward a centrally managed network computing environment characterized by multiple operating systems and server platforms that

Table of Contents

must share information both locally and remotely. In addition, virtual server environments enabled by vendors such as VMware and Microsoft's Hyper-V have led to a marked increase in the trend toward Unified Storage solutions that offer both NAS and SAN attach capabilities in a single storage solution. Organizations require large-scale data storage solutions offering, among other things:

increased connectivity capabilities;

greater capacity;

higher performance;

the ability to share data among different platforms;

greater reliability;

high availability; and

greater protection.

Organizations have responded by implementing tailored networks, optimized for data storage functions that facilitate data access and protection.

Increasing Storage Resources in the Cloud

Storage within the cloud involves large centralized data centers that offer storage resources often combined with compute and network resources, which are priced to customers based on resource levels utilized. There are multiple deployment models such as private clouds, public clouds and hybrid clouds, some of which will utilize entry-level and mid-range networked storage resources and will require the same attributes as traditional storage area networks.

Big Data

Organizations today are facing increasing challenges to manage the growing stores of data. Much of this is driven by a rapid transition to rich media types of unstructured data that includes images, video and other multi-media content. To store, analyze and retrieve this digital content, large and complex database systems are needed to manage this real-time interrelated content. Genomics and oil exploration are examples where data sets are so large that they are difficult to store, manage and analyze. Customers are increasingly evaluating storage systems that deploy storage virtualization and data tiering to deal with the massive size of data, the speed at which it changes and the differing types of data being stored.

Increasing Focus on Total Cost of Ownership and Return on Investment

IT managers are increasingly focused on lowering the total cost of ownership and increasing their return on investment on each technology purchase. IT managers evaluate total cost of ownership and return on investment based upon several metrics, including initial purchase price, ease of provisioning, scalability, reliability and redundancy, ease of management, IT staff productivity, operating costs and after-sale service and support.

Unified Virtual Storage Systems

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

The need for unified virtual storage systems within IT departments in the SMB market segment is creating a new opportunity for storage solutions. Unified storage systems are defined as those that manage both block and file (or SAN and NAS) storage volumes, often with the ability to support multiple protocols, sometimes across multiple brands of storage arrays and manage them through a common interface. Virtual storage systems are those that deliver virtual storage functionality including volume management, thin and tiered provisioning, snapshots, replications and other features that are independent of the underlying hardware in an array with the

Table of Contents

ability to scale out across multiple nodes for higher performance and larger capacity, and manage these features from a single interface tool. We believe there are emerging opportunities for storage systems that offer both unified and virtual features in the same system.

Storage Area Networks

End-users require storage systems that enable them to capture, protect, manage and archive data across a variety of storage platforms and applications without sacrificing performance or reliability. Historically, SCSI was the primary method of connecting storage to servers based on a direct attached storage, or DAS, model. SAS has been adopted to replace parallel SCSI. Subsequently, the Fibre Channel protocol was developed which enables storage devices to connect to servers over a networked architecture, allowing end-users to connect multiple storage devices with high bandwidth throughput over long distances and centrally manage their storage environment. More recently, the iSCSI protocol has emerged in entry-level and mid-range systems for storage connected via standard local area networks, or LANs, and wide area networks, or WANs, and leverages the significant investments and existing deployments of Ethernet technology. Centrally managed network storage systems are designed to provide connectivity across multiple operating systems and devices and may be based on either open or proprietary technology standards.

SANs, whether Fibre Channel or iSCSI based, apply the benefits of a networked approach to data storage applications, allowing large blocks of data to move efficiently and reliably between multiple storage devices and servers without interrupting normal network traffic. SANs provide high scalability, connectivity and fault-tolerance, which permit IT managers to create and manage centralized pools of storage and backup devices with redundant data paths. With the addition of file-sharing software, SANs also allow multiple hosts to share consolidated data, dramatically reducing the need to duplicate, move and manage multiple files in a wide variety of data-intensive applications. SANs primarily employ Fibre Channel technology, although more recently iSCSI is increasingly being employed to provide storage access over Internet Protocol, or IP SANs.

Direct Attached Storage

A significant portion of storage systems that do not require the benefits of a scalable networked storage infrastructure are based on a DAS architecture attached directly to a server. Such storage is typically used to create a large data storage attached to a single server that is then shared or accessed over a general purpose LAN as opposed to a dedicated storage network. Newer clustered file systems, for example, are often based on large arrays of networked servers that each have a local set of disks, or a RAID disk set, as their local data storage. These local DAS RAID arrays can range from several disks housed inside the server and controlled by software RAID or a local RAID controller adapter installed inside the server, up to larger RAID arrays connected to the server via a local high speed dedicated storage link. RAID arrays inside the servers can require a dedicated RAID host bus adapter that interfaces multiple disk drives to the host computer bus to provide a high-performance disk array with RAID level data protection. More recent server implementations are commonly replacing the dedicated RAID host bus adapter with a lower cost built-in disk input/output, or I/O, controller function built into the server motherboard, and implementing the RAID software on the host server operating system. This same RAID controller or software is also capable of connecting to external JBOD or SAS RAID arrays via an external SAS cable to provide extremely cost-effective, local storage for servers. We intend to serve this market with our acquired RAIDCore product, known as AssuredVRA.

Demand for High-performance, Affordable Network Storage Solutions

Customers increasingly demand higher performing, affordable solutions to address expanding storage requirements, interoperability across disparate systems, the need for improved connectivity and rising data management costs. Customers are also demanding open standards architecture and modular systems that allow them to add capacity as needed. These demands have created significant opportunities for network storage system solutions that are affordable and provide high performance. In general, features that were historically only available in high-end storage systems are increasingly required in entry-level and mid-range systems.

Table of Contents

High Availability

One of the most important requirements for many customers is that their stored data are available, and that the systems upon which they are stored be reliable. For example, Internet-related customers can lose significant revenue for every minute their sites are inoperable and users cannot access data from the website. Similarly, the operations of corporate customers can grind to a halt if important data is lost or unavailable. For these reasons, a storage system's reliability is often a very critical factor in making a choice among storage systems.

Hardware Based Storage Solutions

We offer a flexible, broad line of networked data storage solutions composed of standards-based hardware and embedded software for open systems environments including SAS, Fibre Channel and iSCSI storage markets. We incorporate many of the performance attributes and other features demanded by high-end/data center end-users into our products, at prices that are suitable for the entry-level or mid-range markets. Our end-users consist of entry-level and mid-range users, requiring cost-effective, easily managed, high-performance, reliable storage systems. Our AssuredSAN product lines range from a few TB to hundreds of TB storage systems. These offerings allow our products to be integrated in a modular building block fashion or configured into a complete storage solution, increasing OEM flexibility in creating differentiated products. Modular products also allow our OEM partners to customize solutions, bundling our products with value-added hardware, software and services.

These products and services are intended to provide users with the following benefits:

Low Total Cost of Ownership and High Return on Investment. Our products combine reliability, flexibility, scalability and manageability into one of the smallest form factors in today's market. Our product set provides end-users with a low total cost of ownership due to our products' high reliability, the simplicity of our plug-and-play technology, decreased service and support costs and modular system approach that allow end-users to add capacity as needed. The modular nature of our products addresses our end-users' desire for a storage solution that does not require a large, upfront investment in a monolithic structure with unused capacity. In addition, we believe that our AssuredSAN storage systems are among the most space-efficient in the storage industry, maximizing the utilization of our customers' limited space and significantly reducing their costs. By extending and leveraging our customers' installed storage system and architecture, we are able to provide solutions that offer both a lower total cost of ownership and a higher return on investment.

Modular Scalability. Our products are designed using a single cohesive modular architecture that allows customers to size and configure storage systems to meet their specific requirements or storage network type. This modular architecture also allows customers to easily expand and, in some cases, reconfigure a system as their needs change, permitting them to extend the useful life of, and better utilize, their existing systems.

High Availability. We believe that high availability is essential to our customers due to the critical nature of the data being stored. We have demonstrated 99.999% uptime in our product lines and integrate the latest in technological advances to meet expanding market opportunities. We design redundancy, high reliability, high performance and ruggedness into our storage systems. Redundant components have the ability to be replaced while the system is online without interrupting network activity. All of our AssuredSAN 5000 Series products currently offered are certified to operate under extreme climatic and other harsh operating conditions without degradation in reliability or performance, as attested to with the NEBS, Level 3 and MIL-STD-810F certifications. Our AssuredSAN product family is targeted at the general purpose market without compromising our high reliability standards.

High-end performance attributes and features. Our AssuredSAN products are enclosed in a compact two unit high chassis which accommodates up to 12 3.5" disk drives or 24 2.5" disk drives in the array.

Table of Contents

Arrays can be configured from 876 GB for entry-level Series 2000 products to 192 TB for the Series 3000 products. Customers can intermix SAS and SATA II drives in the same enclosure offering a multitude of configuration options that provide greater flexibility to end-users that wish to store different performance profiles of data in the same physical array. Additionally, our AssuredSAN products currently feature the industry's only unified product architecture which utilizes a common RAID controller architecture from the entry-level to the mid-range, regardless of protocol.

Open Systems, Multi-Platform Support. As an independent provider of storage products, we are well positioned to provide storage solutions on a variety of platforms and operating systems, including Linux, HP-UX, Solaris and Windows. Our product lines support access to data by multiple servers using different operating systems simultaneously. This multi-platform compatibility allows customers to standardize on a single storage system that can readily be reconfigured and redeployed at minimal cost as the customer's storage architecture changes.

Manageability. The ability to manage storage systems, particularly through software, is a key differentiator among storage vendors. RAIDar (TM), our storage management software for AssuredSAN products, enables customers to more easily manage and configure their storage systems and respond to their changing system requirements.

Data Management Software. We introduced our data management services, or DMS, in 2007 in conjunction with the launch of our AssuredSAN product family. AssuredSnap (TM) enables point in time snapshots of data for usage in real-time backups, data mining and disaster avoidance. AssuredCopy (TM) enables users to create a clone copy of data at any point in time and AssuredRemote (TM) enables remote replication between arrays. We expect to continue to expand our portfolio of DMS available for our AssuredSAN based products.

Standalone Storage Software

Through our acquisition of Ciprico's RAIDCore assets in September 2008, we offer a high-performance, feature-rich, host-based RAID stack that can be included as a key ingredient of an entry-level or mid-level enterprise class server built by OEMs or SIs. This product line, called AssuredVRA, provides a cost-effective solution for standard Windows and Linux servers that utilizes existing built-in SATA or SAS I/O capabilities of motherboards or simple storage I/O adapters to replace expensive dedicated hardware RAID adapter solutions. Currently, we have one major customer for RAIDCore and revenue has not been significant in any period.

Our Strategy

Our primary objective is to return to, sustain and grow profitability through our core business of selling entry and mid-level storage arrays through OEMs and more recently through channel based resellers. We plan to expand our core product platform to include mid-range systems with embedded software features. Our first mid-range products are expected to launch later this year and while it is unlikely that revenue from these products could be significant in 2012, it could become meaningful in 2013 and beyond. In addition, we will strive to create greater economies of scale and operating leverage in our entry level OEM storage array business, by focusing on new customer opportunities that may arise as a result of industry consolidation.

More specifically our strategy for the storage array business includes the following:

Utilize indirect sales channels. We have adopted an indirect sales model to access end-user markets primarily through our OEM, integrator and reseller partners. This allows us to benefit from our channel partners' extensive direct and indirect distribution networks, installed customer bases and greater sales, marketing and global service and support infrastructures. The costs associated with a direct worldwide sales force are extensive. By leveraging the sales networks of our partners, we can manage our sales and marketing costs to much lower levels. In addition, we encourage our partners to provide direct support and service to end-users.

Table of Contents

Focus on existing customers and develop new customer relationships. We have entered into OEM agreements with, HP, Ericsson, Dell, Motorola, General Dynamics, Lockheed Martin, Tektronix, Samsung, NEC, Stratus, FTS and Concurrent. We intend to focus on expanding our relationships with our existing customers and to continue seeking additional OEM relationships with other industry leaders to sell current products and expand the number of products offered to these customers to enable them to address new markets.

Grow and extend technology leadership. We view our core competencies as the research, design and engineering of modular open storage systems and data protection for enterprise servers. We believe that focused research and development on advanced, cost effective storage technologies is critical to our ongoing success. We intend to continue to develop and integrate high-end features into our products in order to offer more complete storage solutions and enhance our existing products to benefit our channel partners efforts to increase sales.

Leverage our AssuredSAN architecture. We developed our AssuredSAN architecture as a foundational element of our AssuredSAN modular storage arrays. This modular architecture allows us to quickly develop and bring to market new products based on this foundation. We intend to focus and unify our development efforts on this approach, which we believe offers a competitive time to market advantage to us. In particular, we intend to utilize our AssuredSAN products to continually extend the feature sets of both our entry-level and mid-range solutions and build a comprehensive set of software-based features that offer our customers increased levels of value and differentiation.

Quickly adopt new standards. We strive to introduce products that are first to market. For example, in February 2010 we introduced AssuredSAN 3000, the first entry-level storage array with 8Gb Fibre Channel and Fibre Channel / iSCSI interfaces, and continued with 6Gb SAS, 10Gb iSCSI and four port 1Gb iSCSI interface options throughout 2010. We believe our highly modular architecture is a proven platform with flexibility to continue to be first in the industry in many categories. In 2011, we launched the AssuredSAN 3003 series which substantially increased both streaming and random performance. In November 2010, we launched the Dot Hill branded AssuredUVS which is a unified virtual storage solution now selling through reseller channels. In addition, our RAIDCore enterprise RAID stack for Windows and Linux servers allow us to quickly adopt and migrate to next generation Intel and AMD class server architectures due to its highly modular architecture and approach.

Pursue strategic alliances, partnerships and acquisitions. We plan to continue to evaluate and selectively pursue strategic acquisitions, alliances and partnerships and other strategic alternatives that are complementary to our business. We believe that growth of the network storage market will create additional opportunities to expand our business. In some cases, we believe the most efficient pursuit of these opportunities may be through partnerships and relationships that allow us to leverage our existing products, core competencies and channels while capitalizing on products, technologies and channels that may be available through potential strategic partners.

Our Products

We design our family of open systems storage hardware and software products with the reliability, flexibility and performance necessary to meet IT managers' needs for easily scalable cost-effective solutions. We currently offer storage systems in Fibre Channel, iSCSI, and SAS host interfaces which include SSD, SAS and SATA drive technologies. We also offer enterprise class RAID software for industry standard Windows and Linux servers, as well as storage management applications, which can manage any one or all of our storage system configurations. In addition, performance-enhancing and DMS software is sold bundled with our storage systems or licensed separately to OEM customers, including AssuredSnap, AssuredCopy, AssuredRemote and RAIDar.

AssuredSAN. Our current product family based on our AssuredSAN architecture provides high-performance and large disk array capacities for a broad variety of environments. Our current mainstream 2000 and 3000 series

Table of Contents

of entry-level storage products and JBOD arrays are targeted primarily at mainstream enterprise and SMB applications. Our AssuredSAN 5000 Series products have been distinguished by certification as NEBS Level 3 and meets carrier class standards for telecommunications equipment, including storage products. There are three levels of NEBS specifications. The most rugged and reliable equipment is rated carrier-class NEBS Level 3. The NEBS standards mandate a battery of tests designed to simulate the extreme conditions resulting from natural or man-made disasters and cover a range of product requirements for operational continuity. Our AssuredSAN 5000 Series products are also MIL-STD-810F compliant. MIL-STD-810F is a military standard created by the United States Government. It involves a range of tests used to measure the reliability of equipment in extreme conditions, including physical impact, moisture, vibration and high and low temperatures. These standards address system ruggedness and reliability, which are important requirements for end-users, particularly those in these telecommunications and government sectors.

We also offer *AssuredSAN Modular Storage Architecture* products focused on the incorporation of SAS/SATA drive technology with a variety of front-end host interfaces. These products are focused on the general purpose market initially and introduce several technological advancements including EcoStor (elimination of batteries in a RAID cache management system) and SimulCache (high-speed mirrored cache coherency). We believe we were the first RAID vendor to offer mixed SAS, SATA or SSD disk drives in the same two unit high, 12 (2U/12) drive enclosure in a highly reliable storage system. With the introduction of the new 24 drive small form factor drive products (2U/24), we believe we are also the first to offer such systems with full embedded RAID and data protection capability.

Software features available with our AssuredSAN products include the following:

AssuredSnap. AssuredSnap is our DMS software that introduces point in time snapshot technology into the AssuredSAN product family. AssuredSnap provides the ability to create point-in-time copies or backups of disk volumes with restoration of data to any captured point in time snapshot. Since AssuredSnap only copies data that has changed to disk it can virtually eliminate backup windows. The AssuredSnap implementation is not only fast, but also reduces the size of snapshots by storing only a single instance of changed blocks. This technology allows IT managers increased backup efficiency and flexibility.

AssuredCopy. AssuredCopy is our DMS software that introduces data cloning or volume copy services into the AssuredSAN product family. AssuredCopy leverages snapshot technology to create complete, physically independent copies of master or snapshot volumes. Once complete, volume copies can be mounted to any host system for read-only or read-write access. As both a data protection and a data management technology, AssuredCopy can be used to support applications such as backup and data recovery, data mining, decision support, data distribution and migration, application development and test. AssuredCopy protects against accidental or malicious loss or corruption of data, and provides additional protection against complete volume failure.

AssuredRemote. AssuredRemote is our DMS software that introduces remote replication into the AssuredSAN product family. AssuredRemote leverages snapshot technology and then transfers them to a paired array over either Fiber Channel or Ethernet to for enhanced data protection and disaster recovery.

RAIDar. RAIDar is a web-based interface used for configuring, monitoring, error reporting and running diagnostics for certain of our RAID systems. Our OEM customers have the option of customizing their own user interface with the purchase of a customization tool kit. This tool kit enables our OEM customers to private-label the user interface quickly and cost efficiently. RAIDar 2.0 adds greater end-user ease of use capability in the form of simple configuration wizards.

We expect our next generation technologies will allow us to compete in the mid-tier, or mid-range storage array market, as defined by the International Data Corporation, or IDC. IDC established market segments based on product price ranges to facilitate comparison of entities and products within the industry. Current entry level

Table of Contents

products from Dot Hill generally sell in the \$5,000 to \$14,999 price range which IDC defines as bands 2 and 3. The mid-range market includes products that sell in the \$15,000 to \$49,999 range which IDC defines as bands 4 and 5. The mid-range market demands additional functionality that usually includes larger capacity storage systems, faster performance, and value-add software features.

Software. We develop application software technologies and products that are complementary to our overall storage solutions. Our software supports widely used open systems platforms, including Linux, Unix and Windows. Currently, our primary standalone software product AssuredVRA is a high-performance, feature rich, host based RAID stack for Windows and Linux based enterprise servers. Our OEM and SI customers typically integrate AssuredVRA as an ingredient of their entry-level Intel or AMD based server products. It has the ability to replace a dedicated hardware RAID adapter in many applications by utilizing the built in disk I/O ports built into modern server hardware. In most instances, AssuredVRA is private labeled and branded with the OEM's own brand.

Sales and Marketing

Our hardware and software products and services are sold worldwide to facilitate network storage implementations in the entry level and mid-range market segments. Dot Hill branded products are sold primarily through distributors, VARs and resellers while blackbox and OEM-customized products are sold primarily through OEMs and federal contractors. Dot Hill utilizes these channels to reach end-user customers that range in size from small businesses to government agencies and large multinational corporations. We maintain a sales and marketing organization operating out of our office in Longmont, Colorado, with regional offices in Germany, Japan, the United Kingdom and China as well as several smaller localized field sales offices throughout North America. Generally, our customers have no minimum purchase requirements and have certain rights to extend, delay or cancel shipment of their orders without penalty.

We support our indirect and OEM channels with a limited set of marketing programs designed to promote our products and technology leadership, attract additional channel partners and generate end-user demand. Our product marketing team focuses on product strategy, product requirements, the new product introduction process, product messaging, demand assessment and competitive analysis. The marketing team also ensures that product development activities, product launches and channel marketing program activities occur on a well-managed, timely basis in coordination with our development, manufacturing and sales groups, as well as our sales channel partners. The groups work closely with our sales and research and development groups to align our product development roadmap to meet key customer and channel technology requirements.

OEM Partners

The majority of our products are currently sold through our OEM channel. Our OEM partners currently include, among others, HP, Ericsson, Dell, Motorola, General Dynamics, Lockheed Martin, Tektronix, Samsung, NEC, Stratus, FTS, Nokia Siemens Networks, or Nokia Siemens, Autodesk, Inc., or Autodesk and Concurrent. We believe that our product sales through these market leaders strengthen our credibility in the marketplace, validate our technology and enable us to sell our products to a much broader customer base. OEMs generally resell our products under their own brand name and typically assume responsibility for marketing, sales, service and support. Our OEM relationships allow us to sell into geographic or vertical markets where each OEM has significant presence. Our agreements with our OEM partners do not contain any minimum purchase commitments, do not obligate our OEM partners to purchase their storage solutions exclusively from us and may be terminated at any time upon notice from the applicable partners. In addition to expanding and enhancing our relationships with certain of our OEM customers and other channel partners, we intend to seek additional OEM customers as a part of our overall strategy. Sales to our OEM customers approximated 96.0% of our total net revenue in 2011. We expect sales to our OEM customers to continue to represent the majority of our net revenue in 2012.

HP currently represents our most significant OEM partner. We began shipping products to HP in the fourth quarter of 2007. In January 2008, we amended our agreement with HP to allow for sales of additional products to

Table of Contents

additional divisions within HP. In October 2011, we extended our supply agreement with HP by 5 years to expire in October 2016 and also extended the expiration of 1.6 million warrants granted to HP in March 2008 to expire concurrently with the supply agreement in October 2016. Our products are primarily sold as HP's MSA 2000/P2000 product family. Sales to HP increased significantly during 2008 and increased again in 2009 primarily as a result of the successful launch and market acceptance of the HP MSA 2000 products. HP launched its third generation product line, now called the P2000 product line, in February 2010. Sales to HP increased again in 2010 as we began selling our next generation host interfaces across the HP P2000 product line and continued to drive sales growth with HP in 2012. Sales to HP approximated 51% of our total net revenue in 2009, 57% of our total net revenue in 2010 and 73% of our total net revenue in 2011 with 2011 reflecting discontinuance of our sales to NetApp. We expect sales to HP will continue to represent a substantial portion of our net revenue in 2012, as well as a significant percentage of our total net revenue in 2012.

NetApp was previously a significant OEM partner. In the fourth quarter of 2010, we decided to exit our low margin business with NetApp and amended our agreement with NetApp to allow them to manufacture and sell on a royalty-free basis all of the products we previously manufactured and sold to them beginning on or about December 1, 2010. As a result, we currently do not anticipate generating any additional revenue from NetApp. Sales to NetApp approximated 25% of our total net revenue in 2009, 26% of our total net revenue in 2010, and 0% of our total net revenue in 2011.

Oracle (formerly Sun Microsystems) was once a significant OEM partner, however, the products sold to Oracle have reached the end of their lifecycle. As a result, we do not expect to generate significant net revenue from Oracle in future periods. Sales to Oracle approximated 4% of our total net revenue in 2009 and 0% of our total net revenue in 2010 and 2011.

Indirect Channels

Most of our Dot Hill branded products including AssuredSAN and AssuredUVS are sold in conjunction with distributors, resellers, VARs and SIs who work closely with our sales force to sell our products to end-users. Our indirect channel partners resell our products either under the Dot Hill brand or as an unbranded "blackbox" configuration and share responsibility with us for marketing, sales, service and support. We believe indirect channel sales represent an attractive growth opportunity and intend to expand the scope of our indirect channel sales efforts by continuing to actively pursue additional indirect channel partners, both domestically and internationally.

Customer Service and Support

We recognize that providing comprehensive, proactive and responsive support is essential to maintaining and growing customer satisfaction, fostering customer loyalty and securing repeat business. We provide comprehensive 24 hours a day, seven days a week, 365 days a year global customer service and support, either directly or through third-party service providers, aimed at simplifying installation, minimizing usage problems, maximizing system availability and streamlining administration. Through direct and third-party service providers, we maintain a global network of professional engineers and technicians who provide telephonic technical support in various languages from strategically located global response centers on a 24-hour, seven-day basis. In addition, we have the ability to provide four hour on-site service response per contract on a global basis. We also offer all of our customers access to SANsolve, our web-hosted interactive support knowledge base that gives our customers the ability to find answers to technical questions through our Customer Resource Center as well as initiate and track all support requests.

We have also taken steps to better align our service and support structure with our indirect sales model, including the following:

Collaborated with our OEM partners to provide support and service directly to end-users. For example, HP and other OEMs provide all but the highest level of support and service to their end-user customers.

Table of Contents

Identified key areas for further development such as product certification/recertification training for our channel partners. In addition, we offered expanded array support services for a fee through our professional services offerings.

Established additional authorized service providers to provide localized service support in certain Asia and European locations. We continue to capitalize on a growing population of product whose initial warranty expired by providing cost effective extended warranty and out-of-warranty repair services.

