DOT HILL SYSTEMS CORP
Form 10-Q
August 11, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2008

OR

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

For the transition period from to

Commission file number 1-13317

DOT HILL SYSTEMS CORP.
(Exact name of registrant as specified in its charter)

Delaware	**13-3460176**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2200 Faraday Avenue, Suite 100, Carlsbad, CA	**92008**
(Address of principal executive offices)	(Zip Code)

(760) 931-5500
(Registrant s telephone number, including area code)
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

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

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

The registrant had 46,058,904 shares of common stock, $0.001 par value, outstanding as of August 2, 2008.

DOT HILL SYSTEMS CORP.
FORM 10-Q
For the Quarter Ended June 30, 2008
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Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands)

	December 31, 2007	June 30, 2008
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 82,358	$ 62,082
Accounts receivable, net of allowance of $302 and $228	32,445	46,458
Inventories	9,013	13,584
Prepaid expenses and other	3,968	4,534
Total current assets	127,784	126,658
Property and equipment, net	9,599	8,231
Intangible assets, net	2,280	1,467
Other assets	264	225
Total assets	$ 139,927	$ 136,581
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 28,472	$ 36,004
Accrued compensation	3,115	3,237
Accrued expenses	6,227	4,684
Deferred revenue	1,409	1,196
Income taxes payable	143	488
Total current liabilities	39,366	45,609
Other long-term liabilities	4,132	3,616
Total liabilities	43,498	49,225
Commitments and Contingencies (Note 11)		
Stockholders Equity:		
Preferred stock, $0.001 par value, 10,000 shares authorized, no shares issued or outstanding		
Common stock, $0.001 par value, 100,000 shares authorized, 45,781 and 46,055 shares issued and outstanding at December 31, 2007 and June 30, 2008, respectively	46	46
Additional paid-in capital	294,193	298,701
Accumulated other comprehensive loss	(3,100)	(3,202)
Accumulated deficit	(194,710)	(208,189)
Total stockholders equity	96,429	87,356

Total liabilities and stockholders equity	$ 139,927	$ 136,581

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2008	2007	2008
NET REVENUE	$ 56,199	$ 71,027	$ 109,640	$ 123,853
COST OF GOODS SOLD	49,275	63,805	96,042	112,465
GROSS PROFIT	6,924	7,222	13,598	11,388
OPERATING EXPENSES:				
Sales and marketing	3,871	3,647	7,779	7,919
Research and development	4,797	7,125	10,871	14,549
General and administrative	3,322	3,939	6,992	6,982
Legal settlement				(3,836)
Total operating expenses	11,990	14,711	25,642	25,614
OPERATING LOSS	(5,066)	(7,489)	(12,044)	(14,226)
OTHER INCOME:				
Interest income	1,231	358	2,539	1,066
Other income, net				79
Total other income, net	1,231	358	2,539	1,145
LOSS BEFORE INCOME TAXES	(3,835)	(7,131)	(9,505)	(13,081)
INCOME TAX (BENEFIT) EXPENSE	(93)	239	199	398
NET LOSS	$ (3,742)	$ (7,370)	$ (9,704)	$ (13,479)
NET LOSS PER SHARE:				
Basic and diluted	$ (0.08)	$ (0.16)	$ (0.21)	$ (0.29)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:				
Basic and diluted	45,472	46,055	45,315	46,005
COMPREHENSIVE LOSS:				
Net loss	$ (3,742)	$ (7,370)	$ (9,704)	$ (13,479)
Foreign currency translation adjustments	163	130	(441)	(101)
Comprehensive loss	$ (3,579)	$ (7,240)	$ (10,145)	$ (13,580)

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2008
Cash Flows From Operating Activities:		
Net loss	$ (9,704)	$ (13,479)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	3,422	2,991
Loss on disposal of property and equipment	166	57
Reduction in bad debt reserve	(41)	(120)
Issuance of warrant to customer		2,282
Share-based compensation expense	977	1,563
Changes in operating assets and liabilities:		
Accounts receivable	2,169	(13,851)
Inventories	(826)	(4,547)
Prepaid expenses and other assets	725	(530)
Accounts payable	(3,824)	7,370
Accrued compensation and expenses	(3,005)	(1,448)
Deferred revenue	8	(228)
Income taxes payable	15	345
Other long-term liabilities	(65)	(516)
Net cash used in operating activities	(9,983)	(20,111)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(1,914)	(865)
Net cash used in investing activities	(1,914)	(865)
Cash Flows From Financing Activities:		
Proceeds from sale of stock to employees	508	465
Proceeds from exercise of stock options and warrants	134	198
Net cash provided by financing activities	642	663
Effect of Exchange Rate Changes on Cash	(11)	37
Net Decrease in Cash and Cash Equivalents	(11,266)	(20,276)
Cash and Cash Equivalents, beginning of period	99,663	82,358
Cash and Cash Equivalents, end of period	$ 88,397	$ 62,082
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	$	$
Cash paid for income taxes	$ 172	$ 56

Supplemental Disclosure of Non-Cash Investing and Financing Activities:		
Construction in progress costs incurred but not paid	$ 350	$ 275

See accompanying notes to unaudited condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

The Company

Dot Hill Systems Corp (referred to herein as Dot Hill, we, our or us) is a provider of entry level and midrange storage systems for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware, firmware and software products employing a modular system that allows end-users to add capacity as needed. Our broad range of products, from medium capacity stand-alone storage units to complete very high capacity storage area networks, provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our new product family based on our R/Evolution(TM) architecture provides high performance and large 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. Our SANnet products have been distinguished by certification as Network Equipment Building System, or NEBs, Level 3 (a telecommunications standard for equipment used in central offices) and are MIL-STD-810F (a military standard created by the U.S. government) compliant based on their ruggedness and reliability.

Basis of Presentation

The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Securities and Exchange Commission, or SEC, Form 10Q and Article 10 of SEC Regulation S-X. They do not include all of the information and footnotes required by generally accepted accounting principles, or GAAP, for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007. Operating results for the three and six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2008.

Use of Estimates

The preparation of our financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenue and expenses in the reporting periods. We regularly evaluate estimates and assumptions related to allowances for doubtful accounts, sales returns and allowances, warranty reserves, inventory reserves, share-based compensation expense, deferred income tax asset valuation allowances, uncertain tax positions, tax contingencies, litigation and other contingencies. We base our estimates and assumptions on current facts, historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the accrual of costs and expenses that are not readily apparent from other sources. The actual results experienced by us may differ materially and adversely from our estimates. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

Revenue Recognition

In accordance with SEC Staff Accounting Bulletin, or SAB, No. 101, *Revenue Recognition in Financial Statements*, and SAB No. 104, *Revenue Recognition,* we recognize product revenue when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the price to our customer is fixed or determinable and (iv) collection of the resulting accounts receivable is reasonably assured. Revenue is recognized for product sales upon transfer of title to the customer. We record reductions to revenue for estimated product returns and pricing adjustments in the same period that the related revenue is recorded. These estimates are based on historical sales returns, analysis of credit memo data, and other factors known at the time. If actual future returns and allowances differ from past experience, additional allowances may be required. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 to

36 months. We recognize revenue on upfront nonrefundable payments from our customers by deferring the payment and recognizing it ratably over the term of the agreement. In accordance with Emerging Issues Task Force, or EITF, Issue No. 01-9, *Accounting for Consideration Given by a*

Vendor to a Customer (Including a Reseller of the Vendor s Products), when we provide consideration to our customers we recognize the value of that consideration as a reduction in revenue. We maintain inventory, or hubbing, arrangements with certain of our customers. Pursuant to these arrangements we deliver products to a customer or a designated third party warehouse based upon the customer s projected needs, but do not recognize product revenue unless and until the customer reports that it has removed our product from the warehouse to incorporate into its end products.

A majority of our net revenue is derived from a limited number of customers. We currently have three customers that each account for more than 10% of our total net revenue; Sun Microsystems, Hewlett Packard, and NetAPP. For the three months ended June 30, 2008 sales to these OEM customers accounted for approximately 84% of total sales as compared to approximately 75% for the three months ended June 30, 2007. Net revenue to Sun accounted for approximately 28% and 65% of total net revenue for the three months ended June 30, 2008 and 2007, respectively. Net revenue to HP accounted for 33% and less than 1% of total net revenue for the three months ended June 30, 2008 and 2007, respectively. Net revenue to NetAPP accounted for 22% and 9% of total net revenue for the three months ended June 30, 2008 and 2007, respectively. For the six months ended June 30, 2008 sales to these OEM customers accounted for approximately 79% of total sales as compared to approximately 76% for the six months ended June 30, 2007. Net revenue to Sun accounted for approximately 35% and 71% of total net revenue for the six months ended June 30, 2008 and 2007, respectively. Net revenue to HP accounted for 21% and less than 1% of total net revenue for the six months ended June 30, 2008 and 2007, respectively. Net revenue to NetAPP accounted for 23% and less than 5% of total net revenue for the six months ended June 30, 2008 and 2007, respectively. No other customer had net revenue for the three and six months ended June 30, 2008 and 2007 that represented 10% or more of our total net revenue.

Foreign Currency Transaction and Translation

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

During the first quarter of 2008, we closed our operations in the Netherlands and transitioned all functions previously performed in that location to our Carlsbad location. During this process, we performed a review of the functional currency for this operation in accordance with *Financial Accounting Standards Board* , or FASB, Statement No. 52, *Foreign Currency Transactions,* and based on the changes in operating conditions and economic facts and circumstances we changed the functional currency for our operation in the Netherlands from the Euro to the United States dollar effective January 1, 2008. For 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.

Adoption of New Accounting Pronouncements

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and requires enhanced disclosures about fair value measurements. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. In February 2008 the FASB issued FASB staff position, or FSP, No. 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of FASB Statement No. 157 for non-financial assets and liabilities, other than those that are recognized or disclosed at fair value on a recurring basis, to fiscal years beginning after November 15, 2008. The Company s adoption of FASB Statement No. 157 related to financial assets and liabilities in the quarter ended March 31, 2008, had no impact on the Company s condensed consolidated financial statements. The Company is currently evaluating the impact, if any, that FASB Statement No. 157 may have on its future condensed consolidated financial statements related to non-financial assets and liabilities.

Recent Accounting Pronouncements

In December 2007 the FASB issued FASB Statement No. 141(R), *Business Combinations*. FASB Statement No. 141(R) establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. FASB Statement No. 141(R) is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combinations we engage in will be recorded and disclosed following existing GAAP until January 1, 2009. We are in the process of assessing the impact of the adoption of this standard on our future consolidated financial statements.

In April 2008, the FASB issued FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets*. FSP FAS 142-3 amends FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to improve the consistency between the useful life of a recognized intangible asset under FASB Statement No. 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No 141, *Business Combinations*, and other U.S. GAAP. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008. The guidance for determining the useful life of a recognized intangible asset is to be applied prospectively, therefore, the impact of the implementation of this pronouncement cannot be determined until the transactions occur.

2. Share-Based Compensation

We account for share-based compensation in accordance with the FASB Statement No.123(R), *Share-Based Payment*, which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees, directors and consultants, including stock option grants and purchases of stock made pursuant to our 2000 Amended and Restated Equity Incentive Plan, or the 2000 EIP, our 2000 Amended and Restated Non-Employee Directors Stock Option Plan, or the 2000 NEDSOP, and our 2000 Amended and Restated Employee Stock Purchase Plan, or the 2000 ESPP, based on estimated fair values.

FASB Statement No. 123(R) requires us to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the award s portion that is ultimately expected to vest is recognized as expense over the requisite service periods in the accompanying unaudited condensed consolidated financial statements for the three and six months ended June 30, 2007 and 2008.

As of June 30, 2008, total unrecognized share-based compensation cost related to unvested stock options was $6.1 million, which is expected to be recognized over a weighted average period of approximately 2.8 years. We have included the following amounts for share-based compensation cost, including the cost related to the 2000 EIP, 2000 NEDSOP and 2000 ESPP, in the accompanying unaudited condensed consolidated statements of operations (amounts in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2008**	**2007**	**2008**
Cost of goods sold	$ 67	$ 108	$ 170	$ 204
Sales and marketing	120	147	225	286
Research and development	174	261	367	458
General and administrative	391	382	215	615
Share-based compensation expense before taxes	752	898	977	1,563
Related deferred income tax benefits				
Share-based compensation expense, net of income taxes	$ 752	$ 898	$ 977	$ 1,563
Net share-based compensation expense per basic and diluted common share	$ 0.02	$ 0.02	$ 0.02	$ 0.03

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2008**	**2007**	**2008**
Share-based compensation expense is derived from:				
Stock options	$ 661	$ 797	$ 791	$ 1,365
2000 ESPP	91	101	186	198

Share-based compensation expense before taxes	$ 752	$ 898	$ 977	$ 1,563

Share-based compensation expense recognized during the three and six months ended June 30, 2008 included (1) compensation expense for awards granted prior to, but not fully vested as of, January 1, 2006 and (2) compensation expense for the share-based payment awards granted subsequent to December 31, 2005, based on the grant date fair values estimated in accordance with the provisions of FASB Statement No. 123(R). FASB Statement No.123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma disclosures required under FASB Statement No.123, *Accounting for Stock-based Compensation*, for the periods prior to 2006, we accounted for forfeitures as they occurred. We have historically and continue to estimate the fair value of share-based awards using the Black-Scholes option-pricing model. Total unrecognized share-based compensation cost related to unvested stock options as of June 30, 2008 has been adjusted for changes in estimated forfeitures.

To estimate compensation expense under FASB Statement No.123(R) for the six months ended June 30, 2007 and 2008, we used the Black-Scholes option-pricing model with the following weighted-average assumptions for equity awards granted:

	2000 EIP and 2000 NEDSOP Six Months Ended June 30,		**2000 ESPP Six Months Ended June 30,**	
	2007	**2008**	**2007**	**2008**
Risk-free interest rate	4.50%	2.50%	5.16%	2.07%
Expected dividend yield	%	%	%	%
Volatility	68%	68%	68%	68%
Expected life	5.4 years	5.6 years	0.5 years	0.5 years

The risk-free interest rate is based on the implied yield available on U.S. Treasury issues with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the future. The expected volatility is based on implied volatility of our stock for the related vesting period. The expected life of the equity award is based on historical experience.