Research and Development

Our research and development team has been focused on developing innovative storage products, storage virtualization software, storage management software, storage management application software for the open systems market along with the development and integration of our storage controller technology into our designed storage systems. One of the most significant of such functions is something we refer to as Dynamic Virtualization. Dynamic Virtualization utilizes pages instead of blocks to more effectively handle data movement within the storage array. It uses fine grain sub LUN tiering with Page size to automatically move data to the optimal tier based on actual use. The most active pages reside on high-performance SSD, while less active pages reside on SAS 10K or 15K drives. Infrequently accessed data migrates to lower-cost, high-capacity Near Line SAS drives. This eliminates the need for storage administrators to plan data layout in the array for optimal performance, and it continually tunes the storage data layout to meet the specific application needs. This allows users to deploy cost effective hybrid arrays that employ SSDs in the most cost effective way and to maximize overall system performance for mission-critical applications. This technology will form a basis for new products that we hope to introduce in 2012. We have a history of industry firsts, including the first successfully commercialized hot-swappable SCSI disk array and RAID storage system for the UNIX environment and the first NEBS Level 3 certified and MIL-STD-810F tested line of storage systems. We were first to market and have patented SimulCache which increases the write performance in a dual controller array. We were first to market and have patented EcoStor into our AssuredSAN products, which eliminate batteries in the storage system, hence decreasing service costs while ensuring permanent data integrity in the event of power failure. We also believe that we were one of the first in the industry to be able to reliably intermix SAS and SATA drives in the same storage system without caveat. This has enabled us to build products that can optimize capacity and performance applications within the same storage array. We recently launched the first external RAID products using both 24 2.5 drives and 12 3.5 drives in a two unit high chassis form factor for the media and entertainment industry where read and write bandwidth is of significant importance. We are focused on continuously developing products that meet changing customer needs and anticipating and proactively responding to highly evolving technology in a timely and cost-effective manner. We also generally design and develop our products to have a modular architecture that can be scaled to meet customer needs and modified to respond to technological developments in the open systems computing environment across product lines. We are actively working on next generation technologies in both storage hardware protocols and storage software applications. Our total research and development expenses were \$28.1 million in 2009, \$31.6 million in 2010 and \$35.6 million in 2011.

Our intellectual property, or IP, portfolio is focused on data storage security, flexibility/scalability, efficiency, environmental/cooling, modularity/serviceability, high speed, redundancy and high reliability. We are also focused on protecting our business with both the quality of our IP portfolio and quantity, in terms of revenue protection, both of which are considered key processes for patent strength.

Our areas of expertise include Linux, Unix and Windows driver and system software design, storage virtualization software, SAN storage resource management software design, storage system design and integration, RAID controller design and technology, RAID firmware development, data management software development, storage enclosure design and high-speed data interface design. We are currently focusing development efforts on our next-generation family of storage systems and on our software products. Projects include the launch of additional members of the AssuredSAN family of systems, improvements to our storage software offerings and next generation high-speed solutions that will take advantage of the latest transports and technologies.

Table of Contents

Our research and development activities are directed by individuals with significant expertise and industry experience. We currently have three worldwide technology development centers located in Longmont, Colorado, Minneapolis, Minnesota, and Hyderabad, India. The Minneapolis development center focuses on AssuredVRA development.

Manufacturing and Suppliers

We outsource substantially all of our manufacturing to third-party manufacturers in order to reduce sales cycle times and manufacturing infrastructure, enhance working capital and improve margins by taking advantage of the third parties' manufacturing and procurement economies of scale. In September 2008, we entered into a manufacturing agreement with Foxconn. Under the terms of the agreement, Foxconn supplies us with manufacturing, procurement, quality control, product assurance, assembly and test services from its facilities in China. Foxconn provides final integration services including final assembly, testing and configure-to-order services through facilities in Singapore, Houston, TX, and Longhua, China. The agreement provides for an initial three-year term that is automatically renewed at the end of such three-year term for additional one-year terms unless and until the agreement is terminated by either party. In November, 2011, we amended our agreement with Foxconn to extend the manufacturing agreement for three years. Foxconn began manufacturing products for us in July 2009 and we began shipping products for general availability under the Foxconn agreement during the second half of 2009. The majority of our products sold in 2011 were manufactured by Foxconn. We expect Foxconn to manufacture substantially all of our products in 2012.

We have also historically outsourced our manufacturing to Flextronics, MiTAC and SYNEX. We do not expect to outsource much of our manufacturing to Flextronics, SYNEX or MiTAC in 2012.

Intellectual Property

Our success depends significantly upon our proprietary technology. We have received registered trademark protection for the marks SANnet (R), SANpath (R), SANscape (R), Stratis (R), Dot Hill (R), Dot Hill Systems (R) and the Dot Hill logo. Other trademark registrations are in process. We have attempted to protect our intellectual property rights primarily through copyrights, trade secrets, employee and third party nondisclosure agreements and other measures. We have registered trademarks and will continue to evaluate the registration of additional trademarks as appropriate. We claim common law protection for, and may seek to register, other trademarks. In addition, we generally enter into confidentiality agreements with our employees and with key vendors and suppliers.

As of December 31, 2011, we had been awarded a total of 80 United States patents, 4 of which were awarded in 2011. 72 of these patents generally cover RAID controller and SAN-related technology. In addition, as of December 31, 2011 we had 23 filed United States patent applications pending approval. The patents covering our core technologies expire from 2014 to 2040. We are currently exploring opportunities to sell or license some or all of our non-core patents but the likelihood that this will result in significant gains in the future is low. In addition, if we are unable to protect our intellectual property or infringe intellectual property of a third party, our operating results could be harmed.

We also license certain technology from third parties and pay royalties on products shipped that incorporate such technology.

Competition

The storage market is intensely competitive and is characterized by rapidly changing technology. For our AssuredSAN storage hardware products, we compete primarily against independent storage system suppliers including EMC Corp., or EMC, Hitachi Data Systems Corp., or Hitachi, Infotrend, Promise Technology, Inc., or Promise, NEC and NetApp as a result of its acquisition of LSI's Engenio Division in May 2011. We also compete with traditional suppliers of computer systems, including IBM, Oracle, Dell and HP, which market storage systems as well as other computer products.

Table of Contents

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources than we do. 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 public and privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. In the future, it is conceivable that we could compete with some of the original design manufacturers, one of whom is currently our manufacturing partner, as they develop expertise in chassis design and power and cooling technologies.

We believe the principal competitive factors in the hardware storage systems and software storage solutions markets are:

product performance, features, scalability and reliability;

price;

product breadth;

timeliness of new product introductions;

brand reputation;

interoperability and ease of management; and

responsiveness to OEMs and customer support.

We believe that we compete favorably in several of these categories. To remain competitive, we believe we must invest significant resources in developing new products, enhancing our current products and maintaining high quality standards and customer satisfaction.

Employees

As of December 31, 2011, we had 322 full-time employees, of whom 178 were engaged in research and development, 47 in sales and marketing, 38 in manufacturing, 39 in general management and administration and 20 in customer service and support. We have not had a work stoppage among our employees and none of our employees are represented under collective bargaining agreements. We consider our relations with our employees to be good.

Named Executive Officers and Key Employees of the Registrant

Name	Age	Position	Officer or Key Employee Since
Dana W. Kammersgard(2)	56	Chief Executive Officer and President	August 1984(1)
Hanif I. Jamal(2)	51	Senior Vice President, Chief Financial Officer, Treasurer and Corporate Secretary	July 2006
James Kuenzel(3)	58	Senior Vice President of Engineering	February 2006
Ernest Hafersat(3)	62		March 2008

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

Senior Vice President of Worldwide Manufacturing,
Operations and Supply Base Management

- (1) In 1999, Artecon and Box Hill merged to form Dot Hill. Artecon was founded in 1984 and Mr. Kammergard was an officer of Artecon from its inception until the merger, and has been an officer of Dot Hill since that date.
- (2) Named Executive Officers.
- (3) Key employees.

Table of Contents

All officers are elected by our Board of Directors and serve at the pleasure of our Board of Directors as provided in our bylaws.

Dana W. Kammergard has served as our President since August 2004. In March 2006, Mr. Kammergard was appointed as our Chief Executive Officer and President. From August 1999 to August 2004, Mr. Kammergard served as our Chief Technical Officer. Mr. Kammergard was a founder of Artecon and served as a director from its inception in 1984 until the merger of Box Hill and Artecon in August 1999. At Artecon, Mr. Kammergard served in various positions since 1984, including Secretary and Senior Vice President of Engineering from March 1998 until August 1999 and as Vice President of Sales and Marketing from March 1997 until March 1998. Prior to co-founding Artecon, Mr. Kammergard was the director of software development at CALMA, a division of General Electric Company. Mr. Kammergard holds a B.A. in Chemistry from the University of California, San Diego.

Hanif I. Jamal has served as our Senior Vice President, Chief Financial Officer, Treasurer and Corporate Secretary since July 2006. Prior to joining Dot Hill, Mr. Jamal served as Vice President and Corporate Treasurer for Gateway Inc. from 2004 to 2006. Prior to joining Gateway in 2002, Mr. Jamal served in a number of leadership positions over 17 years within Hewlett-Packard Company in the customer financing division, HP Technology Finance. Mr. Jamal led HP's customer financing operations in North America, Latin America and Europe and was also Vice President and General Manager for HP's Commercial and Consumer Financing Division. In 1998, he established Hewlett-Packard International Bank in Dublin, Ireland, and served as Managing Director through 2000. Jamal holds an MBA from Stanford Graduate School of Business and a Bachelor of Science degree, with Honors, in Management Sciences from the University of Manchester Institute of Science and Technology in the United Kingdom.

James Kuenzel has served as our Senior Vice President of Engineering since February 2006. Mr. Kuenzel joined Dot Hill after leaving Maranti Networks Inc. where he began his tenure in 2002 as Vice President of Engineering and then was appointed to President and Chief Operating Officer. Mr. Kuenzel has also held Vice President of Engineering positions at McData Corporation, Cabletron Systems, Inc. and Digital Equipment Corporation. Mr. Kuenzel attended Georgetown University Extension, University of Wisconsin Extension, and holds an A.A. in Electronics from Philco Ford Technical Institute.

Ernest Hafersat has served as our Senior Vice President of Worldwide Manufacturing, Operations and Supply Base Management since November 2008 and previously served as our Vice President of Worldwide Manufacturing Operations and Supply Base Management since March 31, 2008. Mr. Hafersat joined Dot Hill after leaving Western Digital Corporation where he held senior level positions in operations and engineering from 2005 to 2008. Prior to Western Digital, Mr. Hafersat was Vice President, Manufacturing Operations & Program Management for Carrier Access Corp. Previous positions include Vice President, Operations for Vari-I Corp., Vice President/ GM at Read-Rite Corp.-Philippines, Senior Director, Engineering/ NPI at Maxtor Corp. and Director of Engineering at Hyundai Semiconductor-Korea. Mr. Hafersat has overseen operations, supply base management, global supplier quality and engineering for both domestic and international multi-site facilities. His international experience includes China, Pacific Rim countries, Mexico and Costa Rica. Mr. Hafersat has a BSIE/BSEE from Waterbury State Technical University, and attended University of Hartford and Rennsler Polytechnic Institute with credits toward an MBA.

Table of Contents

Item 1A. Risk Factors

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

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

Our business is highly dependent on a limited number of customers. For example, sales to HP accounted for 51% of our net revenue for the year ended December 31, 2009, 57% of our net revenue for the year ended December 31, 2010, and 73% of our net revenue for the year ended 2011. In addition, sales to NetApp accounted for 25% of our net revenue for the year ended December 31, 2009, 26% of our net revenue for the year ended December 31, 2010. We ceased our relationship with NetApp in December of 2010. We expect HP will represent greater than 50% of our overall net revenue and that no other customer will represent greater than 10% of our overall net revenue for the year ended December 31, 2012. If our relationships with HP or certain of our other customers were disrupted or declined significantly, we would lose a substantial portion of our anticipated net revenue and our business could be materially harmed. In October 2011, we extended our supply agreement with HP by five years to expire in October 2016 and also extended the expiration of 1.6 million warrants originally granted to HP in March 2008 to expire concurrently with supply agreement in October 2016. We cannot guarantee that our relationship with HP or our other customers will expand or not otherwise be disrupted.

In the fourth quarter of 2010, we decided to exit our low margin business with NetApp and amended our agreement with NetApp to allow them to manufacture and sell on a royalty-free basis all of the products we previously manufactured and sold to them beginning on or about December 1, 2010. As a result, we generated no revenue from NetApp in 2011.

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

our ability to maintain our products at prices that are competitive with those of our competitors;

our ability to maintain quality levels for our products sufficient to meet the expectations of our customers;

our ability to produce, ship and deliver a sufficient quantity of our products in a timely manner to meet the needs of our customers;

our ability to continue to develop and launch new products that our customers feel meet their needs and requirements, with respect to cost, timeliness, features, performance and other factors;

our ability to provide timely, responsive and accurate customer support to our customers; and

the ability of our customers to effectively deliver, market and increase sales of their own solutions based on our products.

The impact of flooding in Thailand on the hard disk drive supply chain

Recently, the hard disk drive component supply chain has been significantly disrupted as a result of severe flooding in Thailand. In addition, some disk drive manufacturers and their suppliers have substantial manufacturing facilities in Thailand that have been impacted due to flooding. Hard disk drives are a critical

Table of Contents

component in our AssuredSAN storage array products and can represent 30-70% of the cost of such products. While around 75% of our revenue typically comes from customers who purchase our AssuredSAN products on a drive-less basis, these customers need to purchase and install qualified hard disk drives to make these products operational. In addition, these customers may also purchase hard disk drives to incorporate into other products that they might sell such as computer servers, which are often sold as bundles with storage arrays. If these customers experience disk shortages, their demand for our AssuredSAN systems could also decline significantly.

Given the severity of the situation and the potential for extensive hard disk drive shortages for us and our customers, we believe the effects on our business and the data storage industry are likely to be substantial and could extend over multiple quarters. We will make every effort to secure and hold inventory of hard disk drives to incorporate into our products. Any purchase of hard drives beyond our immediate requirements will likely result in increased inventory and a use of cash. In addition, to experiencing shortages for our hard disk drive requirements, we could experience severe price increases of hard disk drives, which we may or may not be able to pass on to our customers, and hence could negatively impact our revenues and margins. At this time, we cannot fully assess the impact of the flooding in Thailand to us, our customers or to the broader hard disk drive ecosystem, but it could potentially have a very significant negative impact on our operations and financial results for multiple quarters.

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

Our products may contain undetected errors or failures that become epidemic failures which may be discovered after shipment, resulting in a loss of net revenue, an increase in costs to rework or replace failed products, product liability claims, a tarnished reputation, a loss of customers, or a loss or delay in market acceptance of our products, any of which could harm or disrupt our business. Product failures or recalls could be the result of components purchased from our suppliers not meeting the required specifications or containing undetected quality errors and manufacturing defects or from our own design deficiencies.

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

In October 2009, we discovered a quality issue associated with certain power supply devices provided by a long-term component supplier, which resulted in a higher than expected level of power supply failures to us and our customers. While we were able to promptly identify and resolve the cause of the failures, we are required to provide replacement products or make repairs to the affected power supply units that had been sold between

Table of Contents

March and October 2009. Through December 31, 2011, our component supplier had repaired all of the faulty power supplies at no cost to us, and reimbursed us for our out-of-pocket costs which was in effect a reimbursement to customers for certain out-of-pocket costs they incurred in connection with these power supply failures. The total amount reimbursed to us by our component supplier approximated \$1.0 million through December 31, 2011. In the second and third quarters of 2011, a material customer provided us with a framework estimating the potential claims precipitated by the power supply failures. Negotiations continued with our customer throughout the fourth quarter of 2011 into the first quarter of 2012. In our judgment, the negotiations have resulted in an increase in our estimated liability at December 31, 2011 to \$5.5 million, resulting in a charge of \$2.7 million during the fourth quarter of 2011 within Accrued expenses on our condensed consolidated balance sheet, and are recorded gross of any third-party recoveries, if any.

In February 2012 we signed a letter of intent with the supplier that will probably result in additional cash compensation of \$1.2 million, a warranty extension on the affected power supply units and incremental product discounts for future product purchases. We recorded a current asset within Prepaid expenses and other assets on our consolidated balance sheet of \$1.2 million as of December 31, 2011.

In addition, we have commenced discussions with our General Liability and Errors and Omissions Insurance and underwriters and will continue to pursue our rights to cover any damages we incur and not reimbursed by our supplier. The insurance company has issued a reservation of rights letter to us and at this time, it is not possible to estimate to what extent, if any, we will be covered by our carrier. As of December 31, 2011, we have not assumed or recorded any insurance reimbursement.

To the extent that we are unsuccessful executing the settlement agreements with our customer and our component supplier on mutually beneficial terms, or our component supplier does not continue to reimburse us for the expenses incurred by us or our customers, and we are unsuccessful in recovering such expenses from our insurance provider, we could incur additional expenses which could potentially have a material effect on our financial statements.

Our acquisition of Cloverleaf, and potential future acquisitions, may not be successfully integrated or produce the results we anticipate.

As part of our strategy, we are continuously evaluating opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets, or enhance our technical capabilities. The acquisition and ongoing integration of new businesses into our business may adversely affect our operations or profitability.

In January 2010, we acquired Cloverleaf, a privately held software company, based primarily in Israel for approximately \$9.5 million in stock and \$2.5 million in cash. The Cloverleaf acquisition provided us with a new team of software development and other professionals. Cloverleaf's products provide heterogeneous storage virtualization and unified storage technologies that can simplify data center management, eliminate downtime and reduce storage costs.

In addition, the accounting treatment for the Cloverleaf acquisition resulted in significant amortizable intangible assets which, when amortized, negatively affects our consolidated results of operations. As of September 30, 2011, we identified a change in circumstances that indicated the carrying amount of our goodwill and long-lived assets may not be recoverable, as our primary AssuredUVS customer informed us that they were changing their strategy which would result in a significant decline in revenue for the Company. Thus, as of the end of September, we tested the carrying values of Goodwill and Long-Lived Assets. The results were that we impaired the entire goodwill amount of \$4.1 million, impaired the entire trade name by \$0.1 million, and reduced the carrying value of the software from \$4.9 million to \$2.1 million.

In February 2012, our Board of Directors approved a plan to exit our AssuredUVS business and close down our Israel Technology Development Center (see Note 3). We evaluated the potential impact, if any, on our

Table of Contents

valuation of our acquired software and other long-lived assets maintained at our Israel Technology Development Center, and based on the facts and circumstances in existence at December 31, 2011, we believe the current valuations are appropriate. However, as a result of our decision in the 2012 fiscal year to shut down our AssuredUVS business, we will assess the recorded long-lived asset valuation for Israel Technology Development Center in the first quarter of 2012.

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

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

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

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

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

Our third-party manufacturers rely on other third parties to supply key components of our storage products. Some of these components are available only from one or limited sources in the quantities and quality we require. Should any of the component suppliers cease to operate due to current economic conditions or otherwise, we would have to qualify and locate alternative suppliers. We estimate that replacing key components we currently use in our products with those of another supplier could involve several months of hardware and

Table of Contents

software modification, which could significantly harm our ability to meet our customers' orders for our products, damage our customer relationships and result in a loss of sales.

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

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

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

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

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

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

Furthermore, we are contractually obligated to purchase excess and obsolete material and finished goods from our contract manufacturer if not consumed within 90 days of contract manufacturer's purchase, which could have a material effect on our financial results.

Table of Contents

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

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

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

the amount of time needed for technical evaluations by customers;

customers' budget constraints and changes to customers' budgets during the course of the sales cycle;

customers' internal review and testing procedures;

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

the complexity of technical challenges that need to be overcome during the development, testing and/or qualification process for new products and/or new customers;

meeting unique customer specifications and requirements; and

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

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

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

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

We believe that to remain competitive, we will need to continue to develop new hardware and software products, which will require a significant investment in new product development. Our competitors and new market participants may be developing alternative technologies, which may

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

adversely affect the market acceptance of our products. If alternative technologies and interface protocols are adopted by the industry that we have not incorporated into our products, we may become uncompetitive and not have product offerings for select

Table of Contents

market segments. Even if our new products are developed on time, we may not be able to manufacture them at competitive prices or in sufficient volumes.

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

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

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

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

The storage market is intensely competitive and is characterized by rapidly changing technology. For our AssuredSAN storage hardware products, we compete primarily against independent storage system suppliers including EMC Corp., or EMC, Hitachi Data Systems Corp., or Hitachi, Infotrend, Promise Technology, Inc., or Promise, NEC and NetApp as a result of its acquisition of LSI's Engenio Division in May 2011. We also compete with traditional suppliers of computer systems, including IBM, Oracle, Dell and HP, which market storage systems as well as other computer products.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources than we do. 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 public and privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. In the future, it is conceivable that we could compete with some of the original design manufacturers, one of whom is currently our manufacturing partner, as they develop expertise in chassis design and power and cooling technologies.

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

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

Table of Contents

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

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

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

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

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

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

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

In addition, we typically plan our production and inventory levels based on forecast data we receive from our customers and industry information on market demand. While we make every effort to work closely with our customers, forecasting is subject to unpredictable changes in demand and can fluctuate suddenly and substantially. In 2011, we experienced such changes in our customer forecasts. From time to time, in response to anticipated long lead times to obtain inventory and materials from our outside suppliers, we may order materials in advance of anticipated customer demand. This advance ordering may result in excess inventory levels or unanticipated inventory write-downs due to expected orders that fail to materialize.

Table of Contents

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

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

increased price competition;

introduction of new products by us or our competitors, including products with price performance advantages;

our inability to reduce production or component costs;

entry into new markets or the acquisition of new customers;

sales discounts and marketing development funds;

increases in material or labor costs;

excess inventory resulting from changes in sales forecasts and/or obsolescence, inventory shrinkages and losses and inventory holding charges;

the timing of purchase price variances resulting from reductions in component costs purchased on our behalf by our contract manufacturers or owned by us in inventory versus the original cost of those components;

increased warranty costs and costs associated with any potential future product quality and product defect issues;

our inability to sell our higher performance products, or our software products and our services;

component shortages which can result in expedite fees, overtime or increased use of air freight; and

increased freight costs resulting from higher fuel prices, or from the need to expedite shipments of components to our contract manufacturers or finished goods to some of our customers and their hub locations.

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

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

expenses which could have an impact on our business, financial condition and results of operations.

Manufacturing and supplier disruptions could harm our business.

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

Due to our use of third-party manufacturers, our ability to control the timing of shipments could decrease. Delayed shipment could result in the deferral or cancellation of purchases of our products. Any significant

Table of Contents

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 not realized, which could also impact cash flow or result in a decline in our stock price. To the extent we establish a relationship with an alternative manufacturer for our products, we may be able to partially mitigate potential disruptions to our business. We may also suffer manufacturing disruptions as we ramp up manufacturing processes for newly introduced products, which could result in delays in delivery of these products to our customers and adversely affect our results of operations. We also generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are covered by supplier warranties. For warranty costs not covered by our suppliers, we reserve for estimated warranty costs in the period the net revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future, or that we have estimated these costs correctly, which could have a material adverse effect on our business, financial condition and results of operations.

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

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

Demand for disk drives and memory has at times surpassed supply, forcing drive, memory and component suppliers to manage allocation of their inventory. If such a shortage were prolonged, we may be forced to pay higher prices for disk drives, memory or components or may be unable to purchase sufficient quantities of these components to meet our customers' demand for our storage products in a timely manner or at all.

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

For the year ended December 31, 2011 we incurred a net loss of \$22.0 million. For the year ended December 31, 2010 we incurred a net loss of \$13.3 million. We expect our business to remain volatile as we are often unable to reliably predict net revenue from HP and our other customers. Our ability to reliably predict net revenue has become more challenging as a result of our 2010 acquisition of Cloverleaf and the termination of our relationship with NetApp. Net revenue from our customers, the mix of products sold to our customers, our ability to introduce new products as planned and our ability to reduce product costs and manage our operating expenses and manufacturing variances will continue to affect our financial results for 2012. Consequently, we cannot assure you that we will be profitable in any future period.

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

our ability to maintain and enhance relationships with our customers, in particular our OEM customers, as well as our ability to win new business;

our ability to implement and achieve targeted gross margin and cost reduction objectives and;

our ability to contain operating expenses and manufacturing variances;

our ability to meet product delivery schedules for HP and other customers which could result in increased air freight, expedite and overtime charges;

Table of Contents

the extent to which we invest in new initiatives such as channel sales and software development;

our plans to maintain and enhance our engineering, research, development and product testing programs;

the success of our manufacturing strategy and relationships with our contract manufacturing partners;

the success of our sales and marketing efforts;

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

the extent and terms of any development, marketing or other arrangements;

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

increased costs associated with our Israeli operations;

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

costs of litigating and defending law suits; and

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

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

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

Furthermore, 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. In addition, we enter into indemnification agreements with third parties in the ordinary course of business that generally require us to reimburse losses suffered by the third party due to various events, such as lawsuits arising from patent or copyright infringement.

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

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 Kammergard, our Chief Executive Officer and President, Hanif Jamal, our Senior Vice President, Chief Financial Officer, Treasurer and Corporate Secretary, James Kuenzel, our Senior Vice President of Engineering and Ernest Hafersat, our Senior Vice-President of World-Wide Manufacturing, Operations and Supply Base Management. If any of these individuals were to

Table of Contents

terminate his employment with us, we would be required to locate and hire a suitable replacement. In addition, if any of our additional key engineering, sales and general and administrative employees were to terminate their employment with us, our business could be harmed. Competition for attracting talented employees in the technology industry can be intense. We may be unable to identify suitable replacements for any employees that we lose. In addition, even if we are successful in locating suitable replacements, the time and cost involved in recruiting, hiring, training and integrating new employees, particularly key employees responsible for significant portions of our operations, could harm our business by delaying our production schedule, our research and development efforts, our ability to execute on our business strategy and our client development and marketing efforts.

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan included, among other things, severance and related costs for the reduction of approximately 10% of our workforce, a 10% salary reduction for all employees at or above the Vice President level and a 5% salary reduction for certain other employee groups. As of December 31, 2011, we had restored a limited number of employee salaries for retention purposes, and had restored all employee salaries to their pre-2010 Plan levels by January 31, 2012. The demand for our technical employees is extremely competitive in our market area. If these actions are viewed as not being sufficiently competitive, we may experience higher employee attrition rates, which would require us to locate and hire suitable replacements and could cause our business to be harmed.

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

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

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

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

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

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

We are subject to income taxes in the United States and various foreign jurisdictions. Our effective income tax rates have recently been and could in the future be adversely affected by changes in tax laws or

Table of Contents

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

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

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

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

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

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

differences between our actual operating results and the published expectations of analysts;

quarterly fluctuations in our operating results;

mergers and acquisitions in the data storage marketplace;

introduction of new products or changes in product pricing policies by our competitors or us;

conditions in the markets in which we operate;

changes in market projections by industry forecasters;

changes in estimates of our earnings by us or industry analysts;

overall market conditions for high technology equities;

rumors or dissemination of false information; and

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

general economic and geopolitical conditions.

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

Table of Contents

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

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

Our system of internal controls may be inadequate.

We maintain a system of internal controls in order to ensure we are able to collect, process, summarize, and disclose the information required by the Securities and Exchange Commission within the time periods specified. Any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Due to these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. Additionally, public companies in the United States are required to review their internal controls under the Sarbanes-Oxley Act of 2002. If the internal controls put in place by us are not adequate or fail to perform as anticipated, errors could occur that would not be detected, which could require us to restate our consolidated financial statements, receive an adverse audit opinion on the effectiveness of our internal controls, and/or take other actions that will divert significant financial and managerial resources, as well as be subject to fines and/or other government enforcement actions. Furthermore, the price of our stock could be adversely affected.

Environmental compliance costs could adversely affect our results of operations.

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

We face increasing complexity in our product design and procurement operations as we adjust to new and future requirements relating to the materials composition of our products, including the restrictions on lead and certain other substances that apply to specified electronic products put on the market in the European Union as of July 1, 2006 (Restriction of Hazardous Substances Directive, or RoHS). We design our products to ensure that they comply with these requirements as well as related requirements imposed by our customers. We are also working with our suppliers to provide us with compliant materials, parts and components. If our products do not comply with the European substance restrictions, we could become subject to fines, civil or criminal sanctions, and contract damage claims. In addition, we could be prohibited from shipping non-compliant products into the European Union, and required to recall and replace any products already shipped, if such products were found to be non-compliant, which would disrupt our ability to ship products and result in reduced net revenue, increased obsolete or excess inventories and harm to our business and customer relationships. Various other countries and states in the United States have issued, or are in the process of issuing, other environmental regulations that may impose additional restrictions or obligations and require further changes to our products. These regulations could impose a significant cost of doing business in those countries and states.

The European Union has enacted the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. Similar legislation has been or may be enacted in other jurisdictions, including in the United States, Canada, Mexico, China and Japan, the cumulative impact of which could be significant.

Table of Contents

Due to the global nature of our business, risks inherent in our international operations could have a material adverse effect on our business.

Although a substantial portion of our business is located and conducted in the United States, a significant portion of our operations are located outside of the United States. A substantial portion of our products are manufactured outside of the U.S., and we have research and development and service centers overseas. Accordingly, our business and our future operating results could be adversely affected by a variety of factors affecting our international operations, some of which are beyond our control, including regulatory, political, or economic conditions in a specific country or region, trade protection measures and other regulatory requirements, government spending patterns, and acts of terrorism and international conflicts. In addition, we may not be able to maintain or increase international market demand for our products.

We face exposure to adverse movements in foreign currency exchange rates as a result of our international operations. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. Our international sales are denominated in U.S. dollars and in foreign currencies. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore potentially less competitive in foreign markets. Conversely, lowering our price in local currency may result in lower U.S.-based revenues. A decrease in the value of the U.S. dollar relative to foreign currencies could increase operating expenses in foreign markets. Prices for our products are substantially U.S. dollar denominated, even when sold to customers that are located outside the United States. Therefore, as a substantial portion of our sales are from countries outside the United States, fluctuations in currency exchanges rates, most notably the strengthening of the U.S. dollar against other foreign currencies, contribute to variations in sales of products in impacted jurisdictions and could adversely impact demand and revenue growth. In addition, currency variations can adversely affect margins on sales of our products in countries outside the United States.

Additional risks inherent in our international business activities generally include, among others, difficulties in managing international operations.

In addition, due to the global nature of our business, we are subject to complex legal and regulatory requirements in the United States and the foreign jurisdictions in which we operate and sell our products, including antitrust and anti-competition laws, rules and regulations, and regulations related to data privacy. We are also subject to the potential loss of proprietary information due to piracy, misappropriation or laws that may be less protective of our intellectual property rights than U.S. laws. Such factors could have an adverse impact on our business, operating results and financial position.

Moreover, in many foreign countries, particularly in those with developing economies, it is common to engage in business practices that are prohibited by our internal policies and procedures, or U.S. laws and regulations applicable to us, such as the Foreign Corrupt Practices Act. There can be no assurance that all of our employees, contractors and agents, as well as those companies to which we outsource certain of our business operations, will comply with these policies, procedures, laws and/or regulations. Any such violation could subject us to fines and other penalties, which could have a material adverse effect on our business, financial condition or results of operations.

Our business could be materially and adversely affected as a result of a natural disaster, terrorist acts or other catastrophic events.

We depend on the ability of our personnel, raw materials, equipment and products to move reasonably unimpeded around the world. Any political, military, terrorism, global trade, world health or other issue that hinders this movement or restricts the import or export of materials could lead to significant business disruptions. Furthermore, any strike, economic failure or other material disruption caused by fire, floods, hurricanes, earthquakes, volcanoes, power loss, power shortages, environmental disasters, telecommunications or business

Table of Contents

information systems failures, break-ins and similar events, such as the recent flooding in Thailand, could also adversely affect our ability to conduct business. If such disruptions result in cancellations of customer orders or contribute to a general decrease in economic activity or corporate spending on information technology, or directly impact our marketing, manufacturing, financial and logistics functions, or impair our ability to meet our customer demands, our results of operations and financial condition could be materially adversely affected.

Our business is subject to increasingly complex corporate governance, public disclosure, and accounting and tax requirements that have increased both our costs and the risk of noncompliance.

Because our common stock is publicly traded, we are subject to certain rules and regulations of federal, state and financial market exchange entities charged with the protection of investors and the oversight of companies whose securities are publicly traded. These entities, including the Public Company Accounting Oversight Board, the SEC, and NASDAQ have implemented requirements and regulations and continue developing additional regulations and requirements in response to corporate scandals and laws enacted by Congress, most notably the Sarbanes-Oxley Act of 2002. Our efforts to comply with these regulations have resulted in, and are likely to continue resulting in, increased general and administrative expenses and diversion of management time and attention from revenue-generating activities to compliance activities.

On July 21, 2010, the President signed into law the Dodd-Frank Act. Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us. However, as we continue to implement changes in response to this new law and its associated regulations, we expect to incur additional operating costs that could have a material adverse effect on our financial condition and results of operations.

A change in accounting standards or practices and varying interpretations of existing accounting pronouncements, such as the changes to revenue recognition standards, the increased use of fair value measures, additional proposed changes to revenue recognition, lease accounting, financial instruments and other accounting standards, and the potential requirement that U.S. registrants prepare financial statements in accordance with International Financial Reporting Standards (IFRS), could have a significant effect on our reported financial results or the way we conduct our business. Implementation of accounting regulations and related interpretations and policies, particularly those related to revenue recognition, could cause us to defer recognition of revenue or recognize lower revenue, which may affect our results of operations.

Because new and modified laws, regulations, and standards are subject to varying interpretations in many cases due to their lack of specificity, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

We are subject to risks related to the provision of employee health care benefits and recent health care reform legislation.

In March 2010, comprehensive health care reform legislation under the Patient Protection and Affordable Care Act (HR 3590) and the Health Care Education and Affordability Reconciliation Act (HR 4872) was passed and signed into law. Among other things, the health reform legislation includes guaranteed coverage requirements, eliminates pre-existing condition exclusions and annual and lifetime maximum limits, restricts the extent to which policies can be rescinded and imposes new and significant taxes on health insurers and health care benefits. Provisions of the health reform legislation become effective at various dates over the next several years. The Department of Health and Human Services, the National Association of Insurance Commissioners, the Department of Labor and the Treasury Department have yet to issue necessary enabling regulations and guidance with respect to the health care reform legislation.

Table of Contents

Due to the breadth and complexity of the health reform legislation, the lack of implementing regulations and interpretive guidance, and the phased-in nature of the implementation, it is difficult to predict the overall impact of the health reform legislation on our business over the coming years. Our results of operations, financial position and cash flows could be materially adversely affected due to this health reform legislation.

If we are unable to establish fair value for any undelivered element of a sales arrangement, all or a portion of the revenues relating to the arrangement could be deferred to future periods.

In the course of our sales efforts, we may enter into multiple element arrangements that include software and hardware related elements and maintenance. If we are required to change the pricing of our software-related elements through discounting, or otherwise introduce variability in the pricing of such elements, we may be unable to maintain Vendor Specific Objective Evidence of fair value of the undelivered elements of the arrangement, and would therefore be required to delay the recognition of all or a portion of the related arrangement. A delay in the recognition of revenues may cause fluctuations in our financial results and may adversely affect our operating margins. To date, these types of transactions have not been significant, but they will become more significant in the future as we expand our product offerings.

We are exposed to the credit and non-payment risk of our customers, resellers, and distributors, especially during times of economic uncertainty and tight credit markets, which could result in material losses.

Most of our sales to customers are on an open credit basis, with typical payment terms between net 30 and net 45 days. While we monitor individual customer payment capability in granting such open credit arrangements, and seek to limit such open credit to amounts we believe are reasonable, we may experience losses due to a customer's inability to pay.

In the past, there have been bankruptcies by our customers to whom we had extended open credit, causing us to incur bad debt charges. We may be subject to similar losses in future periods. Any future losses could harm our business and have a material adverse effect on our operating results and financial condition. Additionally, to the extent that the recent turmoil in the credit markets makes it more difficult for customers to obtain open credit or financing, those customers' ability to purchase our products could be adversely impacted, which in turn could have a material adverse impact on our financial condition and operating results.

We make significant investments in research and development to improve our technology and develop new technologies, and unsuccessful investments could materially adversely affect our business, financial condition and results of operations.

Over the past several years, our business strategy has been to derive a competitive advantage by moving from being a follower of new technologies to being a leader in the innovation and development of new technologies. This strategy requires us to make significant investments in research and development and, in attempting to remain competitive, we may increase our capital expenditures and expenses above our historical run-rate model. There can be no assurance that these investments will result in viable technologies or products, or if these investments do result in viable technologies or products, that they will be profitable or accepted by the market. Significant investments in unsuccessful research and development efforts could materially adversely affect our business, financial condition and results of operations. In addition, increased investments in technology could cause our cost structure to fall out of alignment with demand for our products, which would have a negative impact on our financial results.

Violation of applicable laws, including labor or environmental laws, and certain other practices by our suppliers could harm our business.

We expect our suppliers to operate in compliance with applicable laws and regulations, including labor and environmental laws, and to otherwise meet our required supplier standards of conduct. While our internal

Table of Contents

operating guidelines promote ethical business practices, we do not control our suppliers or their labor or environmental practices. The violation of labor, environmental or other laws by any of our suppliers, or divergence of a supplier's business practices from those generally accepted as ethical in the United States, could harm our business by:

interrupting or otherwise disrupting the shipment of our product components;

damaging our reputation;

forcing us to find alternate component sources;

reducing demand for our products (for example, through a consumer boycott); or

exposing us to potential liability for our supplier's wrongdoings.

We are vulnerable to system failures or attacks, which could harm our business.

We are heavily dependent on our technology infrastructure, among other functions, to operate our factories, sell our products, fulfill orders, manage inventory and bill, collect and make payments. Our systems are vulnerable to damage or interruption from natural disasters, power loss, telecommunication failures, computer viruses, computer denial-of-service attacks and other events. Our business is also subject to break-ins, sabotage and intentional acts of vandalism by third parties as well as employees. Despite any precautions we may take, such problems could result in, among other consequences, interruptions in our business, which could harm our reputation and financial condition.

Item 1B. *Unresolved Staff Comments*

None.

Item 2. *Properties*

Our corporate headquarters currently occupy approximately 58,000 square feet that includes office and laboratory space located in Longmont, Colorado. This facility includes administration, research and development, sales and marketing and operations functions. The expiration date of the lease is January 2013.

We lease approximately 7,300 square feet of office space located in Plymouth, Minnesota, under a lease that expires October 2012. We use this office space as a research and development facility for our AssuredVRA software.

In addition, we lease other international office space in Israel, Germany, Japan, China, Singapore and the United Kingdom primarily for research and development and sales and marketing functions.

We also lease approximately 58,500 square feet in Carlsbad, California, under a lease that expires in April 2013, although we were not utilizing any portion of this facility as of December 31, 2011. For additional information regarding this facility, see Note 6 of the Notes to Consolidated Financial Statements.

Our existing leased facilities are appropriate for our current needs, although additional office space may be needed in the Longmont, Colorado location in the near future. We do not own any real estate.

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

We have two business segments: Storage Systems and Standalone Storage Software. The Storage Systems segment primarily uses our Longmont, Colorado facility as well as our international office space, with the exception of Israel. The Standalone Storage Software segment primarily uses our Plymouth, Minnesota and Israel facilities.

Table of Contents

Item 3. *Legal Proceedings*

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

Item 4. *Mine Safety Disclosures*

None.

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common stock is currently included for quotation on the Nasdaq Global Market and is currently traded under the symbol HILL.

The following table sets forth for the periods indicated the per share range of the high and low sales prices of our common stock as reported on the Nasdaq Global Market.

	Low	High
Year Ended December 31, 2010		
First Quarter	1.37	2.15
Second Quarter	1.07	1.90
Third Quarter	1.01	1.71
Fourth Quarter	1.39	2.10
Year Ended December 31, 2011		
First Quarter	1.72	3.86
Second Quarter	2.49	3.37
Third Quarter	1.45	3.18
Fourth Quarter	1.19	1.96

On February 29, 2012 the last reported sale price for our common stock on the Nasdaq Global Market was \$1.40 per share. As of February 29, 2012 there were 57,866,406 shares of our common stock outstanding held by approximately 103 holders of record. We have never paid any cash dividends on our common stock, and currently intend to retain future earnings, if any, to the extent possible to fund the development and growth of our business. We do not anticipate paying any cash dividends on our common stock in the foreseeable future.

The information required to be disclosed by item 201(d) of Regulation S-K, *Securities Authorized for Issuance Under Equity Compensation Plans*, is included under Item 12 of Part III of this annual report on Form 10-K.

Table of Contents

PERFORMANCE MEASUREMENT COMPARISON

The following graph compares the cumulative 5-year total return provided stockholders on our common stock relative to the cumulative total returns of the S&P 500 Index, the Nasdaq Composite Index and the Nasdaq Computer Index. An investment of \$100 (with reinvestment of all dividends) is assumed to have been made in our common stock and in each index on December 31, 2006 and its relative performance is tracked through December 31, 2011.

Table of Contents**Item 6. Selected Financial Data**

We derived the selected consolidated financial data presented below from our audited consolidated financial statements for the years ended December 31, 2009, 2010 and 2011, which are included elsewhere in this annual report on Form 10-K. Statement of operations data for the years ended December 31, 2007 and 2008 and balance sheet data as of December 31, 2007, 2008 and 2009 have been derived from our audited consolidated financial statements not included herein. All data are in thousands except per share data. You should read the selected consolidated financial data together with our consolidated financial statements and related disclosures thereto and with Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this annual report on Form 10-K.

	2007	2008	2009	2010(5)	2011
Statement of Operations Data:					
Net revenue	\$ 207,095	\$ 272,879	\$ 234,383	\$ 252,494	\$ 197,461
Cost of goods sold(6)	180,662	242,491	196,556	209,664	155,828
Gross profit	26,433	30,388	37,827	42,830	41,633
Operating expenses:					
Research and development	22,564	28,709	28,120	31,578	35,551
Sales and marketing	15,939	13,878	10,970	12,164	13,876
General and administrative	12,606	12,779	10,139	9,928	9,268
Restructuring charge(3)		813	2,430	2,196	668
Legal settlement		(4,036)			
Goodwill and long-lived asset impairment charge(1)(4)(6)	40,725	5,432			4,140
Operating loss	(65,401)	(27,187)	(13,832)	(13,036)	(21,870)
Other income (loss), net	4,996	1,612	167	(2)	(25)
Income tax (benefit) expense	(177)	190	(40)	213	129
Net income (loss)	\$ (60,228)	\$ (25,765)	\$ (13,625)	\$ (13,251)	\$ (22,024)
Net income (loss) attributable to common stockholders	\$ (60,228)	\$ (25,765)	\$ (13,625)	\$ (13,251)	\$ (22,024)
Net income (loss) per share:					
Basic and diluted(2)	\$ (1.32)	\$ (0.56)	\$ (0.29)	\$ (0.25)	\$ (0.40)
Weighted average shares outstanding:					
Basic and diluted	45,534	46,136	47,094	53,015	54,908
Balance Sheet Data:					
Cash, cash equivalents, and short-term investments	\$ 82,358	\$ 56,850	\$ 57,574	\$ 45,732	\$ 46,168
Working capital	88,418	75,261	62,010	49,879	41,387
Total assets	139,927	123,897	108,280	107,502	98,879
Total long-term debt		607	346	71	
Total stockholders' equity	96,429	76,652	66,351	64,378	48,702

(1) During the fourth quarter of 2007 the market value of our common stock substantially declined. As a result of this decline we determined that the goodwill related to our SANnet reporting unit was impaired and recognized an impairment charge to goodwill of \$40.7 million.

(2) See Note 2 of Notes to Consolidated Financial Statements for an explanation of the calculation of net income (loss) per share.

Table of Contents

- (3) See Note 6 of Notes to Consolidated Financial Statements for an explanation of our restructuring charges.

- (4) During the fourth quarter of 2008, we performed an impairment analysis over our long-lived and intangible assets. The impairment analysis identified \$5.4 million of impaired long-lived assets consisting of \$4.4 million of property and equipment and \$1.0 million of intangible assets. See further discussion of our long-lived asset impairment in Note 1 of Notes to Consolidated Financial Statements.

- (5) On January 26, 2010, we acquired 100% of the voting equity interests of Cloverleaf in exchange for (i) \$0.7 million of cash, (ii) 4,758,530 shares of Dot Hill common stock valued at \$8.1 million, or \$1.71 per share, (iii) \$1.8 million of specified assumed outstanding liabilities of Cloverleaf at the acquisition date, and (iv) 327,977 shares of restricted common stock that were issued to the employees of Cloverleaf who became employees of Dot Hill on the acquisition date pursuant to Dot Hill's 2009 Equity Incentive Plan. See further discussion of our acquisition of Cloverleaf in Note 3 of Notes to Consolidated Financial Statements.

- (6) During September, 2011, we performed an impairment analysis over our long-lived and intangible assets. The impairment analysis identified \$4.1 million of impaired goodwill, \$2.8 million of impaired acquired software and \$0.1 million of impaired acquired trade name, all related to our acquisition of Cloverleaf, Inc. As of December 31, 2011, the goodwill impairment charge was recorded as an Operating Expense, whereas the long-lived asset impairment charge was recorded as a component of cost of goods sold. See further discussion of our long-lived asset impairment in Note 1 of Notes to Consolidated Financial Statements.

Table of Contents

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Cautionary Statement for Forward-Looking Information

Certain statements contained in this report, 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 Item 1A

Risk Factors and elsewhere in this annual report on Form 10-K. 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 consolidated financial statements and notes thereto included elsewhere in this annual report on Form 10-K.

Overview

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

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

Our standalone storage software operating segment in 2010 and 2011 consisted of our AssuredUVS and AssuredVRA product lines.

Table of Contents

Our AssuredUVS product line, formerly known as the intelligent storage networking system, or iSN™, is based on the technology we acquired in January 2010 from Cloverleaf Communications, Inc., or Cloverleaf, a privately held software company focused on heterogeneous storage virtualization and unified storage technologies. Such technology was marketed as standalone host based software and also included appliance products consisting of a standard off-the-shelf x86 server combined with the proprietary software that delivers the unified virtual storage feature set. Our storage arrays are also available bundled with this appliance. Sales of AssuredUVS products were not significant in 2011. On February 2, 2012 we decided to re-align our software investments to focus on accelerating the development of software that will be embedded in our AssuredSAN product line to better enable us to launch a set of mid-range storage products in 2012, provide more differentiated entry level products over time and help position us to win new OEM and Channel customers that may be looking for new or alternative suppliers resulting from industry consolidation. Since we do not expect to utilize the Cloverleaf based software in these mid-range product offerings, we have decided to discontinue our investment and development efforts in the Cloverleaf based products. We recently began to market the Cloverleaf asset to prospective acquirers and while there have been indications of interest, there is no assurance we will find a suitable buyer on a timely basis. We have determined that the ongoing cash investment in this operation could outweigh the potential consideration from the sale of this business, and thus, we plan to substantially close down our Israeli software development group by March 31, 2012. Consequently, we do not expect sales of AssuredUVS to represent a significant percentage of our total net revenue in the future.

In September 2008, we acquired certain assets, namely RAIDCore from Ciprico Inc., or Ciprico. These products are marketed to OEM accounts as the AssuredVRA product line. This acquisition opened up new markets for us in the enterprise server and workstation markets for data protection internal to the servers and workstations. In particular, the RAIDCore acquisition allows us to broaden our product portfolio in the redundant array of independent disks, or RAID, market while allowing us to sell into the Band 1 market, and to pursue opportunities at current and target OEM customers. We signed our first customer agreement relating to RAIDCore products in May 2009 and began selling to this customer during the third quarter of 2009. Sales of AssuredVRA products were not significant in 2010 and 2011 and we do not expect sales of our AssuredVRA products to increase, in 2012 we do not expect such sales to represent a significant percentage of our future net revenue.

We decided to expand our routes to market beyond our focus on original equipment manufacturers, or OEMs, and in October of 2009, we launched a Dot Hill channel program targeted at selling through distributors and resellers. We continued to expand our channel program in 2011 and believe this will provide Dot Hill with additional sales channels for all of our products. The majority of sales to our channel partners were represented by our AssuredSAN line of products in 2011. We expect sales to our channel partners of our AssuredSAN products will increase in 2012.

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

Our products and services are sold worldwide to facilitate server and SAN storage implementations, primarily through OEMs, and supplemented by system integrators, or SIs, distributors and value added resellers, or VARs. Our storage system operating segment OEM partners currently include, among others, Hewlett-Packard, or HP, Sony Ericsson, or Ericsson, Motorola, Inc., or Motorola, General Dynamics Government Systems Corporation, or General Dynamics, Lockheed Martin Corporation, or Lockheed Martin, NEC Corporation, or NEC, Tektronix Inc., or Tektronix, Samsung Electronics, or Samsung, Stratus Technologies, or Stratus, Fujitsu Technology Solutions GmbH, or FTS, and Concurrent Computer Corporation, or Concurrent. Our standalone storage software operating segment OEM partners currently include, among others, Dell Inc., or

Table of Contents

Dell. Although our products and services are sold worldwide, the majority of our net revenue is derived from our U.S. operations. See Note 14 of the Notes to Consolidated Financial Statements for information regarding our operating segments and a breakout of our net revenue by geographical regions.

We began shipping products to HP in the fourth quarter of 2007. In January 2008, we amended our agreement with HP to allow for sales of additional products to additional divisions within HP. Our products are primarily sold as HP's MSA 2000/P2000 product family. Sales to HP increased significantly during 2008 and increased again in 2009 primarily as a result of the successful launch and market acceptance of the HP MSA 2000 products. HP launched its third generation product line, now called the P2000 product line, in February 2010. Sales to HP increased again in 2010 as we began selling our next generation host interfaces across the HP P2000 product line. The agreement with HP does not contain any minimum purchase commitments. In October 2011, we extended our supply agreement with HP by 5 years to expire in October 2016 and also extended the expiration of 1.6 million warrants granted to HP in March 2008 to expire concurrently with supply agreement in October 2016. Net revenue from HP approximated 73% of our total net revenue in 2011. We expect sales to HP to continue to represent a substantial percentage of our total net revenue in 2012.

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

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

- our ability to maintain and enhance relationships with our customers, in particular our OEM customers, as well as our ability to win new business;

- our ability to source critical components such as integrated circuits, hard disk drives, memory and other components on a timely basis;

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

- our ability to launch new products in accordance with OEM schedules and milestones;

- general economic and political conditions and specific conditions in the markets we address, including the continuing volatility in the technology sector, current general economic volatility and trends in the data storage markets in various geographic regions;

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

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

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

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

Our manufacturing strategy includes outsourcing substantially all of our manufacturing to third-party manufacturers in order to reduce sales cycle times and manufacturing infrastructure, enhance working capital and

Table of Contents

improve margins by taking advantage of the third parties' manufacturing and procurement economies of scale. In September 2008, we entered into a manufacturing agreement with Foxconn Technology Group, or Foxconn. Under the terms of the agreement, Foxconn supplies us with manufacturing, assembly and test services from its facilities in China and final integration services including final assembly, testing and configure-to-order services through its worldwide facilities. In November 2011 we amended our agreement with Foxconn to extend the manufacturing agreement for a period of three years. In addition, Foxconn agreed to waive the requirement for a letter of credit and improved our payment terms. Foxconn began manufacturing products for us in July 2009 and we began shipping products for general availability under the Foxconn agreement during the second half of 2009. The majority of our products sold in 2010 and 2011 were manufactured by Foxconn. We expect Foxconn to manufacture substantially all of our products in 2012.

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

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

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

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

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

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

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

On February 2, 2012, our Board of Directors approved the implementation of a restructuring and cost reduction plan, or the 2012 Plan, that will include severance and related costs, contractual obligations, administrative costs and long-lived asset impairments associated with the closure of our Israel Technology Development Center totaling \$4.7 to \$5.9 million. The 2012 Plan is designed to re-align our software investments to focus on accelerating the development of embedded software features, in order to launch a competitive set of mid-range storage array products in 2012, and to provide more differentiated entry-level products for both OEM and channel customers. The majority of the activities comprising the 2012 Plan are expected to be completed by the end of 2012. We expect to record severance costs in the range of \$1.2 to \$1.4 million, record contractual obligations in the range of \$1.2 to \$1.5 million, incur legal and other administrative costs in the range of \$0.2 to \$0.4 million and recognize long-lived asset impairments of approximately \$2.1 to \$2.6 million in connection with the 2012 Plan.