Stock Incentive Plans

2*000 EIP*. During 2007 and 2008, we granted options to purchase common stock to our employees under the 2000 EIP. These options expire 10 years from the date of grant and typically vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. The number of shares of common stock reserved for issuance under the 2000 EIP is increased annually on the date of our meeting of stockholders by an amount equal to the lesser of (A) two percent of our outstanding shares as of the date of our annual meeting of stockholders, (B) 1,000,000 shares or (C) an amount determined by our board of directors. If an option is surrendered or for any other reason ceases to be exercisable in whole or in part, the shares with respect to which the option was not exercised shall continue to be available under the 2000 EIP. As of June 30, 2008, options to purchase 6,168,436 shares of common stock were outstanding under the 2000 EIP and the options to purchase 1,908,475 shares of common stock remained available for grant under the 2000 EIP.

2*000 NEDSOP*. Under the 2000 NEDSOP, nonqualified stock options to purchase common stock are automatically granted to our non-employee directors upon appointment to our board of directors (initial grants) and upon each of our annual meetings of stockholders (annual grants). Options granted under the 2000 NEDSOP expire 10 years from the date of the grant. Initial grants vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. Annual grants are fully vested on the date of grant. 1,000,000 shares of common stock are reserved for issuance under the 2000 NEDSOP. As of June 30, 2008, options to purchase 580,000 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 333,124 shares of common stock remained available for grant under the 2000 NEDSOP.

2*000 ESPP*. The 2000 ESPP qualifies under the provisions of Section 423 of the Internal Revenue Code, or IRC, and provides our eligible employees, as defined in the 2000 ESPP, with an opportunity to purchase shares of our common stock at 85% of fair market value, as defined in the 2000 ESPP. The number of shares of common stock reserved for issuance under the 2000 ESPP is increased annually on the date of our meeting of stockholders by an amount equal to the lesser of (A) 100,000 shares or (B) an amount determined by our board of directors. There were 191,594 and 168,971 shares issued for the 2000 ESPP during the six months ended June 30, 2007 and 2008, respectively.

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

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Outstanding at December 31, 2007	6,672,095	$ 5.36		
Granted	1,171,500	2.43		
Exercised	(73,715)	2.69		
Forfeited	(756,027)	3.67		
Expired	(265,417)	8.26		
Outstanding at June 30, 2008	6,748,436	$ 4.96	6.51	$ 392,293
Vested and expected to vest at June 30, 2008	6,197,269	$ 5.12	6.29	$ 362,289
Exercisable at June 30, 2008	4,173,991	$ 5.96	5.05	$ 270,843

The weighted average grant-date fair values of options granted during the three months ended June 30, 2007 and 2008 were $2.40 per share and $1.74 per share, respectively.

The weighted average grant-date fair values of options granted during the six months ended June 30, 2007 and 2008 were $2.22 per share and $1.60 per share, respectively.

During the six months ended June 30, 2008, cash generated from share-based compensation arrangements amounted to $0.2 million from the exercise of options and $0.5 million from the purchase of shares through the 2000 ESPP. We issue new shares from the respective plan share reserves upon exercise of options to purchase common stock and for purchases through the 2000 ESPP.

The total fair value of options to purchase common stock that vested during the three months ended June 30, 2007 and 2008 was $1.0 million and $0.7 million, respectively. The total fair value of options to purchase common stock that vested during the six months ended June 30, 2007 and 2008 was $1.8 million and $1.5 million, respectively.

3. Net Loss Per Share

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

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2008	2007	2008
Shares used in computing basic net loss per share	45,472	46,055	44,315	46,005
Dilutive effect of warrants and common stock equivalents				
Shares used in computing diluted net loss per share	45,472	46,055	44,315	46,005

For the three months ended June 30, 2007, outstanding options to purchase 6,275,531 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,109,084 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive. For the six months ended June 30, 2007, outstanding options to purchase 5,984,137 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,400,961 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive.

For the three and six months ended June 30, 2008, outstanding options to purchase 6,748,436 shares of common stock with exercise prices ranging from $1.34 to $16.36 per share were not included in the calculation of diluted loss per share because their effect was antidilutive.

4. Cash and Cash Equivalents

At June 30, 2008, we had $62.1 million in cash and cash equivalents. Pursuant to FASB Statement No. 157, *Fair Value Measurements* the fair value of our cash equivalents is determined based on Level 1 inputs, which consist of quoted prices in active markets. We place our cash investments in instruments that meet credit quality standards and maturity guidelines, as specified in our investment policy. These guidelines limit the type, maturity and exposure to any one issue. The policy requires all investments to have a minimum rating of AAA, Aaa, AA, A-1 or P-1, as reported by two rating agencies.

Substantially all of our cash and cash equivalents are maintained with two major financial institutions in the United States. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand and, therefore, bear minimal risk.

A summary of our cash and cash equivalents by major security type is as follows (in thousands):

	June 30, 2008
Cash	$ 26,828
Commercial paper	5,888
Institutional money market funds	29,366
Cash and cash equivalents	$ 62,082

5. Inventories

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

	December 31, 2007	June 30, 2008
Purchased parts and materials	$ 1,187	$ 2,997
Finished goods	7,826	10,587
Total inventory	$ 9,013	$ 13,584

6. Intangible Assets

All of our identified intangible assets are considered to have finite lives and are being amortized in accordance with FASB Statement No. 142, *Goodwill and Other Intangible Assets,* and consist of the following (in thousands):

	December 31, 2007		
	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (4,260)	$ 740
Customer relationships	2,500	(2,500)	
Licensed patent portfolio	2,570	(1,030)	1,540
Total intangible assets	$ 10,070	$ (7,790)	$ 2,280

	June 30, 2008		
	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (4,815)	$ 185
Licensed Patent Portfolio	2,570	(1,288)	1,282
Total intangible assets	$ 7,570	$ (6,103)	$ 1,467

Amortization expense related to intangible assets totaled $0.6 million and $0.4 million for the three months ended June 30, 2007 and 2008, respectively. Amortization expense related to intangible assets totaled $1.2 million and $0.8 million for the six months ended June 30, 2007 and 2008, respectively.

Estimated future amortization expense related to intangible assets as of June 30, 2008 is as follows (in thousands):

Years ending December 31,	
2008 (remaining 6 months)	$ 442
2009	514
2010	511
Total	$ 1,467

7. Product Warranties Activity

We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are covered by supplier warranties. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future, which could have a material adverse effect on our operating results and financial condition if these warranties are eliminated. Estimated liabilities for product warranties are included in accrued expenses. The changes in our aggregate product warranty liability are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2008	2007	2008
Balance, beginning of period	$ 1,033	$ 1,208	$ 663	$ 1,381
Charged to operations	1,058	998	2,102	1,619
Deductions for costs incurred	(711)	(753)	(1,385)	(1,547)
Balance, end of period	$ 1,380	$ 1,453	$ 1,380	$ 1,453

Our deferred product maintenance revenue activity for the three and six months ended June 30, 2007 and 2008, respectively, is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2008	2007	2008
Balance, beginning of period	$ 612	$ 1,284	$ 581	$ 1,409
New warranty revenue contracts	306	820	698	1,268

Revenue recognized	(332)	(844)	(693)	(1,417)
Balance, end of period	$ 586	$ 1,260	$ 586	$ 1,260

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8. Income Taxes

We recorded an income tax benefit of $0.1 million and an income tax expense of $0.2 million for the three months ended June 30, 2007 and 2008, respectively. Our effective income tax rate was (3.34)% for the three months ended June 30, 2008 which differs from the federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

We recorded an income tax expense of $0.2 million and $0.4 million for the six months ended June 30, 2007 and 2008, respectively. Our effective income tax rate of (3.04)% for the six months ended June 30, 2008 differs from the federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

On January 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-An Interpretation of FASB Statement No.109*, or FIN 48. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues.