Table of Contents

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 of America. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenue and expenses in the reporting periods. We base our estimates on current facts, historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the accrual of costs and expenses that are not readily apparent from other sources. We evaluate these estimates on an ongoing basis. Actual results may differ from these estimates under different assumptions or conditions. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements. We have many accounting policies that require us to make estimates and assumptions; the determination of useful lives of long-lived assets, warranty reserves, accruals for estimated restructuring, tax and legal liabilities and valuation allowance for deferred tax assets. The items listed below are not inclusive of all of our accounting policies but is a listing, identified by management, of those policies which require the most significant judgments and estimates to be made in the preparation of the consolidated financial statements.

Revenue Recognition

We derive our revenue from sales of our hardware products, software and services.

Hardware

Hardware product revenue consists of revenue from sales of our AssuredSAN storage systems and our AssuredUVS appliance products that includes our AssuredUVS software which is integrated with industry standard hardware which is essential to the functionality of the integrated system product. We recognize hardware product revenue when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the price is fixed or determinable; and (iv) collectability is reasonably assured. Revenue is recognized for hardware product sales upon transfer of title and risk of loss to the customer and in addition, upon installation for certain of our AssuredUVS appliance products. We record reductions to revenue for estimated product returns and pricing adjustments in the same period that the related revenue is recorded. These estimates are based on historical sales returns, analysis of credit memo data and other factors known at the time. If actual future returns and pricing adjustments differ from past experience and our estimates, additional revenue reserves may be required.

Software

In accordance with the specific guidance for recognizing software revenue, where applicable, we recognize revenue from perpetual software licenses at the inception of the license term assuming all revenue recognition criteria have been met. We use the relative method to allocate revenue to software licenses at the inception of the license term when vendor-specific objective evidence, or VSOE, of fair value for all unspecified software updates and enhancements related to our products through service contracts. We have established vendor specific objective evidence, or VSOE, for the fair value of our support services as measured by the stated renewal prices paid by our customers when the services are sold separately on a standalone basis.

Table of Contents

Service

Our service revenue primarily includes out-of-warranty repairs and product maintenance contracts. Out-of warranty repairs primarily consist of product repair services performed by our contract manufacturers for those customers that allowed their original product warranty to expire without purchasing one of our higher level support service plans. Revenue from these out-of-warranty repairs, and the associated cost of sales, is recognized in the period these services are provided. Service revenue also consists of product maintenance contracts. Revenue from our product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 to 36 months. Net revenue derived from services was less than 10% of total revenue for all periods presented.

Revenue Recognition for Arrangements with Multiple Deliverables

For multi-element arrangements that include hardware products containing software essential to the hardware product's functionality, undelivered software elements that relate to the hardware product's essential software, and undelivered non-software services, we allocate revenue to all deliverables based on their relative selling prices. In such circumstances, we use a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (i) VSOE of fair value, (ii) third-party evidence of selling price, or TPE, and (iii) best estimate of the selling price, or ESP. VSOE generally exists only when we sell the deliverable separately and represents the actual price charged by us for that deliverable. ESPs reflect our best estimates of what the selling prices of elements would be if they were sold regularly on a standalone basis.

From time to time, we enter into arrangements with customers that include acceptance criteria. In such instances, we defer all revenue on the arrangement until customer acceptance is obtained or the acceptance clause lapses.

Revenue Recognition for Sales to Channel Partners

On sales to channel partners, we evaluate whether fees are considered fixed or determinable by considering a number of factors, including our ability to estimate returns, payment terms and our relationship and past history with the particular channel partner. If fees are not considered fixed or determinable at the time of sale to a channel partner, revenue recognition is deferred until there is persuasive evidence indicating the product has sold-through to an end-user. Persuasive evidence of sell-through may include reports from channel partners documenting sell-through activity or data indicating an order has shipped to an end-user.

Deferred Revenue

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

Valuation of Inventories

Inventories are comprised of finished goods and purchased parts and assemblies, which include direct labor and overhead, and are valued at the lower of cost (first-in, first-out method) or market value. The valuation of inventory requires us to estimate excess or obsolete inventory. The determination of excess or obsolete inventory

Table of Contents

requires us to estimate the future demand for our products. Because our markets are volatile, are subject to technological risks, price changes and inventory reduction programs by our customers, and as we are required to make last-time buys of certain components on occasion, there is a risk that we will forecast incorrectly and produce excess inventories of particular products or have commitments to purchase excess inventory components from our suppliers. As a result, actual demand will differ from forecasts, and such a difference has in the past and may in the future have a material adverse effect on our gross margin and our results of operations. Any write downs to inventory due to the existence of excess quantities, physical obsolescence, changes in pricing, damage, or other causes establish a new cost basis for the inventory. When we sell or dispose of reserved inventory the new cost basis is charged to cost of sales. The largest factor affecting the accuracy of our provisions for excess inventories is the accuracy of our production and service forecasts of end-customer demand. The accuracy of our estimates depends in part on the accuracy of the non-binding forecasts we get from our end customers, the accuracy of our own forecast of warranty requirements of our customers, the demand for storage systems in our market segments and the speed at which our products are designed in or out of our customers products.

Share-Based Compensation

We account for share-based compensation by measuring and recognizing share-based compensation expense for equity based awards granted, including stock options, restricted stock awards, performance-based restricted stock awards and employee stock purchase plan shares, 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 and employee stock purchase plan 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.

Compensation expense for restricted stock awards is measured based on the fair-value of the award on the grant date (fair-value is calculated based on the closing price of our common stock on the date of grant) multiplied by the number of shares granted, and is recognized as expense over the respective vesting period. Compensation expense for performance-based restricted stock awards is measured similarly to restricted stock, however, compensation expense is only recorded for awards that ultimately vest, which is contingent upon employees achieving various performance criteria.

We currently use the Black-Scholes option pricing model to estimate the fair value of our stock options and employee stock purchase plan shares. The fair values generated by the Black-Scholes model may not be indicative of the actual fair values of our stock options and employee stock purchase plan shares as it does not consider certain factors important to those awards to employees, such as continued employment and periodic vesting requirements as well as limited transferability. The determination of the fair value of share-based payment awards utilizing the Black-Scholes model is affected by our stock price and a number of assumptions, including expected volatility, expected life, risk-free interest rate and expected dividends. We use historical volatility of our stock for the expected life of the grant as the expected volatility assumption required in the Black-Scholes model. Our selection of the historical volatility approach is due to the limited availability of data regarding actively traded options on our stock. The expected life of the stock options is based on historical and other economic data trended into the future. The risk-free interest rate assumption is based on observed interest rates appropriate for the terms of our stock options and employee stock purchase plan shares. The dividend yield assumption is based on our history and expectation of dividend payouts. We evaluate the assumptions used to value stock options on a quarterly basis. If factors change and we employ different assumptions, share-based compensation expense may differ significantly from what we have recorded in the past. If there are any modifications or cancellations of the underlying unvested securities, we may be required to accelerate, increase or cancel any remaining unearned share-based compensation expense.

Table of Contents***Valuation of Goodwill***

We review goodwill for impairment on an annual basis at November 30 and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Our ITC reporting unit, which develops our AssuredUVS software, is a component of the Standalone Storage Software reporting segment identified in the notes to our consolidated financial statements. During September 2011, our primary AssuredUVS customer became delinquent on the settlement of its payables to us and upon our investigation it became evident that its financial resources were limited. It also informed us that they were changing their strategy which would result in a significant decline in our revenue, and we determined it was more-likely-than-not that the reporting unit was less than its carrying value.

Current accounting standards require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of our reporting unit to its carrying value. We determine the fair value of our reporting unit using a combination of the income approach and market capitalization approach. If the fair value of the reporting unit exceeds the carrying value of the net assets, goodwill is not impaired, and we are not required to perform further testing. If the carrying value of the net assets 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 the reporting unit's goodwill exceeds its implied fair value, then we must record an impairment charge equal to the difference.

Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future discounted cash flows. Under the market capitalization approach, valuation multiples are calculated based on operating data from publicly traded companies within our industry. Multiples derived from companies within our industry provide an indication of how much a knowledgeable investor in the marketplace would be willing to pay for a company. These multiples are applied to the operating data for the reporting unit to arrive at an indicated fair value. Significant management judgment is required in the forecasts of future operating results that are used in the estimated future discounted cash flow method of valuation. The estimates we have used are consistent with the plans and estimates that we use to manage our business. We base our fair value estimates on forecasted revenue and operating costs along with business plans. Our forecasts consider the effect of a number of factors including, but not limited to, the current future projected competitiveness and market acceptance of the product, technological risk, the ease of use and ease of implementation of the product, the likely outcome of sales and marketing efforts and projected costs associated with product development, customer support and selling, general and administrative costs. The assumptions and forecasts used were consistent with those used to evaluate certain of our long-lived assets for impairment at September 30, 2011 (see below). It is possible, however, that the plans may change and that actual results may differ significantly from our estimates. The valuation resulted in the recognition of an impairment charge to goodwill of \$4.1 million for the quarter ended September 30, 2011. No additional goodwill remains on the balance sheet of the Company as of December 31, 2011.

Valuation of Long-Lived Assets

Long-lived assets consist primarily of intangible assets with finite lives and property and equipment. We evaluate long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. We assess the recoverability of the assets based on the undiscounted future cash flows the assets are expected to generate and recognize an impairment loss when estimated undiscounted future cash flows expected to result from the use of the assets plus net proceeds expected from disposition of the assets, if any, are less than the carrying value of the assets. If an asset is deemed to be impaired, the amount of the impairment loss represents the excess of the asset's carrying value compared to its estimated fair value. Fair value estimates are based on assumptions concerning the amount and timing of estimated future cash flows and assumed discount rates, reflecting varying degrees of perceived risk.

Table of Contents

All long-lived assets identified with the Israel Technology Center, or ITC reporting unit are considered one asset group, and are included as a component of the Standalone Storage Software reportable segment. Recent events involving our ITC reporting unit resulted in a significant decline in actual and planned earnings.

As of September 30, 2011, we identified a change in circumstances that indicated the carrying amount of our long-lived assets may not be recoverable, as our primary AssuredUVS customer informed us that use of the AssuredUVS software would no longer be a component of its business strategy, which would result in a significant decline in revenues for the Company. Our long-lived assets consist of the intangible assets associated with our acquisition of certain identified Cloverleaf assets acquired in January 2010 with a carrying value of \$5.0 million and property and equipment of \$1.2 million.

Since we did not have an immediate replacement for our AssuredUVS customer, management's forecasted undiscounted cash flows indicated that the assets were potentially not recoverable, and proceeded to estimate the fair value of each long-lived asset. Property and equipment comprise mostly machinery and equipment used for testing and development of our AssuredUVS technology. Management determined that carrying value approximated fair value, as property was either acquired in the 2010 acquisition of Cloverleaf, has been purchased subsequently, or could be re-deployed, establishing recent evidence of fair value. It is depreciated over a 3 - 5 year estimated useful life.

Intangible assets consist primarily of acquired software of \$4.9 million and a trade name of \$0.1 million. We determined the fair value of the acquired software by estimating the replacement cost of the software, taking into account both the software as acquired and subsequent development work, as well as the business alternatives we were considering and the corresponding value of the software in these alternative approaches. We estimated the value of the software based on the probabilities of each of the business alternatives. We determined the fair value of the trade name using an income approach and considered the fact that the software's trade name at the time of acquisition was no longer being used. All estimates were based on management using appropriate assumptions and projections.

Our impairment analysis at September 30, 2011 identified \$2.9 million of impaired long-lived assets, consisting entirely of intangible assets recognized as part of the Cloverleaf acquisition in 2010. Long-lived asset impairment charges are recorded consistent with our treatment of related amortization expense specific to each acquired intangible assets. We recorded \$2.8 million of impaired acquired software and \$0.1 million of impaired acquired trade name as a component of cost of goods sold for the twelve months ended December 31, 2011. We are evaluating numerous alternatives to monetize the software asset including developing an appliance based on industry standard servers, developing storage bundles with our AssuredSAN products, developing and porting the software to be based on open source code such as Linux, integrating some of the AssuredUVS features into some of our AssuredSAN products and making substantial changes to the AssuredUVS operations.

In February 2012, the Board of Directors approved a plan to exit our AssuredUVS business and close down our Israel Technology Development Center. We evaluated the potential impact, if any, on our valuation of our acquired software and other long-lived assets maintained at our Israel Technology Development Center, and based on the facts and circumstances in existence at December 31, 2011, we believe the current valuations are appropriate. However, as a result of our decision in the 2012 fiscal year to shut down our AssuredUVS business, we will assess the recorded long-lived asset valuation for Israel Technology Development Center in the first quarter of 2012.

Table of Contents**Results of Operations**

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

	Years Ended December 31,		
	2009	2010	2011
Net revenue	100.0%	100%	100.0%
Cost of goods sold	83.9	83.0	78.9
Gross profit	16.1	17.0	21.1
Operating expenses:			
Research and development	12.0	12.5	18.0
Sales and marketing	4.7	4.8	7.0
General and administrative	4.3	3.9	4.7
Restructuring charge	1.0	0.9	0.3
Goodwill and long-lived asset impairment charge			2.1
Total operating expenses	22.0	22.1	32.1
Operating loss	(5.9)	(5.2)	(11.0)
Other income, net	0.1	0.0	0.0
Loss before income taxes	(5.8)	(5.2)	(11.0)
Income tax expense (benefit)	0.0	0.1	0.1
Net loss	(5.8)%	(5.2)%	(11.1)%

Year Ended December 31, 2010 Compared to Year Ended December 31, 2011*Net Revenue*

	2010	2011	(Decrease)	% Change
	(in thousands, except percentages)			
Net revenue	\$ 252,494	\$ 197,461	\$ (55,033)	(21.8)%

The decrease in net revenue for the year ended December 31, 2011 to \$197.5 million from \$252.5 million for the year ended December 31, 2010, was primarily due to the decision in the fourth quarter of 2010 to exit our low margin business with NetApp. Sales to NetApp totaled \$65.6 million for the year ended December 31, 2010 and totaled \$0 for the year ended December 31, 2011. A portion of the lost NetApp sales were replaced by sales to OEM partners other than HP which grew to \$44.8 million for the year ended December 31, 2011 from \$36.7 million for the year ended December 31, 2010. Without NetApp sales in 2010, our net revenue would have increased 6% in 2011 over 2010.

Sales to HP remained flat year-over-year totaling \$144.9 million for the year ended December 31, 2011 and \$144.7 million for the year ended December 31, 2010 due largely to the shortage of hard disk drives in the fourth quarter of 2011 as well as HP inventory optimization initiatives. Sales to HP are due to the successful launch and market acceptance of the HP MSA 2000 products, which includes our Series 2000 products and the launch by HP of its third generation product line, now called the P2000 product line, in February 2010, which includes our Series 3000 products. Although our Series 2000 products are in the decline phase of the product life cycle, demand for these products continues to be significant. We released our next generation Series 3000 products in the first quarter of 2010 and sales of these products have increased significantly during each quarter of 2010 and remained consistent throughout 2011. We expect sales to HP to continue to represent a substantial portion of our net revenue in 2012.

Table of Contents*Cost of Goods Sold and Gross Profit*

	2010	% of Net Revenue	2011	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Cost of goods sold	\$ 209,664	83.0%	\$ 155,828	78.9%	\$ (53,836)	(25.7)%
Gross profit	\$ 42,830	17.0%	\$ 41,633	21.1%	\$ (1,197)	(2.8)%

Cost of goods sold decreased for the year ended December 31, 2011 compared to the year ended December 31, 2010 primarily as a result of the decrease in sales. Cost of goods sold as a percentage of revenue decreased from 83.0% for the year-ended December 31, 2010 to 78.9% for the year-ended December 31, 2011.

Gross profit margin for the year ended December 31, 2011 was 21.1% compared to 17.0% for the year ended December 31, 2010. The increase in gross profit margin was primarily due to exiting the low-margin NetApp business, the growth in Channel and non-HP OEM sales, internal cost reduction initiatives and decreases in manufacturing support costs and manufacturing variances. These decreases were partially offset by the cost of goods sold associated with the increase in sales to other OEM customers and the recognition of impairment charges relating to certain of our long-lived assets held at our ITC reporting unit.

Partially offsetting the increase in gross profit margin were higher warranty related expenses of \$5.6 million for the year ended December 31, 2011 compared to the same period in 2010. Warranty related expenses increased primarily as a result of quality issues associated with certain power supply devices provided by one of our component suppliers that required us to make substantial repairs and provide replacement parts. .

Our gross profit margin is typically sensitive to product and customer mix changes. For example, our gross profit margin on sales of the products we sell to HP is higher than the gross profit margin on the products we previously sold to NetApp. In addition, sales of our software products and services typically have a much higher gross profit margin than that of our hardware products. Also, sales to our channel customers typically have a higher gross profit margin than sales to our Tier 1 OEM customers. For the year ended December 31, 2011, we generated a higher percentage of our net revenue from our channel customers, non-HP OEM s and from sales of software and services, which had a favorable impact on our gross profit margin. We expect that our cost of sales will decrease and our gross profit margin will increase in 2012 as a result of expected increases in sales from our channel customers and from sales of services. We also expect that the mix of products we sell, in particular, the products we sell to HP, will continue to affect, and likely increase, our cost of goods sold and gross profit margin.

Research and Development Expenses

	2010	% of Net Revenue	2011	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Research and development expenses	\$ 31,578	12.5%	\$ 35,551	18.0%	\$ 3,973	12.6%

Research and development expense increased \$4.0 million to \$35.6 million for the year ended December 31, 2011 compared to \$31.6 million for the year ended December 31, 2010. This increase was primarily due to a net increase in salaries and payroll related expenses of \$1.3 million, a net increase in stock compensation expenses of \$1.2, an increase in engineering materials of \$0.5, a net increase in depreciation expense of \$0.5 million, an increase in consulting costs of \$0.3 million and an increase in software and maintenance charges of \$0.2 million.

The increase in salary and payroll related expenses is primarily a result of the additional employees engaged in research and development activities associated with the development of next generation entry level products and a mid-range product line, as well as additional investments in our AssuredUVS business. The increase in

Table of Contents

stock compensation expenses is due to a large portion of stock awards vesting in early 2011 when the stock price was elevated compared with the prior year. The increase in engineering materials is largely the result of the timing of our engineering material purchases in conjunction with the release of our next generation of products anticipated for 2012. Consulting costs increased largely as a result of certain engineering functions being performed by consultants in India and an increase in the use of domestic engineering consultants to assist with certain strategic development projects. The increase in depreciation expense was primarily the result of the additional equipment acquired in the Cloverleaf acquisition and also due to additional capital expenditures for our Longmont engineering labs.

	2010	% of Net Revenue	2011	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Sales and marketing expenses	\$ 12,164	4.8%	\$ 13,876	7.0%	\$ 1,712	14.1%

Sales and marketing expense increased \$1.7 million to \$13.9 million for the year ended December 31, 2011 compared to \$12.2 million for the year ended December 31, 2010. This increase was primarily due to an increase in commissions and bonuses of \$0.6 million, a net increase in stock compensation expenses of \$0.2 million, a net increase in salaries and payroll-related expenses of \$0.3 million, an increase in bank fees of \$0.3 million, an increase in travel expenses of \$0.2 million, and other miscellaneous net increases of \$0.4 million. These increases were partially offset by a decrease in customer-related evaluation product expenses of \$0.3 million.

The increase in commissions and bonuses is due to better performance against sales goals. The net increase in stock compensation expenses is due to a new stock bonus plan in 2011 and an overall increase in awards. The net increase in salary and payroll related expenses is primarily a result of additional employees engaged in sales and marketing activities as a result of an increase in the number of sales territories we support and the continued expansion of our channel program. The increase in travel expenses was primarily the result of an increase in sales team employees and customer visits. The increase in bank fees is for credit card merchant fees assessed for one customer that pays by credit card. The decrease in customer-related evaluation product expenses is due to new product releases in 2010, including those products acquired in the Cloverleaf acquisition which were less significant in 2011.

General and Administrative Expenses

	2010	% of Net Revenue	2011	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
General and administrative expenses	\$ 9,928	3.9%	\$ 9,268	4.7%	\$ (660)	(6.6)%

General and administrative expenses decreased \$0.7 million to \$9.3 million for the year ended December 31, 2011 compared to \$9.9 million for the year ended December 31, 2010. This decrease was primarily attributable to a decrease in salary and payroll related expenses of \$0.5 million, a reduction in consulting fees of \$0.5 million, a net reduction in car lease and other miscellaneous expenses of \$0.4 million and a reduction in accounting, legal and advisory fees of \$0.2 million. These decreases were partially offset by an increase in stock compensation related expenses of \$0.7 million and an increase in bad debt expenses of \$0.2 million.

The change in accounting, legal and advisory fees was primarily the result of negotiating lower fees with our service providers. The reduction in salary and payroll related expenses primarily was attributable to a reduction in salaries mandated by executive management that were in effect for part of 2010 and for all of 2011. Consulting fees were elevated in 2010 compared with 2011 as the company made the conscious decision in 2010 to hire temporary labor instead of full-time employees anticipating the move from Carlsbad, California to Longmont, Colorado.

Table of Contents*Restructuring*

	2010	% of Net Revenue	2011	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Restructuring	\$ 2,196	0.9%	\$ 668	0.3%	\$ (1,528)	(69.6)%

In December 2008, our management approved, committed to, and initiated a restructuring plan, or the 2008 Plan, to improve efficiencies in our operations, which was largely driven by our plan to consolidate our facility in Carlsbad, California into the Longmont, Colorado facility.

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan included severance and related costs for the reduction of approximately 10% of our workforce, and fees associated with the acceleration of the closure of our Carlsbad, California facility. For the year ended December 31, 2010, we incurred severance and related costs of \$0.6 million related to both our 2008 Plan and 2010 Plan. We also incurred contract termination costs of \$1.5 million for the year ended December 31, 2010 primarily for facility lease and other associated costs that we continued to incur without economic benefit and due to revisions to our assumptions regarding the timing and amount of tenant sublease income under both our 2008 Plan and 2010 Plan.

We also incurred additional severance-related restructuring charges of approximately \$0.1 million in 2010 related to the termination of a former employee of Cloverleaf. All of the severance-related costs were paid to this employee in 2010.

The \$0.7 million restructuring expense for the year ended December 31, 2011 is primarily related to management's determination that sublease rental income anticipated on the Carlsbad, California facility would not materialize, and the associated write-off of that expected rental income.

See Note 6 of Notes to Consolidated Financial Statements for more details regarding our restructuring activities.

Goodwill impairment charge

	2010		2011		Increase	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Goodwill impairment charge	\$	%	\$ 4,140	2.1%	\$ 4,140	100%

A decline in our ITC reporting unit's AssuredUVS customer base resulted in a significant decline in actual and planned earnings and we determined it was more-likely-than-not that the ITC reporting unit was worth less than its carrying value. As a result we tested goodwill related to our ITC reporting unit for impairment as of September 30, 2011, and determined that the carrying value of goodwill was impaired. We performed the second step of the goodwill impairment test to measure the amount of the impairment resulting in the recognition of an impairment to goodwill of \$4.1 million for the year-ended December 31, 2011.

Other Income, net

	2010	% of Net Revenue	2011	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Other income/(expense), net	\$ (2)	0.0%	\$ (25)	0.0%	\$ (23)	1,150%

Table of Contents

The decrease in other income, net for the year ended December 31, 2011 is primarily attributable to an increase in interest expense related to the amortization of financing fees for amending our credit agreement with Silicon Valley Bank in February, 2011.

Income Taxes

We recorded an income tax provision of \$0.1 million for the year ended December 31, 2011 and an income tax provision of \$0.2 million for the year ended December 31, 2010. The provision for income taxes in both years primarily represents state, local and foreign taxes.

Year Ended December 31, 2009 Compared to Year Ended December 31, 2010*Net Revenue*

	2009	2010	Increase	% Change
	(in thousands, except percentages)			
Net Revenue	\$ 234,383	\$ 252,494	\$ 18,111	7.7%

The increase in net revenue for the year ended December 31, 2010 was primarily due to an increase in sales to HP. Sales to HP totaled \$144.7 million for the year ended December 31, 2010 compared to \$120.5 million for the for the year ended December 31, 2009. The increase in HP net revenue is due to the successful launch and market acceptance of the HP MSA 2000 products, which includes our Series 2000 products and the launch by HP of its third generation product line, now called the P2000 product line, in February 2010, which includes our Series 3000 products. Although our Series 2000 products are in the decline phase of the product life cycle, demand for these products continues to be significant. We released our next generation Series 3000 products in the first quarter of 2010 and sales of these products have increased significantly during each quarter of 2010.

In addition, sales to NetApp increased during the year ended December 31, 2010 compared to the year ended December 31, 2009 based on the success of NetApp's FAS 2000 product line. Sales to NetApp totaled \$65.6 million for the year ended December 31, 2010 compared to \$58.0 million for the year ended December 31, 2009. However, under our agreement with NetApp, NetApp had the right to manufacture and sell, on a royalty and royalty-free basis, up to certain specified percentages of the products we previously manufactured and sold to NetApp. In the fourth quarter of 2010, we decided to exit our low margin business with NetApp and amended our agreement with NetApp to allow NetApp to manufacture and sell on a royalty-free basis all of the products we previously manufactured and sold to NetApp beginning on or about December 1, 2010.

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

We also experienced an increase in net revenue of approximately \$7.4 million for the year ended December 31, 2010 compared to the year ended December 31, 2009 as a result of the launch of our channel program in October of 2009, sales of our AssuredUVS products, which are based on the technology acquired as part of the Cloverleaf acquisition in January 2010 and increased sales of our AssuredVRA products as we renegotiated our contract with a major OEM customer in 2010.

These increases were partially offset by a decrease in net revenue from Oracle, FTS, Sepaton and other smaller customers. Oracle sales decreased to \$0.5 million for the year ended December 31, 2010 compared to \$10.3 million for the year ended December 31, 2009. The decline in Oracle net revenue is due to the products we sell to Oracle reaching the end of their product life cycle. FTS sales decreased to \$2.8 million for the year ended December 31, 2010 compared to \$11.4 million for the year ended December 31, 2009. The decrease in net

Table of Contents

revenue from FTS is due to FTS's decision to internally source the product we sell to FTS. In addition, we also experienced a decline in sales to Sepaton of approximately \$2.4 million as a result of Sepaton buying their storage requirements from another source. We also experienced a net decline in sales to other smaller customers of approximately \$0.3 million.