The cumulative effects of adopting FIN 48 resulted in an increase of $0.5 million to accumulated deficit and an increase in other long term liabilities of $0.5 million of tax benefits that, if recognized, would affect the effective tax rate. At December 31, 2007 we had cumulative unrecognized tax benefits of approximately $4.5 million, of which approximately $0.2 million are included in other long term liabilities that, if recognized, would affect the effective tax rate. The remaining $4.3 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, 2007, the total amount of accrued income tax related interest and penalties included in the consolidated balance sheet was less than $0.1 million. We do not expect that our unrecognized tax benefit will change significantly within the next 12 months. There have been no material changes to the unrecognized tax benefit during the three month period ended June 30, 2008.

Due to net operating losses and other tax attributes carried forward, we are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending March 31, 1994 through December 31, 2007. With few exceptions, our state income tax returns are open to audit for the years ended December 31, 1999 through 2007.

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 June 30, 2008, based on the weight of available evidence, including cumulative losses in recent years and expectations regarding future taxable income, we determined that it was not more likely than not that our United States deferred tax assets would be realized and have a $67.3 million valuation allowance associated with our United States deferred tax assets compared to $65.9 million at December 31, 2007.

As of December 31, 2007, we had federal and state net operating losses of approximately $144.0 million and $77.0 million, which begin to expire in the tax years ending 2013 and 2008, respectively. In addition, we had federal tax credit carryforwards of $3.9 million, of which approximately $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $3.4 million will begin to expire in the tax year ending 2008. We also had state tax credit carryforwards of $4.1 million, of which $3.8 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.3 million began to expire in the tax year ending 2008.

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

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

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

9. Accumulated Other Comprehensive Loss

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

	Foreign Currency Items
Balance, December 31, 2007	$ (3,100)
Quarterly change	(231)
Balance, March 31, 2008	(3,331)
Quarterly change	129
Balance, June 30, 2008	$ (3,202)

10. Credit Facilities

Effective July 1, 2007, we amended our credit agreement to extend our term for two years with Wells Fargo Bank, National Association, or Wells Fargo, which allows us to borrow up to $30.0 million under a revolving line of credit that expires July 1, 2009. Amounts loaned under the credit agreement bear interest at our option at a fluctuating rate per annum equal to the Prime Rate in effect from time to time, or at a fixed rate per annum determined by Wells Fargo to be 0.65% above LIBOR in effect on the first day of the applicable fixed rate term. In connection with the credit agreement, to the extent we have outstanding borrowings, we have granted Wells Fargo a security interest in our investment management account maintained with Wells Capital Management Incorporated. As of December 31, 2007 and June 30, 2008, there were no balances outstanding under this line of credit. The credit agreement limits any new borrowings, loans or advances outside of the credit agreement to an amount less than $1.0 million and annual capital expenditures to an amount less than $10.0 million.

In August, 2008, Dot Hill entered into a credit agreement with Silicon Valley Bank to provide for a revolving credit facility for cash advances and letters of credit of up to an aggregate of $30 million based upon an advance rate of 85% of eligible accounts receivable. The credit agreement expires three years from the effective date. Borrowings under the credit facility bear interest at the prime rate and are secured by substantially all of Dot Hill s accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on Dot Hill s inventory and intellectual property, subject to certain exceptions, and contains usual and customary covenants for an arrangement of its type, including an obligation of Dot Hill to maintain at all times a net worth of $55 million (subject to certain increases). The agreement also includes provisions to increase the financing facility by $20 million subject to Dot Hill 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 Dot Hill s cash and cash equivalents net of the total amount outstanding under the credit facility fall below $20 million (measured on a rolling three-month basis), the interest rate will increase to prime plus 1% and additional restrictions will apply.

On August 4, 2008, Dot Hill terminated its credit agreement dated July 1, 2004, as amended, with Wells Fargo Bank, National Association, effective as of August 6, 2008. The material terms and conditions of the credit agreement are described in Dot Hill s Annual Report on Form 10-K for the fiscal year ended December 31, 2007. The credit agreement was terminated as it was no longer necessary given the establishment of Dot Hill s revolving credit facility with Silicon Valley Bank. There were no early termination penalties associated with the termination of the credit agreement and no outstanding borrowings under the credit line established by the credit agreement at the time of its termination.

11. Commitments and Contingencies

Contingencies

Crossroads Systems Litigation

On October 17, 2003, Crossroads Systems, Inc., or Crossroads, filed a lawsuit against us in the United States District Court in Austin, Texas, alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of Small Computer Systems Interface, or SCSI, storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004.

On June 28, 2006 we entered into a Settlement and License Agreement with Crossroads that settles the lawsuit and licenses to us the family of patents from which it stemmed. We concurrently entered into an Agreement between Dot Hill Systems and Infortrend Re Settlement of Crossroads Lawsuit with Infortrend Technology, Inc. In accordance with the Crossroads and Infortrend agreements, July 14, 2006, we paid $3.35 million to Crossroads for alleged past damages and Crossroads agreed to dismiss, with prejudice, all patent claims against us. In addition, Infortrend paid Crossroads an additional $7.15 million on our behalf, from which $1.43 million was withheld for Taiwan taxes and is included in income tax expense on our statement of operations. Going forward, Crossroads will receive a running royalty of 2.5% based on a percentage of net sales of RAID products sold by us, but only those with functionality that is covered by United States Patents No. 5,941,972 and No. 6,425,035 and other patents in the patent family. For RAID products that use a controller sourced by Infortrend, we will pay 0.8125% of the 2.5% royalty, and Infortrend will be responsible for the remainder. For RAID products that use our proprietary controller, we alone will be paying the 2.5% running royalty. No royalty payments will be required with respect to the sale of storage systems that do not contain RAID controllers, known as JBOD systems, or systems that use only the SCSI protocol end-to-end, even those that perform RAID. Further, royalty payments with respect to the sale of any products that are made, used and sold outside of the United States will only be required if and when Crossroads is issued patents that cover the products and that are issued by countries in which the products are manufactured, used or sold.

On July 24 and 25th, 2006, respectively, Crossroads filed another lawsuit against us in the United States District Court for the Western District of Texas as well as a Motion to Enforce in the aforementioned lawsuit. Both the new lawsuit and motion alleged that Dot Hill had breached the June 28, 2006 Settlement and License Agreement by deducting $1.43 million of the lump sum payment of $10.50 million as withholding against any potential Taiwan tax liability arising out of Dot Hill s indemnification by Infortrend, a Taiwan company. On September 28, 2006 the Court indicated that it would grant Crossroads Motion to Enforce. On October 5, 2006, Crossroads and Dot Hill amended the original Settlement and License Agreement to state that Dot Hill would pay to Crossroads $1.43 million, plus $45,000 in late fees, and would not make deductions based on taxes on royalty payments in the future. The payment of the $1.475 million was made on October 5, 2006. As required by the amended settlement, Crossroads has dismissed with prejudice the original patent action as well as the second lawsuit based on the enforcement of the original settlement.

Thereafter, we gave notice to Infortrend of our intent to bring a claim alleging breach of the settlement agreement seeking reimbursement of $1.475 million from Infortrend. On November 13, 2006, Infortrend filed a lawsuit in the Superior Court of California, County of Orange for declaratory relief. The complaint seeks a court determination that Infortrend is not obligated to reimburse Dot Hill for $1.475 million. On December 12, 2006, we answered the complaint and filed a cross complaint alleging breach of contract, fraud, breach of implied covenant of good faith and fair dealing, breach of fiduciary duty and declaratory relief. Infortrend demurred to the cross complaint. The Court denied the demurrer as to the fraud cause of action and sustained the demurrer as to the claims for breach of the covenant of good faith and fair dealing and breach of fiduciary duty. We have entered into a settlement, the terms of which are confidential, and a stipulation for dismissal of the entire action has been filed with the court. The amount of this settlement will have an immaterial effect on the condensed consolidated financial statements. The outcome of this action is uncertain, and no amounts have been accrued as of June 30, 2008.

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

In late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints allege violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004, and seeking damages therefore. The complaints were consolidated into a single action, and the Court appointed as lead plaintiff a group comprised of the Detroit Police and Fire Retirement System and the General Retirement System of the City of Detroit. The consolidated complaint was filed on August 25, 2006, and we filed a motion to dismiss on October 5, 2006. The Court granted our motion to dismiss on March 15, 2007. Plaintiffs filed their Second Amended Consolidated Complaint on April 20, 2007. We filed a motion to dismiss the Second Amended Consolidated Complaint on May 1, 2008 and a hearing is set for August 14, 2008. The outcome of these actions is uncertain, and no amounts have been accrued as of June 30, 2008.

In addition, three complaints purporting to be derivative actions have been filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. Our demurrer to two of those cases, in which we sought dismissal, was overruled (i.e., denied). We formed a Special Litigation Committee, or SLC, of disinterested directors to investigate the alleged wrongdoing. On January 12, 2007, another derivative action similar to the previous derivative actions with the addition of allegations regarding purported stock option backdating was served on us. On April 16, 2007, the SLC concluded its investigation and based on its findings directed us to file a motion to dismiss the derivative matters. On June 27, 2007, the parties stipulated to consolidate all of the derivative matters for pre-trial proceedings. We filed a motion to dismiss the consolidated matters pursuant to the SLC s directive on May 30, 2008 and a hearing is set for November 18, 2008. The outcome of these actions is uncertain, and no amounts have been accrued as of June 30, 2008.

In August 2007, a securities lawsuit was filed in California state court by a single former stockholder against certain of our directors and executive officers. This complaint is based on the same facts and circumstances described in the federal class action and state derivative complaints, and generally alleges that Dot Hill and the named officers and directors committed fraud and violated state securities laws. The complaint seeks $500,000 in damages, as well as attorneys fees and costs. On November 1, 2007, we filed a motion to dismiss the complaint, which was granted on February 15, 2008. On February 25, 2008, the plaintiff filed his First Amended Complaint. We filed a motion to dismiss the First Amended Complaint on March 6, 2008, which was granted on May 16, 2008. Plaintiffs were granted leave to amend. The outcome of this action is uncertain, and no amounts have been accrued as of June 30, 2008.

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

Other Litigation

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

12. Warrant

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

13. Segment Information

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

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

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

	SANnet Family	Legacy and Other	Services	Total
Three months ended:				
June 30, 2007:				
Net revenue	$54,665	$ 63	$1,471	$56,199
Gross profit	$ 6,197	$ 25	$ 702	$ 6,924
June 30, 2008:				
Net revenue	$69,788	$ 65	$1,174	$71,027
Gross profit	$ 6,718	$ 44	$ 460	$ 7,222

	SANnet Family	Legacy and Other	Services	Total
Six months ended:				
June 30, 2007:				
Net revenue	$106,613	$ 240	$2,787	$109,640
Gross profit	$ 12,392	$ 67	$1,139	$ 13,598
June 30, 2008:				
Net revenue	$120,173	$ 213	$3,467	$123,853
Gross profit	$ 9,316	$ 58	$2,014	$ 11,388

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

	SANnet Family	Legacy and Other	Services	Total
As of:				
December 31, 2007	$132,599	$1,022	$6,306	$139,927
June 30, 2008	$132,848	$ 623	$3,111	$136,581

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Cautionary Statement for Forward-Looking Information

Certain statements contained in this quarterly report on Form 10-Q, including statements regarding the development, growth and expansion of our business and our intent, belief or current expectations with respect to our future operating performance and the products we expect to offer, and other statements regarding matters that are not historical facts, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and are subject to the safe harbor created by these sections. Because such forward-looking statements are subject to risks and uncertainties, many of which are beyond our control, actual results may differ materially from those expressed or implied by such forward-looking statements. Some of the factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements can be found in Part II, Item 1A, Risk Factors and in our reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the year ended December 31, 2007. Readers are cautioned not to place undue reliance on forward-looking statements. The forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.

The following discussion of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q and our consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2007.

Overview

We are a provider of entry level and midrange storage systems for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware, firmware and software products employing a modular system that allows end-users to add capacity as needed. Our broad range of products, from medium capacity stand-alone storage units to complete very high capacity storage area networks, or SANs, provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our new product family based on our R/Evolution architecture provides high performance and large capacities for a broad variety of environments, employing Fibre Channel, or FC, or Internet Small Computer Systems Interface, or iSCSI, or Serial Attached SCSI, or SAS, interconnects to switches and/or hosts. Our SANnet products have been distinguished by certification as Network Equipment Building System, or NEBS, Level 3 (a telecommunications standard for equipment used in central offices) and are MIL-STD-810F (a military standard created by the U.S. government) compliant based on their ruggedness and reliability.

Our products and services are sold worldwide to end-users through our channel partners, which consist primarily of original equipment manufacturers, or OEMs, supplemented by system integrators, or SIs, and distribution and value added resellers, or VARs. Our OEM channel partners currently include, among others, Hewlett Packard, or HP, Sun Microsystems, or Sun, NetAPP, Inc., or NetAPP, Fujitsu Siemens Computers, or Fujitsu Siemens, Motorola, NEC, Sepaton and Stratus Technologies.

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. The warrant was fully vested and exercisable at signing. The fair value of the warrant, determined using the Black-Scholes option-pricing model, was approximately $2.3 million. The Black-Scholes option-pricing model utilized the following assumptions; a risk-free interest rate of 3.18%, expected volatility of 59.5% and a contractual life of five years. The warrant was issued to induce the customer to enter into the Agreement with us. The fair value of the warrant was recorded as a reduction in revenue for the three months ended March 31, 2008, the period the Agreement was signed.