Cost of Goods Sold and Gross Profit

	2009	% of Net Revenue	2010	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Cost of Goods Sold	\$ 196,556	83.9%	\$ 209,664	83.0%	\$ 13,108	6.7%
Gross Profit	\$ 37,827	16.1%	\$ 42,830	17.0%	\$ 5,003	13.2%

Cost of goods sold increased for the year ended December 31, 2010 compared to the year ended December 31, 2009 primarily as a result of an increase in sales. Cost of goods sold as a percentage of revenue decreased from 83.9% for the year-ended December 31, 2009 to 83.0% for the year-ended December 31, 2010.

Gross profit margin for the year ended December 31, 2010 was 17.0% compared to 16.1% for the year ended December 31, 2009. The increase in gross profit margin was primarily due to the continued success of our product cost reduction and value engineering initiatives over the past few years which has significantly reduced our costs for both our Series 2000 and 3000 products that we sell to HP and other customers. In addition, we incurred lower excess and obsolete inventory and scrap charges as a result of various product end of life issues experienced in 2009 and improved inventory management practices in 2010. We were also able to negotiate early payment and volume discounts in 2010, which resulted in lower costs and a higher gross profit margin. We also incurred fewer inventory holding charges as we were able to more efficiently manage inventories being held by our contract manufacturing partners and experienced a decrease in manufacturing overhead costs primarily as a result of our 2010 restructuring activities.

Partially offsetting the increase in gross profit margin were higher amortization expense, warranty related expenses and freight costs for the year ended December 31, 2010 compared to the same period in 2009. Warranty related expenses increased as a result of a higher volume of quality related warranty claims, as we experienced component failure issues with certain of our battery and hard disk drive suppliers, as well as firmware failures within one of our products. Additionally, freight costs increased as a result of the increase in revenue and overall shipment volume as well as from expedite charges. Amortization expense increased due to the inclusion of Ciprico amortization in cost of goods sold as a result of the acquired products now generating revenue, as well as additional amortization resulting from the Cloverleaf acquisition. Prior to 2010, Ciprico amortization was included in research and development expense.

Our gross profit margin is typically sensitive to product and customer mix changes. For example, our gross profit margin on sales of the products we sell to HP is higher than the gross profit margin on the products we previously sold to NetApp. Conversely, the gross profit margin on sales of the products we previously sold to Oracle is higher than that of the products we currently sell to HP. In addition, sales of our software products and services typically have a much higher gross profit margin than that of our hardware products. Also, sales to our channel customers and non-HP OEM customers typically have a higher gross profit margin than sales to HP. For the year ended December 31, 2010, we generated a lower percentage of our net revenue from Oracle, which had an unfavorable impact on our gross profit margin. However, we generated a higher percentage of our net revenue from our channel customers and from sales of software and services, which had a favorable impact on our gross profit margin. We expected that our cost of sales will decrease and our gross profit margin will increase in 2011 as a result of exiting our relationship with NetApp and as a result of expected increases in sales from our channel customers and from sales of software and services. We also expected that the mix of products we sell, in particular, the products we sell to HP, will continue to affect our cost of goods sold and gross profit margin.

Table of Contents*Research and Development Expenses*

	2009	% of Net Revenue	2010 (in thousands, except percentages)	% of Net Revenue	Increase	% Change
Research and Development Expenses	\$ 28,120	12.0%	\$ 31,578	12.5%	\$ 3,458	12.3%

Research and development expense increased \$3.5 million to \$31.6 million for the year ended December 31, 2010 compared to \$28.1 million for the year ended December 31, 2009. This increase was primarily due to an increase in salaries and payroll related expenses of \$2.7 million, an increase in consulting costs of \$1.1 million, an increase in depreciation expense of \$0.4 million, and increases in various other items such as facilities and common expenses and travel, which approximated \$0.1 million. In addition, in 2009 and 2010, we determined it was probable that the amount of contingent consideration due to Ciprico would be lower based on lower actual and projected sales of products eligible for the contingent consideration through the end of the contingent consideration period. Accordingly, we reduced the contingent consideration liability and research and development expense in the statement of operations to reflect the reduction in estimated contingent consideration liability. The reduction to research and development expense approximated \$0.1 million for the year ended December 31, 2010 and \$0.6 million for the year ended December 31, 2009, or a change of \$0.5 million. These increases were partially offset by a decrease in Ciprico intangible asset amortization expense of \$1.1 million and a decrease in engineering materials expense of \$0.2 million.

The increase in salary and payroll related expenses is primarily a result of the additional employees engaged in research and development activities associated with the Cloverleaf acquisition. Consulting costs increased largely as a result of certain engineering functions being performed by consultants in India and an increase in the use of domestic engineering consultants to assist with certain strategic development projects. The increase in depreciation expense was primarily the result of the additional equipment acquired in the Cloverleaf acquisition and also due to additional capital expenditures for our Longmont engineering labs.

Ciprico intangible asset amortization expense decreased as the related AssuredVRA product is now generating revenue and therefore the amortization is included in cost of sales. The decrease in engineering materials expense is largely the result of the timing of our engineering material purchases in conjunction with the release of our next generation series 3000 products, which occurred in the first quarter of 2010.

Sales and Marketing Expenses

	2009	% of Net Revenue	2010 (in thousands, except percentages)	% of Net Revenue	Increase	% Change
Sales and Marketing Expenses	\$ 10,970	4.7%	\$ 12,164	4.8%	\$ 1,194	10.9%

Sales and marketing expense increased \$1.2 million to \$12.2 million for the year ended December 31, 2010 compared to \$11.0 million for the year ended December 31, 2009. This increase was primarily due to an increase in customer-related evaluation product expenses of \$0.5 million, an increase in marketing research, public relations and promotional expenses of \$0.5 million, an increase in salaries and payroll related expenses of \$0.3 million, and an increase in travel expenses of \$0.1 million. These increases were partially offset by decreases in facilities and common costs of \$0.2 million as a result of our 2010 restructuring activities.

The increase in customer-related evaluation product expenses is due to new product releases in 2010, including those products acquired in the Cloverleaf acquisition. The increase in marketing research, public relations and promotional costs is primarily the result of various marketing and branding activities in 2010 for our new products and the continued expansion of our channel programs. The increase in salary and payroll related expenses is primarily a result of additional employees engaged in sales and marketing activities as a result of an increase in the number of sales territories we support and the continued expansion of our channel program. The increase in travel expenses was primarily the result of an increase in customer visits.

Table of Contents*General and Administrative Expenses*

	2009	% of Net Revenue	2010	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
General and Administrative Expenses	\$ 10,139	4.3%	\$ 9,928	3.9%	\$ (211)	(2.1)%

General and administrative expenses decreased \$0.2 million to \$9.9 million for the year ended December 31, 2010 compared to \$10.1 million for the year ended December 31, 2009. This decrease was primarily attributable to a reduction in legal fees of \$0.4 million, changes in foreign currency gains and losses of \$0.3 million, a reduction in Sarbanes-Oxley fees of \$0.3 million and a reduction in board of director fees of \$0.2 million. These decreases were partially offset by an increase in salaries and payroll related expenses of \$0.8 million and an increase in travel expenses of \$0.2 million.

The change in foreign currency gains and losses were primarily the result of changes in the value of the Euro and British pound in relation to the United States dollar. The reduction in legal fees was primarily the result of lower fees associated with litigation matters as certain claims against us were dismissed in the first quarter of 2010. The reduction in Sarbanes-Oxley fees were primarily the result of negotiating lower fees with our service provider. Board of director fees decreased as a result of a reduction in the number of members of our Board of Directors.

Salaries and payroll related expenses and travel expenses increased primarily as a result of our transition of certain of our administrative functions to Longmont, Colorado from Carlsbad, California in 2010, including the costs of duplicative personnel.

Restructuring Charge

	2009	% of Net Revenue	2010	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Restructuring Charge	\$ 2,430	1.0%	\$ 2,196	0.9%	\$ (234)	(9.6)%

In December 2008, our management approved, committed to, and initiated a restructuring plan, or the 2008 Plan, to improve efficiencies in our operations, which was largely driven by our plan to consolidate our facility in Carlsbad, California into the Longmont, Colorado facility. For the year ended December 31, 2009, we incurred severance and related costs of \$1.0 million for various California employees whose positions have been relocated to Colorado. As part of the 2008 Plan, we also incurred contract termination costs of \$1.4 million for the year ended December 31, 2009 primarily for facility lease and other associated costs that we continued to incur without economic benefit and due to revisions to our assumptions regarding the timing and amount of tenant sublease income.

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan included severance and related costs for the reduction of approximately 10% of our workforce, and fees associated with the acceleration of the closure of our Carlsbad, California facility. For the year ended December 31, 2010, we incurred severance and related costs of \$0.6 million related to both our 2008 Plan and 2010 Plan. We also incurred contract termination costs of \$1.5 million for the year ended December 31, 2010 primarily for facility lease and other associated costs that we continued to incur without economic benefit and due to revisions to our assumptions regarding the timing and amount of tenant sublease income under both our 2008 Plan and 2010 Plan.

We also incurred additional severance-related restructuring charges of approximately \$0.1 million in 2010 related to the termination of a former employee of Cloverleaf. All of the severance-related costs were paid to this employee in 2010.

Table of Contents

See Note 6 of Notes to Consolidated Financial Statements for more details regarding our restructuring activities.

Other Income

	2009	% of Net Revenue	2010 (in thousands, except percentages)	% of Net Revenue	(Decrease)	% Change
Other Income, net	\$ 167	0.1%	\$ (2)	0.0%	\$ (169)	(101.2)%

The decrease in other income, net for the year ended December 31, 2010 is primarily attributable to a decrease in interest income primarily due to declining interest rates and lower cash balances.

Income Taxes

We recorded an income tax provision of \$0.2 million for the year ended December 31, 2010 compared to an income tax benefit of \$0.1 million for the year ended December 31, 2009. The 2010 provision for income taxes primarily represents state, local and foreign taxes. The 2009 benefit from income taxes primarily represents federal tax credits, partially offset by state, local and foreign income taxes. The federal tax credits available to us for the year ended December 31, 2009 were not available in 2010.

Liquidity and Capital Resources

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

As of December 31, 2011, we had \$46.2 million of cash and cash equivalents and \$41.4 million of working capital compared to \$45.7 million of cash and cash equivalents and \$49.9 million of working capital as of December 31, 2010. Cash equivalents include highly liquid investments purchased with an original maturity of 90 days or less and consist principally of money market funds. In addition, we had \$0.1 million in short-term debt at December 31, 2011, consisting of a note payable issued in connection with the acquisition of certain intangible assets from Ciprico.

As of December 31, 2011, \$5.9 million of the \$46.2 million of cash, cash equivalents, and marketable securities was held by our foreign subsidiaries. If these funds are needed for our operations in the U.S., we would be required to accrue and pay U.S. taxes to repatriate these funds. However, our intent is to permanently reinvest these funds outside of the U.S. and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

Operating Activities

Net cash provided by operating activities for the year ended December 31, 2011 was \$2.2 million compared to \$9.1 million of cash used in operating activities for the year ended December 31, 2010. The operating activities that affected cash consisted primarily of a net loss which totaled \$22.0 million for the year ended December 31, 2011 compared to \$13.3 million for the year ended December 31, 2010. The increase in our net loss was significantly attributable to asset impairment charges totaling \$7.1 million taken in 2011.

Table of Contents

The adjustments to reconcile net loss to net cash used in operating activities for the year ended December 31, 2011 that did not affect cash consisted of depreciation and amortization of \$4.8 million, stock-based compensation expense of \$5.4 million, goodwill and long-lived asset impairment charges of \$7.1 million, issuance of warrants of \$1.0 million and a bad debt charge of \$0.2 million. Cash flows from operations reflects the positive impact of \$3.3 million related to a decrease in accounts receivable, which was primarily due to a decrease in net revenue in 2011. However, this was offset somewhat by an increase in our days sales outstanding which increased to 62 days for the three-months ended December 31, 2011 compared with 49 days for the three months ended December 31, 2010 primarily due to the timing of intra-quarter sales. Cash flows from operations also reflects the positive impact of \$2.1 million related to an overall decrease in inventories at December 31, 2011, as a larger portion of our inventory in 2011 was purchased directly from vendors by our contract manufacturers as opposed to in 2010 where we more often acted as a middleman in these transactions.

An additional source of cash flows from operations is \$6.2 million related to an increase in accrued compensation and other expenses which was the result of a \$5.5 million increase in contingent liabilities related to the recognition of potential payouts on the issue of the power supply failures, an increase of \$0.8 million in accrued management bonuses as a result of management attaining certain bonus criteria, a \$0.3 increase in accrued commissions and bonuses as a result of the sales force attaining certain of its goals, and an offsetting \$0.4 net decrease in miscellaneous accrued accounts. Cash flows from operations include uses of cash of \$4.3 million related to an increase in prepaid expenses and other assets due to \$1.2 million of asset recovery, the timing of other receivables from our contract manufacturing partners for component parts we buy and ship to them and also due to the timing of payments for various miscellaneous receivables. In addition, cash flows from operations include uses of cash of \$0.6 million of other long-term liabilities primarily related to payments of deferred rent, \$0.5 million of deferred revenues and \$0.3 million in restructuring payments.

Investing Activities

Cash used in investing activities for the year ended December 31, 2011 was approximately \$2.5 million compared to \$2.1 million for the year ended December 31, 2010. Cash used in investing activities for the year ended December 31, 2011 was due primarily to the continuous expansion of our laboratories associated with the development of new products.

Financing Activities

Cash provided by financing activities for the year ended December 31, 2011 was \$0.6 million compared to cash used in financing activities of \$0.7 million for the year ended December 31, 2010. Cash provided by financing activities for the year ended December 31, 2011 is attributable to \$1.0 million of proceeds from the sale of stock to employees under our employee stock plans, offset by \$0.4 million for the ongoing pay-down of our note payable associated with our 2008 acquisition of certain intangible assets from Ciprico.

Based on current macro-economic conditions and conditions in the state of the data storage systems markets, our own organizational structure and our current outlook for 2012, we presently expect our cash and cash equivalents will be sufficient to fund our operations, working capital and capital requirements for at least the next 12 months.

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

Table of Contents

In October 2009, we discovered a quality issue associated with certain power supply devices provided by a long-term component supplier, which resulted in a higher than expected level of power supply failures to us and our customers. While we were able to promptly identify and resolve the cause of the failures, we are required to provide replacement products or make repairs to the affected power supply units that had been sold between March and October 2009. Through June 30, 2011, our component supplier had repaired all of the faulty power supplies at no cost to us, and reimbursed us for our out-of-pocket costs which has constituted a reimbursement to customers for certain out-of-pocket costs they incurred in connection with these power supply failures. The total amount reimbursed to us by our component supplier approximated \$1.0 million through June 30, 2011.

During the third and fourth quarters of 2011 and into the first quarter of 2012, we entered negotiations for a settlement with a material customer. Based on our current expectation of how any such additional product quality claims will ultimately be settled, we believe that we will probably incur a liability of \$5.5 million. Consequently, we recorded an additional liability of \$2.7 million on our consolidated balance sheet as of December 31, 2011 to increase this liability to \$5.5 million. In addition to we have agreed to extend the original three year warranty on the affected power supplies to six years.

In addition, we entered into negotiations with our component supplier during the third and fourth quarters of 2011 and into the first quarter of 2012, to attempt to recover any losses not previously reimbursed relating to the failed power supply units. In February 2012, we signed a non-binding letter of intent with our component supplier whereby we expect to receive \$0.6 million upon signing of the final settlement agreement and a \$0.6 million note receivable to be paid out in four, equal installments commencing three months after signing the final settlement agreement, regardless of future purchases from this supplier. In addition, this supplier will extend the warranty on the impacted power supplies from three years to six years and we will be eligible to receive incremental product discounts which are not reasonably estimable. We have increased the previously recorded current asset of \$0.5 million within Prepaid expenses and other assets to \$1.2 million as of December 31, 2011.

Furthermore, we have commenced discussions with our General Liability and Errors and Omissions Insurance and underwriters and will continue to pursue our rights to cover any damages we incur and not reimbursed by our supplier. The insurance company has issued a reservation of rights letter to us and at this time it is not possible to estimate to what extent, if any, will be covered by our carrier. As of December 31, 2011, we have not assumed or recorded any insurance reimbursement.

To the extent that we are unsuccessful in negotiating settlement agreements with our customer and our component supplier on mutually beneficial terms, or our component supplier does not continue to reimburse us for the expenses incurred by us or our customers, and we are unsuccessful in recovering such expenses from our insurance provider, we could incur additional expenses which could potentially have a material effect on our financial statements.

Recently, the hard disk drive component supply chain has been significantly disrupted as a result of severe flooding in Thailand. In addition, some disk drive manufacturers have substantial manufacturing facilities in Thailand that have been closed down due to flooding. It is estimated that over 30% of the worldwide production of hard disk drives or critical component occurs in Thailand. While over 75% of our revenue typically comes from customers who purchase our AssuredSAN products on a drive-less basis, hard disk drives are a critical component in our AssuredSAN storage array products and can represent 30-70% of the cost of such products. Given the severity of the situation and the potential for extensive hard disk drive shortages for us and our customers, we believe the effects on our business and the data storage industry are likely to be substantial and could extend over multiple quarters.

We will make every effort to secure and hold inventory of hard disk drives to incorporate into our products. Any purchase of hard drives beyond our immediate requirements, will likely result in increased inventory and a use of cash, but we expect any increase in hard drive inventory holdings to be consumed through our normal sales to customers over the near term. Given that approximately only one quarter of revenue are

Table of Contents

dependent on hard disk drive supplies, and given our current cash balances and the availability of additional working capital through Silicon Valley Bank, we do not believe we would be constrained in our ability to secure hard disk drives.

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

We maintain a credit facility with Silicon Valley Bank for cash advances and letters of credit of up to an aggregate of \$30 million based upon an advance rate of 85% of eligible accounts receivable. In February 2011, we amended our credit agreement with Silicon Valley Bank. The amendment extends the maturity date to July 21, 2013, revises the definition of eligible accounts receivable to be less restrictive and also revises the definition of net worth to add stock-based compensation expense, goodwill and long-lived asset impairment charges, subject to certain limitations. Borrowings under the credit facility bear interest at the prime rate and are secured by substantially all of our accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on our inventory and intellectual property, subject to certain exceptions, and contains usual and customary covenants for an arrangement of its type, including an obligation that we maintain at all times a net worth, as defined in the agreement, of \$50 million (subject to certain increases). The agreement also includes provisions to increase the financing facility by \$20 million subject to our meeting certain requirements, including \$40 million in borrowing base for the immediately preceding 90 days, and Silicon Valley Bank locating a lender willing to finance the additional facility. In addition, if our cash and cash equivalents net of the total amount outstanding under the credit facility fall below \$20 million (measured on a rolling three-month basis), the interest rate will increase to prime plus 1% and additional restrictions will apply. Our credit facility also provides for a cash management services sublimit under the revolving credit line of up to \$300,000. As of December 31, 2010 we had an outstanding letter of credit issued to our contract manufacturer in China in the amount of \$5.0 million. As of December 31, 2011, we are no longer required to carry this letter of credit.

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

The following table summarizes our contractual obligations as of December 31, 2011 (in thousands).

Contractual Obligations	Total	2012	2013	2014	Thereafter
Operating lease obligations	\$ 2,861	\$ 2,196	\$ 665	\$	\$
Inventory related purchase obligations	18,487	18,487			
Other purchase obligations	1,654	1,654			
Note payable	71	71			
Total	\$ 23,073	\$ 22,408	\$ 665	\$	\$

We lease office space, equipment and automobiles under non-cancelable operating leases, which expire at various dates through June 2013. For purposes of the table above, the operating lease obligations exclude common area maintenance, real estate taxes and insurance expenses.

Inventory related purchase obligations represent contractual purchase commitments to our suppliers for certain components in order to ensure supply of select key components at the most favorable pricing.

Other purchase obligations represent purchase commitments made in the ordinary course of business.

Table of Contents

In addition to the amounts shown in the table above, \$0.2 million of unrecognized tax benefits have been recorded as liabilities in accordance with FASB Interpretation 48, and we are uncertain as to if or when such amounts may be settled.

Off-Balance Sheet Arrangements

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

We enter into indemnification agreements with third parties in the ordinary course of business that generally require us to reimburse losses suffered by the third party due to various events, such as lawsuits arising from patent or copyright infringement. These indemnification obligations are considered off-balance sheet arrangements under accounting guidance. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Such indemnification agreements may not be subject to maximum loss clauses. Historically, we have not incurred material costs as a result of obligations under these agreements.

Recent Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) No. 2011-05, *Comprehensive Income (ASC Topic 220) Presentation of Comprehensive Income*. The ASU requires companies to report comprehensive income, including items of other comprehensive income, for all periods presented in a single continuous financial statement in the Consolidated Statements of Operations or split between the Consolidated Statements of Operations and a separate Consolidated Statements of Other Comprehensive Income. The ASU is effective for our first quarter of fiscal year 2012. Other than requiring additional disclosures, the adoption of this new guidance will not have a material impact on our consolidated financial statements. In addition, in December 2011, the FASB issued Accounting Standards Update 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU 2011-05* (ASU 2011-12). ASU 2011-12 defers the specific requirement within ASU 2011-05 to present on the face of the financial statements items that are reclassified from accumulated other comprehensive income to net income separately with their respective components of net income and other comprehensive income. The effective dates for ASU 2011-12 are consistent with the effective dates for ASU 2011-05 and, similar to our evaluation for the adoption of ASU 2011-05, the adoption of this guidance does not have a material effect on our consolidated financial statements.

Item 7A. *Quantitative and Qualitative Disclosures About Market Risk* Interest Rate Risk

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

Table of Contents

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

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

Foreign Currency Exchange Rate Risk

We conduct a portion of our business in currencies other than the U.S. dollar, the currency in which our consolidated financial statements are reported. The most significant foreign currencies that subjected us to foreign currency exchange rate risk for the year ended December 31, 2011 were the Euro, British Pound, Japanese Yen and the Israeli New Shekel. Correspondingly, our operating results could be adversely affected by foreign currency exchange rate volatility relative to the U.S. dollar. Although we continue to evaluate strategies to mitigate risks related to the effect of fluctuations in currency exchange rates, we will likely continue to recognize gains or losses from international transactions and foreign currency changes. Although foreign currency transaction gains and losses have not historically been material, we incurred 0.3 million in foreign currency transaction gains during the year ended December 31, 2011, primarily resulting from the remeasurement process of certain of our European subsidiaries that maintain their books of record in a currency other than the functional currency. Future changes in foreign currency rates could adversely impact our operating results. A 10% unfavorable change in exchange rates would result in foreign currency losses of approximately \$4.2 million.

Item 8. Financial Statements and Supplementary Data

The information required by this Item is incorporated by reference from the financial statements beginning on page F-1 of this annual report on Form 10-K.

Item 9. Changes In and Disagreements With Accountants On Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control over Financial Reporting

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

Table of Contents

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of consolidated financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Management assessed our internal control over financial reporting as of December 31, 2011, the end of our fiscal year. Management based its assessment on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management's assessment included evaluation of elements such as the design and operating effectiveness of key financial reporting controls, process documentation, accounting policies, and our overall control environment.

Based on our assessment, management has concluded that our internal control over financial reporting was effective as of the end of the fiscal year to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

Our independent registered public accounting firm, Deloitte and Touche LLP, independently assessed the effectiveness of the company's internal control over financial reporting, as stated in their attestation report, which is included at the end of Part II, of this Form 10-K.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Dot Hill Systems Corp. and subsidiaries

Longmont, Colorado

We have audited the internal control over financial reporting of Dot Hill Systems Corp. and subsidiaries (the Company) as of December 31, 2011, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2011 of the Company and our report dated March 15, 2012 expressed an unqualified opinion on those financial statements.

/s/ Deloitte & Touche LLP

Denver, Colorado

March 15, 2012

Table of Contents**Item 9B. Other Information**

None.

PART III**Item 10. Directors, Executive Officers and Corporate Governance**

Some of the information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2012 annual meeting of stockholders under the headings Election of Directors and Section 16(a) Beneficial Ownership Reporting Compliance. Other information required by this item is incorporated by reference to Item 1 of Part I of this annual report on Form 10-K under the heading Named Executive Officers and Key Employees of the Registrant.

We have adopted a code of ethics that applies to our principal executive officer and principal financial officer, who is also our principal accounting officer. This code of ethics is incorporated in our code of business conduct and ethics that applies to all of our officers, directors and employees. A copy of our code of business conduct and ethics is available on our web site at www.dothill.com. We intend to satisfy the SEC's disclosure requirements regarding amendments to, or waivers of, the code of business conduct and ethics by posting such information on our web site. A paper copy of our code of business conduct and ethics may be obtained free of charge by writing to our Investor Relations Department at our principal executive office.

Item 11. Executive Compensation

The information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2012 annual meeting of stockholders under the headings Executive Compensation, Compensation Committee Report and Compensation Committee Interlocks and Insider Participation.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information under the heading Security Ownership of Certain Beneficial Owners and Management in our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2012 annual meeting of stockholders is incorporated by reference.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table sets forth our equity securities authorized for issuance under equity compensation plans as of December 31, 2011.

Stock Plan	Number of Securities to be Issued Upon Exercise of Outstanding Options and Rights	Weighted Average Exercise Price of Outstanding Options and Rights	Number of Securities Remaining Available for Future Issuance
2000 EIP	4,253,299	\$ 4.19	
2009 EIP	2,600,742	\$ 2.20	6,931,498
2000 ESPP	Not Applicable	Not Applicable	2,542,630
2000 NEDSOP	460,000	\$ 2.81	433,124
Total	7,314,041	\$ 3.39	9,907,252

All of our equity compensation plans have been approved by our stockholders.

Table of Contents

Item 13. *Certain Relationships and Related Transactions, and Director Independence*

The information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2012 annual meeting of stockholders under the headings Election of Director(s), Transactions with Related Persons and Policies and Procedures with Respect to Related Party Transactions.