We have been shipping our products to Sun for resale to Sun s customers since October 2002 and continue to do so. Over the past year we have experienced a decline in net revenues from Sun. Pursuant to our Development and OEM Supply Agreement with NetAPP, we are designing and developing general purpose disk arrays for a variety of products to be sold under private label by NetAPP. We began shipping products to NetAPP under the agreement for general availability in the third quarter of 2007 and expect revenues from NetAPP to increase during 2008. Pursuant to our Master Purchase Agreement with Fujitsu Siemens, we jointly developed with Fujitsu Siemens storage solutions utilizing key components and patented technologies from Dot Hill. We began shipping products to Fujitsu Siemens under the agreement in July 2006.

Our agreements with our channel partners do not contain any minimum purchase commitments and may be terminated at any time upon notice from the applicable partner. Our ability to achieve a return to profitability will depend on the level and mix of orders we actually receive from our channel partners, the actual amounts we spend for inventory support and incremental internal investment, our ability to reduce product cost, our product lead time and our ability to meet delivery schedules required by our channel partners.

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 party s manufacturing and procurement economies of scale. Since 2002, we have outsourced substantially all of our manufacturing operations to Solectron Corporation, or Solectron, which was subsequently purchased by Flextronics International Limited, or Flextronics. In February 2007, we entered into a manufacturing agreement with MiTAC International Corporation, or MiTAC, a leading provider of contract manufacturing and original design manufacturing services, and SYNNEX Corporation, or SYNNEX, a leading global information technology, or IT, supply chain services company. Under the terms of the agreement, MiTAC supplies Dot Hill with manufacturing, assembly and test services from its facilities in China and SYNNEX provides Dot Hill with final assembly, testing and configure-to-order services through its facilities in Fremont, California and Telford, United Kingdom. We began shipping products for general availability under the MiTAC and SYNNEX agreement in 2007. All of our Series 2000 and Series 5000 R/Evolution products are now manufactured by these partners.

We derive net revenues primarily from sales of our SANnet II and Series 2000 family of products and we are in the process of transitioning SANnet II customers to our Series 2000 family of products.

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

Sales and marketing expenses consist primarily of salaries and commissions, advertising and promotional costs and travel expenses. Research and development expenses consist primarily of project-related expenses and salaries for employees directly engaged in research and development. General and administrative expenses consist primarily of compensation to officers and employees performing administrative functions, expenditures for administrative facilities as well as expenditures for legal and accounting services and fluctuations in currency valuations.

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

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Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our condensed 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 in accordance with United States generally accepted accounting principles, or 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 revenues and expenses in the reporting periods. We regularly evaluate estimates and assumptions related to allowances for doubtful accounts, sales returns and allowances, warranty reserves, inventory reserves, share-based compensation expense, deferred income tax asset valuation allowances, uncertain tax positions, tax contingencies, litigation and other contingencies. We base our estimates and assumptions on current facts, historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the accrual of costs and expenses that are not readily apparent from other sources. The actual results experienced by us may differ materially and adversely from our estimates. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

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

Revenue Recognition

We recognize product revenue when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) our price to the customer is fixed or determinable and (iv) collection of the resulting accounts receivable is reasonably assured. We recognize revenue for product sales upon transfer of title to the customer. Customer purchase orders and/or contracts are generally used to determine the existence of an arrangement. Shipping documents and the completion of any customer acceptance requirements, when applicable, are used to verify product delivery or that services have been rendered. We assess whether a price is fixed or determinable based upon the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess the collectibility of our accounts receivable based primarily upon the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 to 36 months. 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. Historically these amounts have not been material. In accordance with Emerging Issues Task Force, or EITF, Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products),* when we provide consideration to our customers we recognize the value of that consideration as a reduction in revenue.

A majority of our net revenue is derived from a limited number of customers. We currently have three customers that each account for more than 10% of our total net revenue; Sun Microsystems, Hewlett Packard, and NetAPP. For the three months ended June 30, 2008 sales to these OEM customers accounted for approximately 84% of total sales as compared to approximately 75% for the three months ended June 30, 2007. Net revenue to Sun accounted for approximately 28% and 65% of total net revenue for the three months ended June 30, 2008 and 2007, respectively. Net revenue to HP accounted for 33% and less than 1% of total net revenue for the three months ended June 30, 2008 and 2007, respectively. Net revenue to NetAPP accounted for 22% and 9% of total net revenue for the three months ended June 30, 2008 and 2007, respectively. For the six months ended June 30, 2008 sales to these OEM customers accounted for approximately 79% of total sales as compared to approximately 76% for the six months ended June 30, 2007. Net revenue to Sun accounted for approximately 35% and 71% of total net revenue for the six months ended June 30, 2008 and 2007, respectively. Net revenue to HP accounted for 21% and less than 1% of total net revenue for the six months ended June 30, 2008 and 2007, respectively. Net revenue to NetAPP accounted for 23% and less than 5% of total net revenue for the six months ended June 30, 2008 and 2007, respectively. No other customer had net revenue for the three and six months ended June 30, 2008 and 2007 that represented 10% or more of our total net revenue.

We maintain inventory, or hubbing, arrangements with certain of our customers. Pursuant to these arrangements we deliver products to a customer or a designated third party warehouse based upon the customer s projected needs, but do not recognize product revenue unless and until the customer reports that it has removed our product from the warehouse to incorporate into its end products. If a customer does not take our product under a hubbing arrangement in accordance with the schedule it originally provided to us, our future net revenue stream could vary substantially from our forecasts and our results of operations could be materially affected.

In July 2007, we received an upfront nonrefundable payment from one of our customers in the amount of $2.5 million. This amount represented a reimbursement for production test equipment and tooling that will be utilized over the term of the agreement to manufacture product for this customer. The upfront nonrefundable payment has been deferred and is being recognized ratably over the term of the agreement.

Valuation of Inventories

Inventories are comprised of purchased parts and assemblies, which include direct labor and overhead. We record inventories at the lower of cost or market value, with cost generally determined on a first-in, first-out basis. We establish inventory reserves for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of inventory and its estimated realizable value based upon assumptions about future demand and market conditions. If actual demand and market conditions are less favorable than those projected by management, additional inventory reserves could be required. Under the hubbing arrangements that we maintain with certain customers, we own inventory that is physically located in a third party s warehouse. As a result, our ability to effectively manage inventory levels may be impaired, which would cause our total inventory turns to decrease. In that event, our expenses associated with excess and obsolete inventory could increase and our cash flow could be negatively impacted.

Foreign Currency Transaction and Translation

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

During the first quarter of 2008, we closed our operations in the Netherlands and transitioned all functions previously performed in that location to our Carlsbad location. During this process, we performed a review of the functional currency for this operation in accordance with Financial Accounting Standards Board, or FASB, Statement No. 52 *Foreign Currency Transactions* and based on the changes in operating conditions and economic facts and circumstances we changed the functional currency for our operation in the Netherlands from the Euro to the United States dollar effective January 1, 2008. For 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.

Deferred Taxes

We utilize the liability method of accounting for income taxes. We record a valuation allowance to reduce our deferred tax assets to the amount that we believe is more likely than not to be realized. In assessing the need for a valuation allowance, we consider all positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies, and recent financial performance. As a result of our cumulative losses in the U.S. and certain foreign jurisdictions, we have concluded that a full valuation allowance against our net deferred tax assets is appropriate in such jurisdictions. In certain other foreign jurisdictions where we do not have cumulative losses, we record valuation allowances to reduce our net deferred tax assets to the amount we believe is more likely than not to be realized. In the future, if we realize a deferred tax asset that currently carries a valuation allowance, we may record a reduction to income tax expense in the period of such realization. In July 2006 the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109*, or FIN 48, which requires income tax positions to meet a more-likely-than-not recognition threshold to be recognized in the financial statements. Under FIN 48, tax positions that previously failed to meet the more-likely-than-not threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Prior to 2007 we recorded estimated income tax liabilities to the extent they were probable and could be reasonably estimated. We are subject to taxation in many jurisdictions, and the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax laws and regulations in various taxing jurisdictions. If we ultimately determine that the payment of these liabilities will be unnecessary, we reverse the liability and recognize a tax benefit during the period in which we determine the requirement to recognize the liability no longer applies. Conversely, we record additional tax charges in a period in which we determine that a recorded tax liability is less than we expect the ultimate assessment to be. In assessing the need for a valuation allowance, we consider all positive and negative evidence.

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The application of tax laws and regulations is subject to legal and factual interpretation, judgment and uncertainty. Tax laws and regulations themselves are subject to change as a result of changes in fiscal policy, changes in legislation, the evolution of regulations and court rulings. Therefore, the actual liability for U.S. or foreign taxes may be materially different from our estimates, which could result in the need to record additional tax liabilities or potentially reverse previously recorded tax liabilities or deferred tax asset valuation allowance.

Share-Based Compensation

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

As of June 30, 2008, total unrecognized share-based compensation cost related to unvested stock options was $6.1 million, which is expected to be recognized over a weighted average period of approximately 2.8 years.

Contingencies

From time to time we are involved in disputes, litigation and other legal proceedings. We prosecute and defend these matters aggressively. However, there are many uncertainties associated with any litigation, and we cannot assure you that these actions or other third party claims against us will be resolved without costly litigation and/or substantial settlement charges. In addition, the resolution of intellectual property litigation may require us to pay damages for past infringement or to obtain a license under the other party s intellectual property rights that could require one-time license fees or running royalties, which could adversely impact gross profit and gross margins in future periods, or could prevent us from manufacturing or selling some of our products. If any of those events were to occur, our business, financial condition and results of operations could be materially and adversely affected. We record a charge equal to at least the minimum estimated liability for a loss contingency when both of the following conditions are met: (i) information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements and (ii) the range of loss can be reasonably estimated. However, the actual liability in any such disputes or litigation may be materially different from our estimates, which could result in the need to record additional costs.

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Results of Operations

The following table sets forth certain items from our statements of operations as a percentage of net revenue for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2008	2007	2008
Net revenue	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	87.7	89.8	87.6	90.8
Gross profit	12.3	10.2	12.4	9.2
Operating expenses:				
Sales and marketing	6.9	5.1	7.1	6.4
Research and development	8.5	10.0	9.9	11.8
General and administrative	5.9	5.6	6.4	5.6
Legal settlement				(3.1)
Total operating expenses	21.3	20.7	23.4	20.7
Operating loss	(9.0)	(10.5)	(11.0)	(11.5)
Other income, net	2.2	0.5	2.3	0.9
Income tax (benefit /)expense		0.3		0.3
Net loss	(6.7)%	(10.4)%	(8.9)%	(10.9)%

(percentages may not aggregate due to rounding)

Three Months Ended June 30, 2007 Compared to the Three Months Ended June 30, 2008

Net Revenue

	Three Months Ended June 30,			
	2007	2008	Increase	% Change
	(in thousands, except percentages)			
Net Revenue	$ 56,199	$ 71,027	$ 14,828	26.5%

The increase in net revenue is primarily attributable to an increase in net revenue from HP, who sells a version of our Series 2000 family of products, and from NetAPP, partially offset by a decrease in net revenue from Sun who sells our SANnet II family of products under the ST-3000 brand product line. Our net revenue from HP for the three months ended June 30, 2008 totaled $23.8 million, or 33.4% of total net revenue. There was no significant net revenue from HP for the three months ended June 30, 2007. The substantial increase in HP net revenue is due to the execution of the amended OEM agreement with HP in January 2008, whereby we expanded our product offerings to additional divisions of HP. Our net revenue from NetAPP increased $10.3 million, or 196.4%, from the three months ended June 30, 2007 as compared to the three months ended June 30, 2008. For the three months ended June 30, 2007, net revenue from NetAPP totaled $5.3 million, or 9.4% of our total net revenue, compared to $15.6 million, or 22.0%, of our total net revenue for the three months ended June 30, 2008. The rapid growth in net revenue from NetAPP was driven by NetAPP s product launch during the third quarter of 2007. Our net revenues from Sun decreased $16.6 million, or 45.1%, from the three months ended June 30, 2007 as compared to the three months ended June 30, 2008. For the three months ended June 30, 2007, net revenue from Sun totaled $36.7 million, or 65.3%, of our total net revenue, compared to $20.2 million, or 28.3%, of our total net revenue for the three months ended June 30, 2008. The decline in Sun net revenue is primarily due to the products nearing the end of their lifecycle and the lack of follow-on products for the ST-3000 line having been developed to date. We expect net revenue from Sun to continue to decline over future periods.

Cost of Goods Sold

	Three Months Ended June 30, 2007		Three Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
			(in thousands, except percentages)			
Cost of Goods Sold	$ 49,275	87.7%	$ 63,805	89.8%	$ 14,531	29.5%

The increase in cost of goods sold in absolute dollars was primarily due to a 26.5% increase in net revenue. The increase in cost of goods sold as a percentage of net revenue was attributable to a change in product and customer sales mix. Net revenue from our highest margin product, sold to Sun and other SANnet II customers, declined as a percentage of total net revenue. Sun net revenue declined from 65.4% of total net revenue for the three months ended June 30, 2007 to 28.3% of total net revenue for the three months ended June 30, 2008. This was replaced by lower margin net revenue from our Series 2000 products and net revenue from NetAPP. Cost of goods sold as a percentage of revenue, associated with our Series 2000 products, improved significantly from the three months ended June 30, 2007 as compared to the three months ended June 30, 2008 as the Series 2000 product first started shipping in the third quarter of 2006 and was initially manufactured in a mostly soft tooled environment resulting in higher costs of goods sold. Also, we substantially completed the transition of the manufacturing of our Series 2000 products from Flextronics to MiTAC and SYNNEX and have been able to take advantage of their lower manufacturing costs. This transition was largely completed during the fourth quarter of 2007. Additionally, the Series 2000 product cost of goods sold has improved due to higher volume from our amended agreement with HP, component cost reductions and value engineering of the products. Our historical experience indicates that gross margins on new products sold to new customers start out low initially and increase over the first several quarters. Thereafter the margin improvements are generally more modest. The cost of goods sold on our business with NetAPP improved from the three months ended June 30, 2007 as compared to the three months ended June 30, 2008 primarily for the same reasons as for the Series 2000 products. The product we sell to NetAPP does not include higher margin value added features such as RAID controllers. As we continue to transition our net revenue from Sun and other SANnet II customers with higher margins to HP and NetAPP and other customers with lower margins, we anticipate cost of goods sold will continue to be a higher percentage of net revenue throughout 2008 in comparison to corresponding periods in the prior year.