Item 14. *Principal Accounting Fees and Services*

The information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2012 annual meeting of stockholders under the heading Ratification of Selection of Independent Auditors.

Table of Contents**PART IV****Item 15. Exhibits, Financial Statement Schedules**

a) The following documents are filed as part of this report:

(1) Financial statements:

The consolidated balance sheets as of December 31, 2010 and 2011, and the consolidated statements of operations and comprehensive loss, stockholders' equity and cash flows for the years ended December 31, 2009, 2010 and 2011, together with notes thereto included elsewhere in this annual report on Form 10-K are incorporated herein by reference.

(2) All other schedules have been omitted from this annual report on Form 10-K because they are not applicable or because the information required by any applicable schedule is included in the consolidated financial statements or the notes thereto.

(3) Exhibits:

Exhibit

Number	Description
2.1	Agreement and Plan of Merger dated as of February 23, 2004, by and among Dot Hill Systems Corp., DHSA Corp., Chaparral Network Storage, Inc., and C. Timothy Smoot, as Stockholders' Representative.(1)
2.2	Amended and Restated Asset Purchase and Technology License Agreement dated September 17, 2008 by and between Dot Hill Systems Corp. and Ciprico Inc.(2)
2.3	Agreement and Plan of Merger and Reorganization dated as of January 4, 2010, among Dot Hill Systems Corp., Telluride Acquisition Sub, Inc., Cloverleaf Communications Inc., Cloverleaf Communications (Israel) Ltd., Cloverleaf Communications Corporation (BVI) and E. Shalev Management 2000 (1999) Ltd.(8)
3.1	Certificate of Incorporation of Dot Hill Systems Corp.(3)
3.2	Amended and Restated By-laws of Dot Hill Systems Corp.(4)
4.1	Certificate of Incorporation Dot Hill Systems Corp.(3)
4.2	Amended and Restated By-laws of Dot Hill Systems Corp.(4)
4.3	Form of Common Stock Certificate.(5)
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.(6)
4.5	Form of Rights Certificate.(6)
4.6	Warrant to Purchase Shares of Common Stock dated January 4, 2008.(9)
10.1	Rights Agreement dated as of May 19, 2003 by and between Dot Hill Systems Corp. and American Stock Transfer and Trust Company.(6)
10.2	2000 Amended and Restated Equity Incentive Plan.(10)
10.3	2009 Equity Incentive Plan.(11)
10.4	Form of Stock Option Agreement (Incentive and Non-statutory Stock Options) used in connection with the 2000 Amended and Restated Equity Incentive Plan.(10)
10.5	Form of Stock Option Grant Notice used in connection with the 2000 Amended and Restated Equity Incentive Plan.(10)

Table of Contents

Exhibit

Number	Description
10.6	Amended and Restated 2000 Employee Stock Purchase Plan.(11)
10.7	Amended and Restated 2000 Non-Employee Directors Stock Option Plan.(12)
10.8	Form of Stock Option Agreement used in connection with the 2000 Non-Employee Directors Stock Option Plan.(13)
10.9	Amended and Restated Employment Agreement between Dot Hill Systems Corp. and Dana Kammersgard, effective as of December 18, 2008.(14)
10.10	Amended and Restated Employment Agreement between Dot Hill Systems Corp. and Hanif I. Jamal, effective as of March 16, 2009.(32)
10.11	Description of 2008 Executive Compensation Plan.(15)
10.12	Description of Amended and Restated Policy for Director Compensation.(16)
10.13	Form of Indemnity Agreement.(17)
10.14	Lease Agreement by and between Dot Hill Systems Corp. and Equastone 2200 Faraday, LLC effective as of September 1, 2005 and dated as of September 16, 2005.(18)
10.15	Lease Agreement by and between Dot Hill Systems Corp. and Circle Capital Longmont LLC as of April 12, 2007.(19)
10.16	Loan and Security Agreement dated August 1, 2008 by and between Dot Hill Systems Corp. and Silicon Valley Bank.(20)
10.17	Manufacturing Agreement between Dot Hill Systems Corp. and Flextronics Corporation dated May 20, 2002.(21)*
10.18	Amendment to Manufacturing Agreement between Dot Hill Systems Corp. and Solectron Corporation dated April 5, 2005.(22)*
10.19	Second Amendment to Manufacturing Agreement dated September 16, 2005 between Dot Hill Systems Corp. and Solectron Corporation.(23)*
10.20	Second Award Letter dated September 16, 2005 between Dot Hill Systems Corp. and Solectron Corporation.(23)*
10.21	Manufacturing Agreement by and among Dot Hill Systems Corp., MiTAC International Corporation and SYNEX Corporation dated February 20, 2007.(24)*
10.22	Manufacturing and Purchase Agreement dated September 24, 2008 by and between Dot Hill Systems Corp. and Hon Hai Precision Industry LTD.(2)*
10.23	Amended and Restated Technology License Agreement, dated as of October 29, 2010 among NetApp, Inc., NetApp Holding and Manufacturing B.V. and Dot Hill Systems Corp.(33)*
10.24	Product Purchase Agreement dated September 10, 2007 by and between Dot Hill Systems Corp. and Hewlett-Packard Company.(30)*
10.25	Amendment One to Product Purchase Agreement dated January 4, 2008, by and between Dot Hill Systems Corp. and Hewlett-Packard Company.(30)*
10.26	Amendment Eight to Product Purchase Agreement dated September 30, 2008 by and between Dot Hill Systems Corp. and Hewlett Packard Company.(2)*
10.27	Patent Cross License dated December 29, 2005 between Dot Hill Systems Corp. and International Business Machines Corporation.(27)*
10.28	Amended Settlement and License Agreement dated October 5, 2006 by and between Dot Hill Systems Corp. and Crossroads, Inc.(31)*

Table of Contents

Exhibit

Number	Description
10.29	Amendment One to Manufacturing and Purchase Agreement dated January 28, 2009 by and between Dot Hill Systems Corp. and Hon Hai Precision Industry LTD.(29)*
10.30	Amendment to Loan and Security Agreement dated July 30, 2009 by and between Dot Hill Systems Corp. and Silicon Valley Bank.(25)
10.31	Second Amendment to Loan and Security Agreement dated February 3, 2011 by and between Dot Hill Systems Corp. and Silicon Valley Bank. (28)
10.32	Israeli Appendix to the 2009 Equity Incentive Plan.(26)
10.33	Israeli Appendix to the Amended and Restated 2000 Employee Stock Purchase Plan.(33)
10.34	Amendment Eleven to Product Purchase Agreement and Amendment One to Warrant to Purchase Shares of Common Stock dated September 30, 2008 by and between Dot Hill Systems Corp. and Hewlett Packard Company.*
10.35	Amendment Two to Manufacturing and Purchase Agreement dated January 28, 2009 by and between Dot Hill Systems Corp. and Hon Hai Precision Industry Co., LTD.*
21.1	Subsidiaries of Dot Hill Systems Corp.(7)
23.1	Consent of Deloitte & Touche LLP.
24.1	Power of Attorney. Reference is made to the signature page hereto.
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.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

Indicates management or compensatory plan or arrangement.

* Confidential treatment has been granted by, or requested from, the SEC. Dot Hill's Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K have a Commission File Number of 001-13317.

(1) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on February 24, 2004 and incorporated herein by reference.

(2) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2008 and incorporated herein by reference.

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

- (3) 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.

Table of Contents

- (4) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 26, 2007 and incorporated herein by reference.
- (5) 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.
- (6) 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.
- (7) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference.
- (8) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 5, 2010 and incorporated herein by reference.
- (9) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 7, 2008 and incorporated herein by reference.
- (10) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on August 23, 2000 and incorporated herein by reference.
- (11) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on June 19, 2009 and incorporated herein by reference.
- (12) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2009 and incorporated herein by reference.
- (13) Filed as an exhibit to our Registration Statement on Form S-8 (No. 333-43834) and incorporated herein by reference.
- (14) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 24, 2008 and incorporated herein by reference.
- (15) Filed as item 5.02(e) of our Current Report on Form 8-K filed with the SEC on April 3, 2008 and incorporated herein by reference.
- (16) Incorporated herein by reference to the description contained in our Current Report on Form 8-K filed with the SEC on July 29, 2005.
- (17) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 13, 2005 and incorporated herein by reference.
- (18) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on September 21, 2005 and incorporated herein by reference.
- (19) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on April 16, 2007 and incorporated herein by reference.
- (20) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on August 5, 2008 and incorporated herein by reference.

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

- (21) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 and incorporated herein by reference.
- (22) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005 and incorporated herein by reference.
- (23) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2005 and incorporated herein by reference.
- (24) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 and incorporated herein by reference.

Table of Contents

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

- (26) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference.

- (27) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.

- (28) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on February 7, 2011 and incorporated herein by reference.

- (29) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2009 and incorporated herein by reference.

- (30) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2008 and incorporated herein by reference.

- (31) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 and incorporated herein by reference.

- (32) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on March 20, 2009 and incorporated herein by reference.

- (33) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2010 and incorporated herein by reference.

Table of Contents**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DOT HILL SYSTEMS CORP.

By: */s/* DANA W. KAMMERSGARD
Dana W. Kammersgard
Chief Executive Officer and President

Date: March 15, 2012

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Dana W. Kammersgard and Hanif I. Jamal, and each of them, as his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place, and stead, in any and all capacities, to sign any and all amendments to this Report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming that all said attorneys-in-fact and agents, or any of them or their or his substitute or substituted, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Title	Date
<i>/s/</i> DANA W. KAMMERSGARD	Chief Executive Officer, President and Director (Principal Executive Officer)	March 15, 2012
Dana W. Kammersgard		
<i>/s/</i> HANIF I. JAMAL	Chief Financial Officer, and Treasurer (Principal Financial and Accounting Officer)	March 15, 2012
Hanif I. Jamal		
<i>/s/</i> CHARLES CHRIST	Chairman of the Board of Directors	March 15, 2012
Charles Christ		
<i>/s/</i> TOM MARMEN	Director	March 15, 2012
Tom Marmen		
<i>/s/</i> RICHARD MEJIA	Director	March 15, 2012
Richard Mejia, Jr.		
<i>/s/</i> BARRY RUDOLPH	Director	March 15, 2012
Barry Rudolph		
<i>/s/</i> RODERICK M. SHERWOOD III	Director	March 15, 2012

Roderick M. Sherwood III

/s/ DEBBIE TIBEY

Director

March 15, 2012

Debbie Tibey

Table of Contents

INDEX TO FINANCIAL STATEMENTS

	Page
<u>REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM</u>	F-2
<u>FINANCIAL STATEMENTS:</u>	
<u>Consolidated balance sheets as of December 31, 2010 and 2011</u>	F-3
<u>Consolidated statements of operations and comprehensive loss for the years ended December 31, 2009, 2010 and 2011</u>	F-4
<u>Consolidated statements of stockholders' equity for the years ended December 31, 2009, 2010 and 2011</u>	F-5
<u>Consolidated statements of cash flows for the years ended December 31, 2009, 2010 and 2011</u>	F-6
<u>Notes to consolidated financial statements for the years ended December 31, 2009, 2010 and 2011</u>	F-7

F-1

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Dot Hill Systems Corp. and subsidiaries

Longmont, Colorado

We have audited the accompanying consolidated balance sheets of Dot Hill Systems Corp. and subsidiaries (the Company) as of December 31, 2010 and 2011, and the related consolidated statements of operations and comprehensive loss, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2011. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Dot Hill Systems Corp. and subsidiaries as December 31, 2010 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011, in conformity with accounting principals generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2011, based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 15, 2012 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche, LLP

Denver, Colorado

March 15, 2012

Table of Contents**DOT HILL SYSTEMS CORP. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****AS OF DECEMBER 31, 2010 AND 2011****(In thousands, except par value data)**

	2010	2011
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 45,732	\$ 46,168
Accounts receivable, net	35,202	31,697
Inventories	7,340	5,251
Prepaid expenses and other assets	3,540	7,896
Total current assets	91,814	91,012
Property and equipment, net	3,597	4,972
Goodwill	4,140	
Intangible assets, net	7,581	2,601
Other assets	370	294
Total assets	\$ 107,502	\$ 98,879
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	\$ 30,555	\$ 31,434
Accrued compensation	3,899	5,049
Accrued expenses	4,171	10,860
Deferred revenue	1,371	883
Restructuring accrual	1,664	1,328
Current portion of long-term note payable	275	71
Total current liabilities	41,935	49,625
Long-term note payable	71	
Other long-term liabilities	1,118	552
Total liabilities	43,124	50,177
Commitments and Contingencies (Note 13)		
Stockholders Equity:		
Preferred stock, \$.001 par value, 10,000 shares authorized, no shares issued and outstanding at December 31, 2010 and 2011, respectively		
Common stock, \$.001 par value, 100,000 shares authorized, 55,953 and 57,699 shares issued and outstanding at December 31, 2010 and 2011, respectively	56	58
Additional paid-in capital	315,257	321,681
Accumulated other comprehensive loss	(3,584)	(3,662)
Accumulated deficit	(247,351)	(269,375)
Total stockholders equity	64,378	48,702
Total liabilities and stockholders equity	\$ 107,502	\$ 98,879

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

See accompanying notes to consolidated financial statements.

F-3

Table of Contents**DOT HILL SYSTEMS CORP. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS****FOR THE YEARS ENDED DECEMBER 31, 2009, 2010 AND 2011****(In thousands, except per share amounts)**

	2009	2010	2011
NET REVENUE	\$ 234,383	\$ 252,494	\$ 197,461
COST OF GOODS SOLD	196,556	209,664	155,828
GROSS PROFIT	37,827	42,830	41,633
OPERATING EXPENSES:			
Research and development	28,120	31,578	35,551
Sales and marketing	10,970	12,164	13,876
General and administrative	10,139	9,928	9,268
Restructuring charge	2,430	2,196	668
Goodwill impairment charge			4,140
Total operating expenses	51,659	55,866	63,503
OPERATING LOSS	(13,832)	(13,036)	(21,870)
OTHER INCOME (LOSS):			
Interest income (expense), net	161	(19)	16
Other income (expense), net	6	17	(41)
Total other income (loss), net	167	(2)	(25)
LOSS BEFORE INCOME TAXES	(13,665)	(13,038)	(21,895)
INCOME TAX (BENEFIT) EXPENSE	(40)	213	129
NET LOSS	\$ (13,625)	\$ (13,251)	\$ (22,024)
NET LOSS PER SHARE:			
Basic and diluted	\$ (0.29)	\$ (0.25)	\$ (0.40)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:			
Basic and diluted	47,094	53,015	54,908
COMPREHENSIVE LOSS:			
Net loss	\$ (13,625)	\$ (13,251)	\$ (22,024)
Foreign currency translation adjustments	35	(145)	(78)
Comprehensive loss	\$ (13,590)	\$ (13,396)	\$ (22,102)

See accompanying notes to consolidated financial statements.

Table of Contents

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2009, 2010 AND 2011

(In thousands)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders Equity
	Shares	Amount				
Balance, January 1, 2009	46,308	46	300,555	(3,474)	(220,475)	76,652
Common stock issued under stock plans	2,644	3	464			467
Share-based compensation expense			2,822			2,822
Foreign currency translation adjustment				35		35
Net loss					(13,625)	(13,625)
Balance, December 31, 2009	48,952	\$ 49	\$ 303,841	\$ (3,439)	\$ (234,100)	\$ 66,351
Shares issued in connection with acquisition	4,759	5	8,127			8,132
Common stock issued under stock plans	2,242	2	286			288
Share-based compensation expense			3,003			3,003
Foreign currency translation adjustment				(145)		(145)
Net loss					(13,251)	(13,251)
Balance, December 31, 2010	55,953	\$ 56	\$ 315,257	\$ (3,584)	\$ (247,351)	\$ 64,378
Issuance of warrant to customer			1,007			1,007
Common stock issued under stock plans	1,746	2	1,026			1,028
Share-based compensation expense			4,379			4,379
Excess tax benefit			12			12
Foreign currency translation adjustment				(78)		(78)
Net loss					(22,024)	(22,024)
Balance, December 31, 2011	57,699	\$ 58	\$ 321,681	\$ (3,662)	\$ (269,375)	\$ 48,702

See accompanying notes to consolidated financial statements.

Table of Contents**DOT HILL SYSTEMS CORP. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****FOR THE YEARS ENDED DECEMBER 31, 2009, 2010 AND 2011****(In thousands)**

	2009	2010	2011
Cash Flows From Operating Activities:			
Net loss	\$ (13,625)	\$ (13,251)	\$ (22,024)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	2,871	4,032	4,755
Adjustment to contingent consideration	(649)	(144)	
Provision for (reduction in) bad debt reserve	(63)		203
Share-based compensation expense	2,822	3,003	5,385
Issuance of warrant to customer			1,007
Long-lived assets impairment charge			2,928
Goodwill impairment charge			4,140
Changes in operating assets and liabilities, net of effects of business acquisition:			
Accounts receivable	6,888	(816)	3,309
Inventories	9,794	(2,938)	2,091
Prepaid expenses and other assets	(445)	1,702	(4,263)
Accounts payable	(2,564)	1,543	(92)
Accrued compensation and other expenses	(415)	(1,394)	6,169
Deferred revenue	(1,658)	147	(501)
Restructuring accrual	1,016	(33)	(336)
Other long-term liabilities	(539)	(946)	(571)
Net cash (used in) provided by operating activities	3,433	(9,095)	2,200
Cash Flows From Investing Activities:			
Purchases of property and equipment	(2,939)	(1,490)	(2,548)
Acquisition, net of cash required		(625)	
Net cash used in investing activities	(2,939)	(2,115)	(2,548)
Cash Flows From Financing Activities:			
Principal payment of note and loan payable	(249)	(1,036)	(398)
Payments on bank borrowings		(5,800)	
Proceeds from bank borrowings		5,800	
Shares withheld for tax purposes		(477)	(422)
Common stock issued under stock plans	467	765	1,450
Net cash provided by (used in) financing activities	218	(748)	630
Effect of Exchange Rate Changes on Cash and Cash Equivalents	12	116	154
Net (Decrease) Increase in Cash and Cash Equivalents	724	(11,842)	436
Cash and Cash Equivalents, beginning of year	56,850	57,574	45,732
Cash and Cash Equivalents, end of year	\$ 57,574	\$ 45,732	\$ 46,168

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

Supplemental Disclosures of Cash Flow Information:

Cash paid for income taxes	\$ 78	\$ 90	\$ 235
----------------------------	-------	-------	--------

Supplemental Disclosures of Non-Cash Investing and Financing Activities:

Capital assets acquired but not paid	\$ 170	\$ 67	\$ 1,540
Common stock issued in connection with acquisition	\$	\$ 8,132	\$

See accompanying notes to consolidated financial statements.

F-6

Table of Contents

DOT HILL SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2009, 2010 and 2011

1. Organization and Summary of Significant Accounting Policies

Description of Business

Dot Hill Systems Corp (referred to herein as Dot Hill, we, our or us) is a provider of software and hardware storage systems for the entry and mid-range storage markets for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware, firmware and software products employing a modular system that allows end-users to add various capacity or data protection schemes as needed. Our broad range of products, from medium capacity standalone storage units to complete multi-terabyte storage area networks, or SANs, provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP.

Principles of Consolidation

The accompanying consolidated financial statements include our accounts and the accounts of our wholly-owned subsidiaries. Intercompany transactions and balances have been eliminated in consolidation.

Foreign Currency Translation

For our foreign subsidiaries whose functional currency is the local currency, assets and liabilities are translated into United States dollars at period-end exchange rates. Revenues and expenses, and gains and losses, are translated at rates of exchange that approximate the rates in effect on the transaction date. Resulting translation gains and losses are recognized as a component of other comprehensive loss.

For our foreign subsidiaries that maintain their books of record in a currency other than the functional currency, the subsidiaries remeasure monetary assets and liabilities using current rates of exchange at the balance sheet date and remeasure non-monetary assets and liabilities using historical rates of exchange. Gains and losses from remeasurement for such subsidiaries are recognized currently in income as a component of general and administrative expenses.

Foreign currency translation adjustments comprise the entire amount of our accumulated other comprehensive loss at December 31, 2010 and 2011. We incurred foreign currency transaction losses of \$0.1 million for the year ended December 31, 2009, and foreign currency transaction gains of \$0.2 million and \$0.3 million for the years ended December 31, 2010 and 2011, respectively.

Use of Accounting Estimates

The preparation of our financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenue and expenses in the reporting periods. The accounting estimates that require management's most significant and subjective judgments include revenue recognition, inventory valuation, the valuation and recognition of stock-based compensation expense, and the valuation of

Table of Contents

long-lived assets, goodwill and other intangibles, as well as any other assets and liabilities acquired and accounted for under the purchase method of accounting for business combinations. In addition, we have other accounting policies that involve estimates such as the determination of useful lives of long-lived assets, warranty reserves, accruals for restructuring and valuation allowance for deferred tax assets. Actual results may differ from these estimates under different assumptions or conditions and such differences could be material.

Revenue Recognition

We derive our revenue from sales of our hardware products, software and services.

Hardware

Hardware product revenue consists of revenue from sales of our AssuredSAN storage systems and our AssuredUVS appliance products that includes our AssuredUVS software which is integrated with industry standard hardware which is essential to the functionality of the integrated system product. We recognize hardware product revenue when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the price is fixed or determinable; and (iv) collectability is reasonably assured. Revenue is recognized for hardware product sales upon transfer of title and risk of loss to the customer and in addition, upon installation for certain of our AssuredUVS appliance products. We record reductions to revenue for estimated product returns and pricing adjustments in the same period that the related revenue is recorded. These estimates are based on historical sales returns, analysis of credit memo data and other factors known at the time. If actual future returns and pricing adjustments differ from past experience and our estimates, additional revenue reserves may be required.

Software

In accordance with the specific guidance for recognizing software revenue, where applicable, we recognize revenue from perpetual software licenses at the inception of the license term assuming all revenue recognition criteria have been met. We use the relative method to allocate revenue to software licenses at the inception of the license term when vendor-specific objective evidence, or VSOE, of fair value for all unspecified software updates and enhancements related to our products through service contracts. We have established VSOE for the fair value of our support services as measured by the stated renewal prices paid by our customers when the services are sold separately on a standalone basis.

Service

Our service revenue primarily includes out-of-warranty repairs and product maintenance contracts. Out-of-warranty repairs primarily consist of product repair services performed by our contract manufacturers for those customers that allowed their original product warranty to expire without purchasing one of our higher level support service plans. Revenue from these out-of-warranty repairs, and the associated cost of sales, is recognized in the period these services are provided. Service revenue also consists of product maintenance contracts. Revenue from our product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 to 36 months. Net revenue derived from services was less than 10% of total revenue for all periods presented.

Revenue Recognition for Arrangements with Multiple Deliverables

For multi-element arrangements that include hardware products containing software essential to the hardware product's functionality, undelivered software elements that relate to the hardware product's essential software, and undelivered non-software services, the Company allocates revenue to all deliverables based on their relative selling prices. In such circumstances, the Company uses a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (i) VSOE of fair value, (ii) third-party evidence of selling price, or TPE, and (iii) best estimate of the selling price, or ESP. VSOE generally exists only when the Company sells the

Table of Contents

deliverable separately and represents the actual price charged by the Company for that deliverable. ESPs reflect the Company's best estimates of what the selling prices of elements would be if they were sold regularly on a standalone basis.

From time to time, the Company enters into arrangements with customers that include acceptance criteria. In such instances, the Company defers all revenue on the arrangement until customer acceptance is obtained or the acceptance clause lapses.

Revenue Recognition for Sales to Channel Partners

On sales to channel partners, we evaluate whether fees are considered fixed or determinable by considering a number of factors, including our ability to estimate returns, payment terms and our relationship and past history with the particular channel partner. If fees are not considered fixed or determinable at the time of sale to a channel partner, revenue recognition is deferred until there is persuasive evidence indicating the product has sold-through to an end-user. Persuasive evidence of sell-through may include reports from channel partners documenting sell-through activity or data indicating an order has shipped to an end-user.

Deferred Revenue

We also defer revenue on upfront nonrefundable payments from our customers and recognize it ratably over the term of the agreement, unless the payment is in exchange for products delivered that represent the culmination of a separate earnings process. When we provide consideration to a customer we normally recognize the value of that consideration as a reduction in net revenue, except in limited circumstances where consideration is provided in relation to previously recorded obligations to the customer. In those situations, consideration will be presented as a component of the financial statement caption related to the original obligation. We may be required to maintain inventory with certain of our largest OEM customers, which we refer to as hubbing arrangements. Pursuant to these arrangements we deliver products to a customer or a designated third-party warehouse based upon the customer's projected needs, but do not recognize product revenue unless and until the customer has removed our product from the warehouse to incorporate into its end products.

We report taxes collected from customers on behalf of governmental authorities on a net basis and are excluded from revenues.

Advertising Costs

We expense advertising costs in the period incurred. Advertising expense is included as a component of sales and marketing expense. Advertising expense was \$0.4 million, \$1.1 million and \$1.2 million for the years ended December 31, 2009, 2010 and 2011, respectively.

Shipping and Handling

Cost related to the shipping and handling of our products is included in cost of goods sold for all periods presented.

Research and Development

Research and development costs are expensed as incurred. In conjunction with the development of our products, we incur certain software development costs. No costs have been capitalized because the period between achieving technological feasibility and completion of such software is relatively short and software development costs qualifying for capitalization have been insignificant.

Table of Contents***Stock-Based Compensation***

Stock-based compensation expense for all share-based payment awards granted is determined based on the grant-date fair value. We recognize these compensation costs net of an estimated forfeiture rate, and recognize compensation cost only for those shares expected to vest on a straight-line basis over the requisite service period of the award, which is generally the vesting term of the share-based payment awards. We estimate forfeiture rates based on our historical experience.

Income Taxes

We recognize deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts using enacted tax rates in effect for the year the differences are expected to reverse. We record a valuation allowance to reduce the deferred tax assets to the amount that is more likely than not to be realized.

Cash and Cash Equivalents

We classify investments as cash equivalents if they are readily convertible to cash and have original maturities of three months or less at the time of acquisition. Cash and cash equivalents consist primarily of money market funds issued or managed in the United States. At December 31, 2010 and 2011, the carrying value of cash and cash equivalents approximates fair value due to the short period of time to maturity.

As of December 31, 2011, \$5.9 million of the \$46.2 million of cash, cash equivalents, and marketable securities was held by our foreign subsidiaries. If these funds are needed for our operations in the U.S., we will be required to accrue and pay U.S. taxes to repatriate these funds. However, our intent is to permanently reinvest these funds outside of the U.S. and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

Allowance for Doubtful Accounts

We establish an allowance for doubtful accounts for accounts receivable amounts that may not be collectible. We determine the allowance for doubtful accounts based on the aging of our accounts receivable balances and an analysis of our historical experience of bad debt write-offs. Bad debt expense was \$0.0, \$0.0 and \$0.2 million for the year-ended December 31, 2009, 2010 and 2011, respectively.

Balance sheet details were as follows for the following fiscal years ended December 31, (in thousands):

	2009	2010	2011
Balance, beginning of year	\$	\$	\$
Additions to allowance			203
Balance, end of year	\$	\$	\$ 203

Inventories

The components of inventories consist of the following as of December 31, (in thousands):

	2010	2011
Purchased parts and materials	\$ 4,901	\$ 3,994
Finished goods	2,439	1,257
Total inventories	\$ 7,340	\$ 5,251

Inventories are valued at the lower of cost (first-in, first-out method) or market value. The valuation of inventory requires us to estimate excess or obsolete inventory. The determination of excess or obsolete inventory

Table of Contents

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

Property and Equipment

Property and equipment are recorded at cost less accumulated depreciation. Property and equipment are depreciated for financial reporting purposes using the straight-line method over the following estimated useful lives: machinery and equipment, furniture, fixtures and computer software, 3-5 years; leasehold improvements are amortized using the straight-line method over the shorter of the useful lives of the assets or the terms of the leases. Significant improvements to our property and equipment are capitalized while expenditures for maintenance and repairs are charged to expense in the period incurred.

The components of property and equipment consist of the following as of December 31, (in thousands):

	2010	2011
Machinery and equipment	\$ 8,678	\$ 11,577
Furniture, fixtures, and computer software	274	854
Leasehold improvements	836	1,034
Construction in progress	171	855
Total property and equipment, at cost	9,959	14,320
Less accumulated depreciation	(6,362)	(9,348)
Total property and equipment, net	\$ 3,597	\$ 4,972

Depreciation expense was \$1.7 million, \$2.0 million and \$2.7 million for the years ended December 31, 2009, 2010 and 2011, respectively.

Long-lived Asset Impairment

We periodically review the recoverability of the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. An impairment in the carrying value of an asset group is recognized whenever anticipated future undiscounted cash flows from an asset group are estimated to be less than its carrying value. The amount of impairment recognized is the difference between the carrying value of the asset group and its fair value. Fair value estimates are based on assumptions concerning the amount and timing of estimated future cash flows and assumed discount rates, reflecting varying degrees of perceived risk. All long-lived assets identified with the Israel Technology Center, or ITC reporting unit are considered one asset group, and are included as a component of the Standalone Storage Software reportable segment. Recent events involving our ITC reporting unit resulted in a significant decline in actual and planned earnings.

As of September 30, 2011, we identified a change in circumstances that indicated the carrying amount of our long-lived assets may not be recoverable, as our primary AssuredUVS customer informed us that the AssuredUVS software would no longer be a component of its business strategy, which would result in a significant decline in revenues for the Company. Our long-lived assets consist of the intangible assets associated with our acquisition of certain identified Cloverleaf Communications, Inc., or Cloverleaf, assets acquired in January 2010 with a carrying value of \$5.0 million and property and equipment of \$1.2 million.

Table of Contents

Since we did not have an immediate replacement for our AssuredUVS customer, management's forecasted undiscounted cash flows indicated that the assets were potentially not recoverable, and proceeded to estimate the fair value of each long-lived asset. Property and equipment comprise mostly machinery and equipment used for testing and development of our AssuredUVS technology. Management determined that carrying value approximated fair value, as property was either acquired in the 2010 acquisition of Cloverleaf, has been purchased subsequently, or could be re-deployed, establishing recent evidence of fair value. It is depreciated over a 3-5 year estimated useful life.

Intangible assets consist primarily of acquired software of \$4.9 million and a trade name of \$0.1 million. We determined the fair value of the acquired software by estimating the replacement cost of the software, taking into account both the software as acquired and subsequent development work, as well as the business alternatives we were considering and the corresponding value of the software in these alternative approaches. We estimated the value of the software based on the probabilities of each of the business alternatives. We determined the fair value of the trade name using an income approach and considered the fact that the software's trade name at the time of acquisition was no longer being used. All estimates were based on management using appropriate assumptions and projections.

Our impairment analysis at September 30, 2011 identified \$2.9 million of impaired long-lived assets, consisting entirely of intangible assets recognized as part of the Cloverleaf acquisition in 2010. Long-lived asset impairment charges are recorded consistent with our treatment of related amortization expense specific to each acquired intangible assets. We recorded \$2.8 million of impaired acquired software and \$0.1 million of impaired acquired trade name as a component of cost of goods sold for the year ended December 31, 2011. We are evaluating numerous alternatives to monetize the software asset including, developing an appliance based on industry standard servers, developing storage bundles with our AssuredSAN products, developing and porting the software to be based on open source code such as Linux, integrating some of the AssuredUVS features into some of our AssuredSAN products and making substantial changes to the AssuredUVS operations.

In February 2012, our Board of Directors approved a plan to exit our AssuredUVS business and close down our Israel Technology Development Center (see Note 3). We evaluated the potential impact, if any, on our valuation of our acquired software and other long-lived assets maintained at our Israel Technology Development Center, and based on the facts and circumstances in existence at December 31, 2011, we believe the current valuations are appropriate. However, as a result of our decision in the 2012 fiscal year to shut down our AssuredUVS business, we will assess the recorded long-lived asset valuation for Israel Technology Development Center in the first quarter of 2012.

Valuation of Goodwill

We review goodwill for impairment on an annual basis at November 30 and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Our ITC reporting unit, which develops our AssuredUVS software, is a component of the Standalone Storage Software reporting segment identified in the notes to our consolidated financial statements. During September 2011, our primary AssuredUVS customer became delinquent on the settlement of its payables to us and upon our investigation it became evident that its financial resources were limited. It also informed us that they were changing their strategy which would result in a significant decline in revenue for the Company, and we determined it was more-likely-than-not that the reporting unit was less than its carrying value.

Current accounting standards require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of our reporting unit to its carrying value. We determine the fair value of our reporting unit using a combination of the income approach and market capitalization approach. If the fair value of the reporting unit exceeds the carrying value of the net assets, goodwill is not impaired, and we are not required to perform further testing. If the carrying value of the net assets 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

Table of Contents

goodwill and compare it to the carrying value of the reporting unit's goodwill. If the carrying value of the reporting unit's goodwill exceeds its implied fair value, then we must record an impairment charge equal to the difference.

Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future discounted cash flows. Under the market capitalization approach, valuation multiples are calculated based on operating data from publicly traded companies within our industry. Multiples derived from companies within our industry provide an indication of how much a knowledgeable investor in the marketplace would be willing to pay for a company. These multiples are applied to the operating data for the reporting unit to arrive at an indicated fair value. Significant management judgment is required in the forecasts of future operating results that are used in the estimated future discounted cash flow method of valuation. The estimates we have used are consistent with the plans and estimates that we use to manage our business. We base our fair value estimates on forecasted revenue and operating costs along with business plans. Our forecasts consider the effect of a number of factors including, but not limited to, the current future projected competitiveness and market acceptance of the product, technological risk, the ease of use and ease of implementation of the product, the likely outcome of sales and marketing efforts and projected costs associated with product development, customer support and selling, general and administrative costs. The assumptions and forecasts used were consistent with those used to evaluate certain of our long-lived assets for impairment at September 30, 2011. It is possible, however, that the plans may change and that actual results may differ significantly from our estimates. The valuation resulted in the recognition of an impairment charge to goodwill of \$4.1 million, for the quarter ended September 30, 2011. No additional goodwill remains on the balance sheet of the Company as of December 31, 2011.

Product Warranties

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

In October 2009, we discovered a quality issue associated with certain power supply devices provided by a long-term component supplier, which resulted in a higher than expected level of power supply failures to us and our customers. While we were able to promptly identify and resolve the cause of the failures, we are required to provide replacement products or make repairs to the affected power supply units that had been sold between March and October 2009. Through June 30, 2011, our component supplier had repaired all of the faulty power supplies at no cost to us, and reimbursed us for our out-of-pocket costs which has constituted a reimbursement to customers for certain out-of-pocket costs they incurred in connection with these power supply failures. The total amount reimbursed to us by our component supplier approximated \$1.0 million through June 30, 2011.

In the second and third quarters of 2011, a material customer provided us with a framework estimating the potential claims precipitated by the power supply failures. As previously disclosed, the customer's preliminary framework of potential claims provided to us included additional costs related to the customer's internal overhead for other internal indirect costs, in addition to third-party direct costs. Based on preliminary discussions for settlement and our analysis of the framework provided by the customer including future potential claims through the warranty period, we estimated that we had incurred a probable loss of approximately \$2.8 million. Consequently, in addition to the \$1.3 million previously recognized as of June 30, 2011, we recorded an estimated liability of \$1.5 million as of September 30, 2011 within Accrued expenses on our condensed consolidated balance sheet.

Table of Contents

Negotiations continued with our customer throughout the fourth quarter of 2011 into the first quarter of 2012. In our judgment, the negotiations have resulted in an increase in our estimated liability at December 31, 2011 to \$5.5 million, resulting in a charge of \$2.7 million during the fourth quarter of 2011 within Accrued expenses on our condensed consolidated balance sheet, and are reported gross of any third-party recoveries.

While our estimated liability relating to failed power supply units is subject to some uncertainty until settled, based on our current expectation of what the terms of the final negotiated settlement will stipulate, we do not believe the incurrence of an additional loss is either probable or reasonably possible at this time.

During the second quarter of 2011, based on the advice of legal counsel, we established that our component supplier is contractually obligated to reimburse us for fair and reasonable costs we incur with our customers associated with these power supply failures. Our component supplier had continued to re-work and distribute to our customer the affected population of power supplies at no cost to us. In addition, at the time, our collection experience with similar amounts already reimbursed to us by our supplier and our belief that our component supplier and its parent companies had the financial ability to continue to reimburse us for any additional costs we may incur, we recorded a current asset within Prepaid expenses and other assets on our consolidated balance sheet of \$1.3 million as of June 30, 2011.

During the third quarter of 2011, as the claims from our customer became clearer, we commenced negotiations with our component supplier for fair and reasonable costs that we have and are likely to incur through the warranty period associated with this component failure. While we have not agreed to an amount to cover the costs associated with replacing customers' power supplies, we continue to maintain that we have legal recourse against this component supplier. Originally we determined that the supplier was unlikely to make an up-front cash payment for the original settlement amount of \$1.3 million, but it indicated a willingness to provide some form of reimbursement for costs incurred, in the form of cash and/or note receivable of \$0.5 million plus future product rebates. Based on our judgment at the time, we reduced the previously recorded current asset of \$1.3 million within Prepaid expenses and other assets to \$0.5 million as of September 30, 2011. We continued to negotiate this settlement with our supplier and subsequent to December 31, 2011, the supplier signed a letter of intent providing for additional reimbursements above what was recognized as of September 30, 2011. Pursuant to the signed letter of intent, the supplier has agreed to cash consideration of \$1.2 million, of which \$0.6 million will be received upon the subsequent signing of the Settlement Agreement, with the remainder to be received in four quarterly installments commencing three months from the date the Settlement Agreement is signed. Additionally, our supplier committed to product rebates and/or price concessions on post-2011 product orders for a period of approximately three years, commencing three months from the date of signing the Settlement Agreement, in return for our agreement to release our supplier from all obligations relating to the power supply failures known by us to date. This agreement is not subject to any required future purchases. Based on our judgment, we have increased the previously recorded current asset of \$0.5 million within Prepaid expenses and other assets to \$1.2 million as of December 31, 2011.

In addition, we have commenced discussions with our General Liability and Errors and Omissions Insurance and underwriters and will continue to pursue our rights to cover any damages we incur and not reimbursed by our supplier. The insurance company has issued a reservation of rights letter to us and at this time, it is not possible to estimate to what extent, if any, we will be covered by our carrier. As of December 31, 2011, we have not assumed or recorded any insurance reimbursement.

To the extent that we are unsuccessful in negotiating settlement agreements with our customer and our component supplier on mutually beneficial terms, or our component supplier does not continue to reimburse us for the expenses incurred by us or our customers, and we are unsuccessful in recovering such expenses from our insurance provider, we could incur additional expenses which could potentially have a material effect on our financial statements.

Table of Contents

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

	2009	2010	2011
Balance, beginning of year	\$ 1,560	\$ 993	\$ 982
Charged to operations	2,061	2,623	8,244
Deductions for costs incurred	(2,628)	(2,634)	(2,355)
Balance, end of year	\$ 993	\$ 982	\$ 6,871

The table above includes \$5.5 million of charges recorded to cost of sales in 2011 related to the liability established for certain third-party material and service costs incurred by our customer related to replacing failed power supplies. The table above does not include the corresponding \$1.2 million benefit recorded within cost of sales in 2011 related to the current asset established for the recovery of such costs incurred by our customer which are to be reimbursed to us by our component supplier.

Concentrations of Credit Risk, Customers and Suppliers

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

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

	2009	2010	2011
Hewlett Packard	51%	57%	73%
NetApp, Inc.	25%	26%	0%
Oracle (formerly Sun Microsystems)	4%	0%	0%
Other customers less than 10%	20%	17%	27%
Total	100%	100%	100%

Due to the discontinuance of our agreement with NetApp, Inc., or NetApp, our sales to HP represented a substantially higher percentage of our total net revenue in 2011 compared to 2010. If our relationship with HP were disrupted or declined significantly, we would lose a substantial portion of our anticipated net revenue and our business could be materially harmed. We cannot guarantee that our relationship with HP or our other customers will expand or not otherwise be disrupted. Related to the power supply failures, if we are unable to reach a satisfactory settlement with the material customer, it could result in a material reduction in revenue.

In the fourth quarter of 2010, we decided to exit our low margin business with NetApp beginning on or about December 1, 2010. As a result, no revenue from NetApp was generated in 2011.

We expect that the sale of our products to a limited number of customers will continue to account for a high percentage of net revenue for the foreseeable future. On October 31, 2011, we amended, or the Amendment, the Product Purchase Agreement originally entered into with HP on September 10, 2007. The Amendment extends the agreement with HP for a five year period through October 30, 2016. In addition, the Amendment provides that we will continue to comply with the contractually required cost reduction process and to support HP with respect to certain products or statements of work upon any assignment of the agreement for a specified period of time. The Amendment does not contain any minimum purchase commitments by HP (see Note 13).

Simultaneously with the extension of the Product Purchase Agreement, we agreed to extend until October 30, 2016 the expiration date of the warrant previously issued to HP to purchase 1,602,489 shares of our

Table of Contents

common stock at the original exercise price of \$2.40 per share. The impact of this extension on our financial statements is an expected non-cash contra-revenue charge of approximately \$1.0 million in Dot Hill's 2011 GAAP financial results. We currently rely on a limited number of contract manufacturing partners to produce substantially all of our products. As a result, should any of our current manufacturing partners such as Foxconn Technology Group, or parts suppliers not produce and deliver inventory for us to sell on a timely basis, operating results may be adversely impacted.

Recent Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) No. 2011-05, *Comprehensive Income (ASC Topic 220) Presentation of Comprehensive Income*. The ASU requires companies to report comprehensive income, including items of other comprehensive income, for all periods presented in a single continuous financial statement in the Consolidated Statements of Operations or split between the Consolidated Statements of Operations and a separate Consolidated Statements of Other Comprehensive Income. The ASU is effective for the Company's first quarter of fiscal year 2012. In addition, in December 2011, the FASB issued Accounting Standards Update 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU 2011-05* (ASU 2011-12). ASU 2011-12 defers the specific requirement within ASU 2011-05 to present on the face of the financial statements items that are reclassified from accumulated other comprehensive income to net income separately with their respective components of net income and other comprehensive income. The effective dates for ASU 2011-12 are consistent with the effective dates for ASU 2011-05 and, similar to the Company's evaluation for the adoption of ASU 2011-05, the adoption of this guidance does not have a material effect on the Company's consolidated financial statements.

2. Net Loss Per Share

Basic net loss per share is calculated by dividing net loss for the period by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing net loss for the period by the weighted average number of shares of common stock outstanding during the period and including the dilutive effect of common stock that would be issued assuming conversion or exercise of outstanding warrants, stock options, share based compensation awards and other dilutive securities. No such items were included in the computation of diluted loss per share in the twelve months ended December 31, 2009, 2010 or 2011 because we incurred a net loss in each of these periods and the effect of inclusion would have been anti-dilutive.

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

	31-Dec-09		31-Dec-10		31-Dec-11	
	Number of Potential Shares	Range of Exercise Prices	Number of Potential Shares	Range of Exercise Prices	Number of Potential Shares	Range of Exercise Prices
Stock options	6,142,901	\$ 0.47 - \$16.36	6,179,547	\$ 0.47 - \$16.36	7,314,039	\$ 0.47 - \$16.36
Unvested restricted stock awards	1,511,205	\$	2,099,523	\$	2,221,205	\$
Warrants	1,602,489	\$ 2.40	1,602,489	\$ 2.40	1,602,489	\$ 2.40

3. Acquisitions**Cloverleaf**

On January 26, 2010, or the acquisition date, Dot Hill acquired 100% of the voting equity interests of Cloverleaf Communications Inc., a Delaware corporation, or Cloverleaf. Prior to the acquisition, Cloverleaf was a privately held software company focused on heterogeneous storage virtualization and unified storage technologies. Following the acquisition, Dot Hill changed its operating segment reporting structure and

Table of Contents

Cloverleaf joined Dot Hill's Standalone Storage Software business segment, augmenting its existing software offering portfolio of products. The acquisition of Cloverleaf is intended to broaden Dot Hill's market opportunities and help accelerate Dot Hill's transition from a provider of storage arrays to a provider of storage solutions and software. The Cloverleaf acquisition also provided Dot Hill with a new team of software developers and other professionals located in Israel.

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

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

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

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

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

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

Table of Contents

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

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

The acquired software consists of heterogeneous storage virtualization and unified storage technologies that can simplify data center management, eliminate downtime and reduce storage costs. The Cloverleaf Intelligent Storage Networking System iSN trade name is an intelligent, network resident, storage network management system that provides a combination of benefits, features and capabilities targeted to meet the demands of mid to large-sized data centers. Dot Hill expects to amortize the fair value of the acquired software and the trade name on a straight-line basis over a period of seven years and five years, respectively, which management believes to reasonably reflect the pattern over which the economic benefits are being derived.

The goodwill of \$4.1 million arising from the Cloverleaf acquisition was deemed impaired and has been written off as of December 31, 2011 (see Note 6).

Revenue of \$0.6 and \$0.5 million and a net loss of \$5.5 and \$13.4 million attributable to the operations of Cloverleaf since the acquisition date are included in our consolidated results of operations for the years ended December 31, 2010 and 2011, respectively. The \$5.5 million net loss includes \$0.1 and \$0.0 million of non-recurring restructuring costs and \$0.5 and \$0.2 million of stock-based compensation expense for the years ended December 31, 2010 and 2011, respectively.

Pro forma results

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

(in thousands, except per share data)	Year Ended December 31, 2010
Net revenue	\$ 252,571
Net loss	\$ (13,237)

Basic and diluted net loss per share	\$	(0.25)
--------------------------------------	----	--------

F-18

Table of Contents**4. Identifiable Intangible Assets**

Identifiable intangible assets are follows as of December 31, (in thousands):

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

	Estimated Useful Life	Gross	2011 Accumulated Amortization	Net
RaidCore technology	4 years	\$ 4,256	\$ (3,477)	\$ 779
NAS technology	3 years	214	(214)	
Software	3 years	2,050	(228)	1,822
Total intangible assets		\$ 6,520	\$ (3,919)	\$ 2,601

During the third quarter of 2011, we recorded a \$2.8 million impairment of our acquired software and \$0.1 million impairment of our trade name (see Note 1). Additionally, as part of the process of valuing the acquired software we revised the estimated remaining useful life to approximately three years from five, which is subject to further revisions as the facts and circumstances may change in the future. Amortization expense related to identifiable intangible assets totaled \$1.1 million, \$2.0 million and \$2.1 million, for the years ended December 31, 2009, 2010 and 2011, respectively.

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

2012	2,601
2013	
Thereafter	
Total	\$ 2,601

Table of Contents**5. Goodwill**

The changes in the carrying amount of goodwill are as follows during the years ended December 31, (in thousands):

	Storage Systems	Standalone Storage Software	Total
Balance as of January 1, 2010			
Goodwill	\$ 40,700	\$	\$ 40,700
Accumulated impairment losses	(40,700)		(40,700)
Goodwill acquired during year		4,140	4,140
Impairment losses			
Balance as of December 31, 2010			
Goodwill	40,700	4,140	44,840
Accumulated impairment losses	(40,700)		(40,700)
	\$	\$ 4,140	\$ 4,140
	Storage Systems	Standalone Storage Software	Total
Balance as of January 1, 2011			
Goodwill	\$ 40,700	\$ 4,140	\$ 44,840
Accumulated impairment losses	(40,700)		(40,700)
		4,140	
Goodwill acquired during year			
Impairment losses		(4,140)	(4,140)
Balance as of December 31, 2011			
Goodwill	40,700	4,140	44,840
Accumulated impairment losses	(40,700)	(4,140)	(44,840)
	\$	\$	\$

During the third quarter-ended September 30, 2011, we recorded a \$4.1 million impairment of our goodwill associated with the 2010 acquisition of Cloverleaf (see Note 3) which was included in earnings.

6. Restructuring Charge**2008 Plan**

In December 2008, our management approved, committed to, and initiated a restructuring plan, or the 2008 Plan, to improve efficiencies in our operations, which was largely driven by our plan to consolidate our facility in Carlsbad, California into the Longmont, Colorado facility. As a result of this relocation, we terminated approximately 70 California employees whose positions have been relocated to Colorado and incurred approximately \$1.5 million in severance-related costs since the inception of the 2008 Plan, all of which was recognized as of December 31, 2010. The remainder of the restructuring costs, all of which represent future minimum lease payments relating to the Carlsbad, California facility, will be paid out over the remainder of the lease term ending in April 2013.

As part of the 2008 Plan, we also incurred contract termination costs of \$3.8 million since the inception of the 2008 Plan through December 31, 2011. We record charges for contract termination and other associated costs as restructuring expense, which is presented as a separate component within operating expenses. We expect to pay these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our estimates, we do not expect to receive any material amounts of sublease income beginning in the fourth

Table of Contents

quarter of 2011 through the remainder of the lease term, and accordingly recognized an additional \$0.6 million of contract lease termination costs as of the year ended December 31, 2011.

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

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

2008 Plan

	Severance and Related Costs	Contract Termination and Other Associated Costs	Total
Accrued restructuring balance as of December 31, 2009	\$ 439	\$ 1,258	\$ 1,697
Restructuring plan charges	233	1,289	1,522
Cash payments	(672)	(1,047)	(1,719)
Accrued restructuring balance as of December 31, 2010		1,500	1,500
Restructuring plan charges		621	621
Cash payments		(909)	(909)
Accrued restructuring balance as of December 31, 2011	\$	\$ 1,212	\$ 1,212

2010 Plan

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

As part of the 2010 Plan, we also incurred contract termination costs of \$0.3 million since the plan inception through December 31, 2011 for facility lease and other associated costs that we continue to incur without economic benefit, as we exited the remaining portion of our Carlsbad, California facility. We record charges for contract termination costs and other associated costs as restructuring expense, which is presented as a separate component within operating expenses. We expect to pay these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our estimates, we do not expect to receive any material amounts of sublease income beginning in the fourth quarter of 2011 through the remainder of the lease term, and accordingly, recognized an additional \$0.6 million of contract lease termination costs in the third quarter of 2011.

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

Table of Contents

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

2010 Plan

	Severance and Related Costs	Contract Termination and Other Associated Costs	Total
Accrued restructuring balance as of December 31, 2009	\$	\$	\$
Restructuring plan charges	377	188	565
Cash payments	(357)	(44)	(401)
Accrued restructuring balance as of December 31, 2010	20	144	164
Restructuring plan charges	62	62	62
Cash payments	(20)	(90)	(110)
Accrued restructuring balance as of December 31, 2011	\$	\$ 116	\$ 116

We also incurred additional severance-related restructuring charges of approximately \$0.1 million in the first quarter of 2010 related to the termination of a former employee of Cloverleaf. All of the severance-related costs were paid to this employee in the first quarter of 2010.

All costs related to the 2008 and 2010 Plans are recorded in the restructuring accrual line on our consolidated balance sheets and restructuring charge line on our consolidated statement of operations.

7. Credit Facilities

We maintain a credit facility with Silicon Valley Bank for cash advances and letters of credit of up to an aggregate of \$30 million based upon an advance rate of 85% of eligible accounts receivable. In February 2011, we amended our credit agreement with Silicon Valley Bank. The amendment extends the maturity date to July 21, 2013. Borrowings under the credit facility bear interest at the prime rate and are secured by substantially all of our accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on our inventory and intellectual property, subject to certain exceptions, and contains usual and customary covenants for an arrangement of its type, including an obligation that we maintain at all times a net worth, as defined in the agreement, of \$50 million (subject to certain increases). The definition of net worth adds stock-based compensation expense, goodwill and long-lived asset impairment charges, subject to certain limitations. The agreement also includes provisions to increase the financing facility by \$20 million subject to our meeting certain requirements, including \$40 million in borrowing base for the immediately preceding 90 days, and Silicon Valley Bank locating a lender willing to finance the additional facility. In addition, if our cash and cash equivalents net of the total amount outstanding under the credit facility fall below \$20 million (measured on a rolling three-month basis), the interest rate will increase to prime plus 1% and additional restrictions will apply. Our credit facility also provides for a cash management services sublimit under the revolving credit line of up to \$300,000. As of December 31, 2011 we had no outstanding letters of credit.

As of December 31, 2010 and 2011, there were no amounts outstanding under the Silicon Valley Bank line of credit.

8. Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, notes payable, bank borrowings and certain other long-term liabilities. The carrying values on our balance sheet of our cash and cash equivalents, accounts receivable, accounts payable and bank borrowings approximate their fair values due to their short maturities. The carrying value on our balance sheet of our notes payable and contingent consideration due to Ciprico, Inc. or Ciprico, in connection with the acquisition of certain

Table of Contents

intangible assets approximates fair value as our credit-adjusted interest rate continues to represent a market participant rate.

9. Fair Value Measurements*Assets Measured at Fair Value on a Recurring Basis*

Description	December 31, 2010	Fair Value Measurements Using			Total (Losses)
		Quoted Prices for Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Cash and cash equivalents	\$ 45,732	45,732			

Description	December 31, 2011	Fair Value Measurements Using			Total (Losses)
		Quoted Prices for Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Cash and cash equivalents	\$ 46,168	46,168			

Assets Measured at Fair Value on a Non-Recurring Basis

Description	December 31, 2011	Fair Value Measurements Using			Total (Losses)
		Quoted Prices for Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Property and equipment, net	\$ 1,150			\$ 1,150	\$
Software	2,050			2,050	(2,807)
Trade Name					(121)
Goodwill					(4,140)
					\$ (7,068)

Property and equipment, net with a carrying amount of \$1.2 million was tested for impairment as part of our measurement of fair value for long-lived assets held and used and included as a component of our ITC reporting unit. We did not identify any impaired assets classified as property and equipment, net and included within our ITC asset group.

Software acquired as part of our Cloverleaf acquisition in 2010 with a carrying amount of \$4.9 million was written down to its fair value of \$2.1 million, resulting in an impairment charge of \$2.8 million, which was included in earnings for the year-ended December 31, 2011.

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

The iSN™ trade name acquired as part of our Cloverleaf acquisition in 2010 with a carrying amount of \$0.1 million was written down to its fair value of \$0.0 million, resulting in an impairment charge of \$0.1 million, which was included in earnings for year-ended December 31, 2011.

Goodwill acquired as part of our Cloverleaf acquisition in 2010 with a carrying amount of \$4.1 million was written down to its fair value of \$0.0 million, resulting in an impairment charge of \$4.1 million, which was included in earnings for the year-ended December 31, 2011.

F-23

Table of Contents**10. Income Taxes**

Components of income (loss) before taxes are as follows for the years ended December 31, (in thousands):

	2009	2010	2011
Income (loss) before taxes:			
U.S.	\$ (17,084)	\$ (7,958)	\$ (6,310)
Foreign	3,419	(5,080)	(15,585)
Total income (loss) before taxes	\$ (13,665)	\$ (13,038)	\$ (21,895)

Components of the income tax provision (benefit) are as follows for the years ended December 31, (in thousands):

	2009	2010	2011
Current:			
Federal	\$ (205)	\$	\$
State, local and foreign	145	213	129
	(60)	213	129
Deferred:			
Federal			
State, local and foreign	20		
	20		
Total income tax provision (benefit)	\$ (40)	\$ 213	\$ 129

The reconciliation of the income tax provision computed using the federal statutory income tax rate to the recognized income tax provision (benefit) is as follows for the years ended December 31, (in thousands):

	2009	2010	2011
Federal statutory rate	\$ (4,646)	\$ (4,432)	\$ (7,444)
State and local income taxes, net of federal benefit	46	(153)	(85)
State rate change and other adjustments		737	160
Increase in valuation allowance	4,225	3,298	6,302
Foreign tax differential	(23)	(76)	(716)
Research and development credits	(253)	(48)	(49)
Goodwill impairment			1,408
Share based compensation	555	532	484
Other	56	203	69
Income tax provision (benefit)	\$ (40)	\$ 213	\$ 129

Table of Contents

The tax effect of temporary differences that give rise to deferred income taxes are as follows as of December 31, (in thousands):

	2010	2011
Deferred tax assets:		
Net operating loss and tax credit carry forwards	\$ 87,204	\$ 88,675
Inventory reserve and uniform capitalization	1,707	1,959
Stock options and warrants	2,070	2,807
In-process research and development	248	241
Allowance for bad debts	21	265
Vacation accrual	411	354
Deferred rent	513	283
Warranty accrual	364	494
Depreciation and amortization	1,753	1,579
Other accruals and reserves	2,508	4,252
Acquired intangibles	656	1,386
Total deferred tax assets	97,455	102,295
Deferred tax liabilities:		
State taxes	(3,677)	(3,568)
Cloverleaf intangibles	(1,214)	(456)
Total deferred income tax liabilities	(4,891)	(4,024)
Valuation allowance	(92,564)	(98,271)
Net deferred tax assets	\$	\$

As a result of certain realization requirements of ASC 718, the table of deferred tax assets and liabilities shown above does not include deferred tax assets for net operating losses as of December 31, 2011 that arose directly from tax deductions related to equity compensation in excess of compensation recognized for financial reporting. Equity will be increased by \$0.3 million if and when such excess tax benefits are recognized through current taxes payable. The Company uses ASC 740 ordering when determining when excess tax benefits have been realized.

U.S. income and withholding taxes have not been recognized on the excess of the amount for financial reporting over the tax basis of investments in foreign subsidiaries that are essentially permanent in duration. This amount becomes taxable upon a repatriation of assets from the subsidiary or a sale or liquidation of the subsidiary. The amount of such temporary differences totals \$ 0.5 million at December 31, 2011. Determination of the amount of any unrecognized deferred tax liability on this temporary difference is not practicable.

The following table summarizes the activity related to our unrecognized tax benefits (in thousands):

	2009	2010	2011
Balance, January 1	\$ 4,756	\$ 4,842	\$ 5,111
Increase related to prior period positions	167	367	
Increase related to current year tax positions		91	124
Decrease related to prior period positions		(101)	(210)
Decrease related to change in prior year estimate	(81)	(88)	
Balance, December 31	\$ 4,842	\$ 5,111	\$ 5,025

At December 31, 2009, December 31, 2010, and December 31, 2011 we had cumulative unrecognized tax benefits of approximately \$4.8 million, \$5.1 million, and \$5.0 million respectively, of which approximately \$0.2 million, \$0.2 million, and \$0.2 million, respectively, are included in other long term liabilities that, if recognized,

Table of Contents

would affect the effective tax rate. The remaining \$4.6 million, \$4.9 million and \$4.8 million of unrecognized tax benefits will have no impact on the effective tax rate due to the existence of net operating loss carryforwards and a full valuation allowance. Consistent with previous periods, penalties and tax related interest expense are reported as a component of income tax expense. As of December 31, 2009, December 31, 2010 and December 31, 2011, the total amount of accrued income tax related interest and penalties included in the consolidated balance sheet was less than \$0.1 million. We do not expect that our unrecognized tax benefit will change significantly within the next 12 months.

Due to net operating losses and other tax attributes going forward, we are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending March 31, 1999 through December 31, 2010. With few exceptions, our state income tax returns are open to audit for the years ended December 31, 2007 through 2010.

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

At December 31, 2011, based on the weight of available evidence, including cumulative losses in recent years and expectations regarding future taxable income, we determined that it was not more likely than not that our deferred tax assets would be realized and have a \$98.3 million valuation allowance associated with our deferred tax assets.

As of December 31, 2011, we had federal and state net operating losses of approximately \$194.5 million and \$102.3 million, respectively, which begin to expire in the tax years ending 2017 and 2012, respectively. We had foreign net operating losses of \$37.0 million, which have no expiration date. In addition, we had federal tax credit carryforwards of \$4.2 million, of which approximately \$0.5 million can be carried forward indefinitely to offset future tax liability, and the remaining \$3.7 million begin to expire in the tax year ending 2012. We also had state tax credit carryforwards of \$3.5 million, of which \$0.1 million will begin expiring in 2012, and the remaining \$3.4 million have no expiration date.

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

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

As a result of our acquisition of Cloverleaf, a third ownership change, within the meaning of IRC Section 382, occurred on January 26, 2010. As a result, annual use of Cloverleaf'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.

Table of Contents**11. Stockholders Equity, Equity Incentive Plans and Warrants*****Stock Incentive Plans***

2009 EIP. Our stockholders approved the 2009 Equity Incentive Plan, or the 2009 EIP, at our Annual Meeting of Stockholders held on June 15, 2009. The 2009 EIP authorizes the issuance or grant of incentive stock options, non-statutory stock options, restricted stock awards, restricted stock unit awards, stock appreciation rights, performance awards, performance cash awards and other stock awards to our employees, directors and consultants and is intended as the successor to and continuation of our 2000 EIP. Following the approval of the 2009 EIP by our stockholders, no additional stock awards may be granted under the 2000 Amended and Restated Equity Incentive Plan, or the 2000 EIP. All outstanding stock awards granted under the 2000 EIP will remain subject to the terms of the 2000 EIP provided, however, that any shares subject to outstanding stock awards granted under the 2000 EIP that expire or terminate for any reason prior to exercise or settlement shall become available for issuance pursuant to awards granted under the 2009 EIP. Awards granted under the 2000 EIP expire 10 years from the date of grant. Awards granted under the 2009 EIP expire seven years from the date of grant. As of June 15, 2009, the total number of shares of our common stock reserved for issuance under the 2009 EIP consisted of 4,500,000 shares plus 7,112,217 shares that are subject to outstanding stock awards under the 2000 EIP that may become available for grant under the 2009 EIP if they expire or terminate for any reason prior to exercise or settlement under the 2000 EIP. On May 2, 2011, shareholders approved our Amended 2009 Equity Incentive Plan, primarily to increase the share reserve by 8,000,000 shares. Unless sooner terminated by our Board of Directors, the 2009 EIP shall automatically terminate on April 26, 2019, the day before the tenth anniversary of the date the 2009 EIP was adopted by the Board. The Board of Directors may also amend the 2009 EIP at any time subject to applicable laws and regulations, including the rules and regulations of The NASDAQ Stock Market LLC. In general, no amendment or termination of the 2009 EIP may adversely affect any rights under awards already granted to a participant unless agreed to by the affected participant.

During 2010 and 2011, we granted restricted stock and options to purchase common stock with various vesting as approved by the Board upon each grant. As of December 31, 2011, 2,027,414 shares of restricted stock were outstanding under the 2009 EIP, of which 438,313 were performance-based restricted stock awards. These performance based awards consist of 131,334 shares that were issued in January 2010, 28% of which will vest in the first quarter of 2012 provided that the time-based objectives are achieved, and 306,979 shares granted in 2011, that will vest in 2012 and 2013 provided that the performance objectives are achieved. We will determine the actual number of shares the recipient receives based on results achieved versus goals based on internal non-financial operational targets. Additionally, 194,124 shares of restricted stock were outstanding under the 2000 EIP. As of December 31, 2011, options to purchase 2,600,742 and 4,253,297 shares of common stock were outstanding under the 2009 EIP and 2000 EIP, respectively. 6,931,498 shares of common stock remained available for grant under the 2009 EIP.

2000 NEDSOP. Under our 2000 Non-Employee Directors Stock Option Plan, or 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 meeting 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 December 31, 2011, options to purchase 460,000 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 433,124 shares of common stock remained available for grant under the 2000 NEDSOP.

2000 ESPP. Our stockholders approved our Amended and Restated Employee Stock Purchase Plan, or 2000 ESPP, at our Annual Meeting of Stockholders held on June 15, 2009, primarily to increase the share reserve under the 2000 ESPP by 4,000,000 shares. The 2000 ESPP qualifies under the provisions of Section 423 of the Internal Revenue Code, or IRC, and provides our eligible employees, as defined in the 2000 ESPP, with an

Table of Contents

opportunity to purchase shares of our common stock at 85% of fair market value. There were 895,071 and 667,265 shares issued under the 2000 ESPP for the years ended December 31, 2010 and 2011, respectively. As of December 31, 2011, the 2000 ESPP had a total of 2,542,630 shares available for purchase.

As of December 31, 2011, total unrecognized share-based compensation cost related to unvested stock options, restricted stock awards, management stock incentive plan and our 2000 ESPP was \$5.5 million, which is expected to be recognized over a weighted-average period of approximately 2.9 years. The following table summarizes share-based compensation expense for the years ended December 31, (in thousands):

	2009	2010	2011
Cost of goods sold	\$ 382	\$ 489	828
Sales and marketing	288	333	540
Research and development	1,112	1,231	2,382
General and administrative	1,040	950	1,635
Share-based compensation expense before taxes	2,822	3,003	5,385
Related deferred income tax benefits			
Share-based compensation expense	\$ 2,822	\$ 3,003	\$ 5,385
Share-based compensation expense is derived from:			
Stock options	\$ 2,237	\$ 1,589	1,478
Restricted stock awards	310	1,052	2,482
Stock bonus plan			1,006
2000 ESPP	275	362	419
Total	\$ 2,822	\$ 3,003	\$ 5,385

We estimate forfeitures at the time of grant and revise, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We have historically and continue to estimate the fair value of share-based awards using the Black-Scholes option-pricing model.

A summary of stock option activity is as follows:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at January 1, 2011	6,179,547	\$ 3.57		
Granted	1,902,500	2.58		
Exercised	(291,984)	1.90		
Forfeited	(204,919)	2.12		
Expired	(190,593)	4.83		
Outstanding at December 31, 2011	7,394,551	\$ 3.39	5.17	\$ 81,196
Vested and expected to vest at December 31, 2011	7,076,011	\$ 3.43	5.08	\$ 80,547
Exercisable at December 31, 2011	4,877,883	\$ 3.96	4.82	\$ 55,672

A summary of restricted stock award activity for 2011 is as follows:

Number of shares	Weighted average grant date fair value
------------------	--

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

Outstanding at January 1, 2011	2,099,523	\$	1.47
Granted	1,362,329		2.68
Vested	(825,760)		1.67
Forfeited	(402,529)		1.73
Outstanding and unvested at December 31, 2011	2,233,563	\$	2.09

F-28

Table of Contents

The weighted average grant-date fair values of options granted during the years ended December 31, 2009, 2010 and 2011 were \$0.45 per share, \$0.97 per share, and \$1.78 per share, respectively. The total intrinsic value of options exercised during the years ended December 31, 2009, 2010 and 2011 were \$0.0 million, \$0.0 million, and \$0.8 million, respectively.

The weighted average grant-date fair values of restricted stock awards granted during the years ended December 31, 2009, 2010 and 2011 were \$0.55, \$1.68 and \$2.68 per share, respectively. The fair value of restricted stock awards that vested during the years ended December 31, 2009, 2010 and 2011 was \$0.1, \$0.8 and \$1.4, respectively.

Cash generated from options exercised under all share-based compensation arrangements for the years ended December 31, 2009, 2010 and 2011 were \$0.0 million, \$0.1 million and \$0.5 million, respectively. Cash generated from the purchase of shares through the 2000 ESPP for the years ended December 31, 2009, 2010 and 2011, was \$0.5 million, \$0.7 million, and \$0.9 million respectively. 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.

The aggregate intrinsic value in the stock option summary table above is based on our closing stock price of \$1.33 per share as of the last business day of the fiscal year ended December 31, 2011, which value would have been realized 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 years ended December 31, 2009, 2010 and 2011 was \$2.4 million, \$1.1 million, and \$1.2 million, respectively.

To estimate compensation expense for the years ended December 31, 2009, 2010, and 2011 we used the Black-Scholes option-pricing model with the following weighted-average assumptions for equity awards granted:

	EIP and NEDSOP Years Ended December 31,			ESPP Years Ended December 31,		
	2009	2010	2011	2009	2010	2011
Risk-free interest rate	2.01%	2.25%	1.84%	0.32%	0.19%	0.17%
Expected dividend yield	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Volatility	69%	74%	85%	120%	101%	70%
Expected Term	5.5 years	5.9 years	5.36 years	0.5 years	0.5 years	0.5 years
Forfeiture Rate	0%-12.37%	0%-12.69%	0%-12.25%	0%	0%	0%

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

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

The forfeiture rate is estimated when awards are granted and updated if information becomes available indicating that actual forfeitures will differ.

Warrants

In January 2008, we amended our Product Purchase Agreement, or Agreement, originally entered into with HP in September 2007, to allow for sales to additional divisions within HP. In connection with the Agreement, we issued a warrant to HP to purchase 1,602,489 shares of our common stock (approximately 3.5% of our outstanding shares prior to the issuance of the warrant) at an exercise price of \$2.40 per share.

On October 31, 2011, we amended again the Product Purchase Agreement originally entered into with HP on September 10, 2007. In part, this Amendment extends until October 30, 2016 the expiration date of the warrant previously issued to HP to purchase 1,602,489 shares of our common stock at the original exercise price

Table of Contents

of \$2.40 per share. The impact of this extension on our financial statements is a non-cash contra-revenue charge of approximately \$1.0 million in Dot Hill's 2011 statement of operations.

12. Employee Retirement Benefit Plans***Dot Hill Retirement Savings Plan***

The Dot Hill Retirement Savings Plan, which qualifies under Section 401(k) of the IRC, is open to eligible employees over 21 years of age. Under the plan, participating United States employees may defer up to 100% of their pretax salary, but not more than statutory limits. At our discretion we may make contributions to this plan for plan participants. Our matching contributions vest to employees as a percentage based on years of employment from one to five years, and matching contributions are fully vested to employees after five years of employment. Our matching contributions to the retirement savings plan for the years ended December 31, 2009, 2010 and 2011 were \$0.2 million, \$0.1 million and \$0.1 million, respectively.

13. Commitments and Contingencies***Operating Leases***

We lease office space, equipment and automobiles under non-cancelable operating leases, which expire at various dates through June 2013. Rent expense for the years ended December 31, 2009, 2010 and 2011 was \$1.4 million, \$1.6 million and \$1.6 million, respectively. We record rent expense on a straight line basis based on contractual lease payments.

Future minimum lease payments due under all non-cancelable operating leases as of December 31, 2011 are as follows (in thousands):

2012	\$ 2,196
2013	665
2014	
Total minimum lease payments	\$ 2,861

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

Warranty

Our standard warranty provides that if our systems do not function to published specifications, we will repair or replace the defective component or system without charge generally for a period of approximately three years. We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are intended to be covered by corresponding supplier warranties. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future or that our warranty obligations to our customers will be covered by corresponding warranties from our suppliers, the absence of which could have a material effect on our financial statements. Estimated liabilities for product warranties are included in accrued expenses (see Note 1).

Unconditional Purchase Obligations

We have unconditional inventory related purchase obligations to certain suppliers for certain commodities in order to ensure supply of select key components at the most favorable pricing. Additionally, we have non-inventory related purchase obligations that represent purchase commitments made in the ordinary course of business. At December 31, 2011 we had approximately \$20.1 million of unconditional purchase obligations.

Table of Contents

Legal Proceedings

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

14. Segment Information

Primarily as a result of our acquisition of Cloverleaf in January 2010, as well as our ongoing strategic development, planning and evaluation, we changed the structure of our internal organization to focus on our storage systems and standalone software products. As a result, we now have two operating segments, which include storage systems and standalone storage software. Our storage hardware operating segment consists predominantly of our business prior to the acquisition of Cloverleaf and includes our AssuredSAN products. Our standalone storage software operating segment consists primarily of the business we acquired from Cloverleaf and the intellectual property assets we purchased from Ciprico and includes our AssuredUVS and AssuredVRA products.

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

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

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

Description of Segments

Storage Systems

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

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

Standalone Storage Software

We offer a line of unified virtual storage appliances called the AssuredUVS product line. To OEM customers, we market this technology as a software-only product with a license based business model. To end-user customers, we market this as complete appliance products (hardware servers, software, and storage

Table of Contents

options) through our indirect sales channel under the Dot Hill brand. The AssuredUVS product line delivers the following:

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

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

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

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

During the third quarter of 2011, we identified certain assets assigned to our ITC reporting unit, which is a component of our Standalone Storage Software operating segment, as impaired and their carrying amounts on the balance sheet were reduced to reflect their estimated fair value as of December 31, 2011 (see Note 1).

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

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

	Year Ended December 31,		
	2009	2010	2011
Storage Systems net revenue	\$ 234,360	\$ 250,631	\$ 192,965
Standalone Storage Software net revenue	23	2,112	5,022
Total segment net revenue	234,383	252,743	197,987
Elimination of intersegment net revenue		(249)	(526)
Total Dot Hill consolidated net revenue	\$ 234,383	\$ 252,494	\$ 197,461
Storage Systems operating loss	\$ (10,618)	\$ (5,046)	\$ (8,386)
Standalone Storage Software operating loss	(3,214)	(7,990)	(13,484)
Total operating loss	\$ (13,832)	\$ (13,036)	\$ (21,870)
Total other income (loss), net	167	(2)	(25)
Loss before income taxes	\$ (13,665)	\$ (13,038)	\$ (21,895)

Total assets were as follows (in thousands)

	December 31, 2010	December 31, 2011
Storage Systems total assets	\$ 95,227	\$ 94,224
Standalone Storage Software total assets	12,275	4,655
Total Dot Hill consolidated total assets	\$ 107,502	\$ 98,879

F-32

Table of Contents

Depreciation and amortization expense by operating segment were as follows (in thousands):

	Year Ended December 31,		
	2009	2010	2011
Storage Systems depreciation expense	\$ 1,698	\$ 1,681	\$ 2,132
Standalone Storage Software depreciation expense	37	347	569
	\$ 1,735	\$ 2,028	\$ 2,701
Storage Systems amortization expense	\$	\$	\$
Standalone Storage Software amortization expense	1,136	2,004	2,054
	\$ 1,136	\$ 2,004	\$ 2,054

The following is a summary of geographical information (in thousands):

	Year Ended December 31,		
	2009	2010	2011
Net revenue:			
United States	\$ 215,093	\$ 245,379	\$ 194,780
Europe	16,813	5,624	601
Asia	2,477	1,491	2,080
	\$ 234,383	\$ 252,494	\$ 197,461
Long-lived assets:			
United States	\$ 6,851	\$ 5,140	\$ 4,945
Europe	11	6,408	2,922
Asia			
	\$ 6,862	\$ 11,548	\$ 7,867

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

Long-lived assets include property and equipment, net, identifiable intangible assets, net, and other non-current assets.

2011 Standalone Storage operating loss includes a \$2.9 million loss on impairment of long-lived assets and \$4.1 million loss on impairment of goodwill (see Notes 1 and 5) relating to our Israel Technology Development Center asset group, which is a component of the Standalone Storage Software operating segment.

15. Quarterly Financial Information (Unaudited)

The information presented below reflects all adjustments, which, in the opinion of management, are of a normal and recurring nature necessary to present fairly the results of operations for the periods presented (in thousands, except per share amounts).

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year Ended December 31, 2010:				

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-K

Net revenue	\$ 59,974	\$ 65,493	\$ 61,586	\$ 65,441
Gross profit	8,125	9,669	11,295	13,741
Income (Loss) before income taxes	(6,378)	(5,799)	(1,260)	399
Net income (loss)	(6,427)	(5,834)	(1,269)	279
Basic and diluted net income (loss) per share	\$ (0.12)	\$ (0.11)	\$ (0.02)	\$ 0.01

F-33

Table of Contents

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year Ended December 31, 2011:				
Net revenue	\$ 49,174	\$ 53,179	\$ 48,071	\$ 47,037
Gross profit	12,102	13,195	8,042	8,294
Income (Loss) before income taxes	(1,221)	(1,880)	(12,107)	(6,687)
Net income (loss)	(1,271)	(1,945)	(12,182)	(6,626)
Basic and diluted net income (loss) per share	\$ (0.02)	\$ (0.04)	\$ (0.22)	\$ (0.12)

During the first, second, third and fourth quarters of 2010, we incurred approximately \$0.3 million, \$1.4 million, \$0.1 million and \$0.4 million, respectively, of restructuring charges related to our 2008 restructuring plan. During the first, second, third and fourth quarters of 2011, we incurred approximately \$0.0 million, \$0.0 million, \$0.7 million and \$0.0 million, respectively, of restructuring charges related to our 2008 and 2010 restructuring plans. See further discussion of our restructuring activities in Note 6.

On January 26, 2010, we acquired 100% of the voting equity interests of Cloverleaf in exchange for (i) \$0.7 million of cash, (ii) 4,758,530 shares of Dot Hill common stock valued at \$8.1 million, or \$1.71 per share, (iii) \$1.8 million of specified assumed outstanding liabilities of Cloverleaf at the acquisition date, and (iv) 327,977 shares of restricted common stock that were issued to the employees of Cloverleaf who became employees of Dot Hill on the acquisition date pursuant to Dot Hill's 2009 Equity Incentive Plan. See further discussion of our acquisition of Cloverleaf in Note 3.

16. Subsequent Events***2012 Restructuring and Cost Reduction Plan***

On February 2, 2012, our Board of Directors approved the implementation of a restructuring and cost reduction plan or the 2012 Plan that will include severance and related costs, contractual obligations, administrative costs and long-lived asset impairments associated with the closure of our Israel Technology Development Center totaling \$4.7 to \$5.9 million. The 2012 Plan is designed to re-align our software investments to focus on accelerating the development of embedded software features, in order to launch a competitive set of mid-range storage array products in 2012, and to provide more differentiated entry-level products for both OEM and channel customers. The majority of the activities comprising the 2012 Plan are expected to be completed by the end of 2012. We expect to record severance costs in the range of \$1.2 to \$1.4 million, record contractual obligations in the range of \$1.2 to \$1.5 million, incur legal and other administrative costs in the range of \$0.2 to \$0.4 million and recognize long-lived asset impairments of approximately \$2.1 to \$2.6 million in connection with the 2012 Plan.