Gross Profit

	Three Months Ended June 30, 2007		Three Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
			(in thousands, except percentages)			
Gross Profit	$ 6,924	12.3%	$ 7,222	10.2%	$ 298	4.3%

The slight increase in gross profit in absolute dollars for the three months ended June 30, 2008 compared to the three months ended June 30, 2007 was primarily attributable to an increase in net revenue of $14.8 million or 26.5% and a change in product and revenue mix. Net revenue on our highest margin product, sold to Sun, declined as a percentage of total net revenue from 65.4% of net revenue for the three months ended June 30, 2007 to 28.3% of net revenue for the three months ended June 30, 2008. This was replaced by lower margin net revenue from our Series 2000 products and net revenue from NetAPP. Net revenue from our Series 2000 products sold primarily to HP and net revenue from NetAPP represented 22.8% of our net revenue for the three months ended June 30, 2007 compared to 64.5% of our net revenue for the three months ended June 30, 2008.

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Sales and Marketing Expenses

	Three Months Ended June 30, 2007		Three Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Sales and Marketing Expenses	$ 3,871	6.9%	$ 3,647	5.1%	$ (224)	(5.8)%

The decrease in sales and marketing expenses in both absolute dollars and as a percentage of net revenue was primarily attributable to a decrease in intangible asset amortization and other professional fees. Intangible asset amortization decreased by $0.2 million due to the asset becoming fully amortized in 2007. Other professional fees decreased by approximately $0.1 million due to lower manufacturing representative commissions. These decreases are offset by a slight increase in evaluation unit expense.

Research and Development Expenses

	Three Months Ended June 30, 2007		Three Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Research and Development Expenses	$ 4,797	8.5%	$ 7,125	10.0%	$ 2,328	48.5%

The increase in research and development expense in both absolute dollars and as a percentage of net revenue was primarily due to a $0.8 million increase in project materials, as well as a $0.3 million increase in outside testing and tooling to support development projects for our OEM customer HP. Additionally, we had a $0.2 million increase due to consulting fees for the development of an application-specific integrated circuit, or ASIC, chip. We also had an increase in salaries of $0.2 million to support HP and other projects and an increase in general overhead expense of $0.4 million. The three months ended June 30, 2007 included the benefit of $0.4 million of non-recurring engineering recovery billed to NetAPP.

General and Administrative Expenses

	Three Months Ended June 30, 2007		Three Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
	$ 3,322	5.9%	$ 3,939	5.6%	$ 618	18.6%

General and Administrative
Expenses

The increase in general and administrative expenses in both absolute dollars and as a percentage of net revenue was primarily due to an increase in Sarbanes-Oxley Act of 2002, or SOX, fees of $0.2 million, recruiting fees of $0.2 million and consulting/other professional fees of $0.1 million. Recruiting increased due to fees incurred while locating and hiring key talent within the organization. The increase in consulting/other professional fees is primarily due to expenses associated with IT consultants for our Oracle production environment.

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Other Income, net

	Three Months Ended June 30, 2007		Three Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Other Income, net	$ 1,231	2.2%	$ 358	0.5%	$ (873)	(71.0)%

The decrease in other income, net is primarily due to a decrease in interest income of $0.9 million. The decrease in interest income is primarily attributable to lower overall cash and cash equivalents balance and declining interest rates. Cash and cash equivalents decreased from $88.4 million as of June 30, 2007 to $62.1 million as of June 30, 2008.

Income Taxes

We recorded an income tax expense of $0.2 million for the three months ended June 30, 2008 compared to an income tax benefit of $0.1 million for the three months ended June 30, 2007. Our effective income tax rate of 3.34% for the three months ended June 30, 2008 differs from the U.S. federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

Six Months Ended June 30, 2007 Compared to the Six Months Ended June 30, 2008

Net Revenue

	Six Months Ended June 30,			
	2007	2008	Increase	% Change
	(in thousands, except percentages)			
Net Revenue	$ 109,640	$ 123,853	$ 14,213	13.0%

The increase in net revenue is primarily attributable to an increase in net revenue from HP, who sells a version of our Series 2000 family of products, and from NetAPP, partially offset by a decrease in net revenue from Sun who sells our SANnet II family of products under the ST-3000 brand product line. Our net revenue from HP for the six months ended June 30, 2008 totaled $25.9 million, or 20.9% of total net revenue. The $25.9 million in net revenue from HP for the six months ended June 30, 2008 is net of a $2.3 million reduction in net revenue, representing the fair value of the warrant issued to HP to induce them to enter into the agreement with us. There was no significant net revenue from HP for the six months ended June 30, 2007. The substantial increase in HP net revenue is due to the execution of the amended OEM agreement with HP in January 2008, whereby we expanded our product offerings to additional divisions of HP. Our net revenue from NetAPP increased $22.4 million, or 398.4%, from the six months ended June 30, 2007 as compared to the six months ended June 30, 2008. For the six months ended June 30, 2007, net revenue from NetAPP totaled $5.6 million, or 5.1% of our total net revenue, compared to $28.1 million, or 22.7%, of our total net revenue for the six months ended June 30, 2008. The rapid growth in net revenue from NetAPP was driven by NetAPP s product launch during the third quarter of 2007. Our net revenues from Sun decreased $33.9 million, or 43.8%, from the six months ended June 30, 2007 as compared to the six months ended June 30, 2008. For the six months ended June 30, 2007, net revenue from Sun totaled $77.4 million, or 70.6%, of our total net revenue, compared to $43.5 million, or 35.1%, of our total net revenue for the six months ended June 30, 2008. The decline in Sun net revenue is primarily due to the products nearing the end of their lifecycle and the lack of follow-on products for the ST-3000 line having been developed to date. We expect net revenues from Sun to continue to decline over future periods.

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Cost of Goods Sold

	Six Months Ended June 30, 2007		Six Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Cost of Goods Sold	$ 96,042	87.6%	$ 112,465	90.8%	$ 16,423	17.1%

The increase in cost of goods sold in absolute dollars was primarily due to a 13.0% increase in net revenue. The increase in cost of goods sold as a percentage of net revenue was primarily attributable to a change in product and customer sales mix. Net revenue on our highest margin product, sold to Sun and other SANnet II customers, declined as a percentage of total net revenue. Sun net revenue declined from 70.7% of total net revenue for the six months ended June 30, 2007 to 35.1% of total net revenue for the six months ended June 30, 2008. This was replaced by lower margin net revenue from our Series 2000 products and net revenue from NetAPP. Cost of goods sold associated with our Series 2000 products improved significantly from the six months ended June 30, 2007 as compared to the six months ended June 30, 2008 as the Series 2000 product first started shipping in the third quarter of 2006 and was initially manufactured in a mostly soft tooled environment resulting in higher costs of goods sold. Also, we completed the transition of the manufacturing of our Series 2000 products from Flextronics to MiTAC and SYNNEX and have been able to take advantage of their lower manufacturing costs. This transition was largely completed during the fourth quarter of 2007. Additionally, the Series 2000 product cost of goods sold has improved due to higher volume from our amended agreement with HP, component cost reductions and value engineering of the products. Our historical experience indicates that gross margins on new products sold to new customers start out low initially and increase over the first several quarters. Thereafter the margin improvements are generally more modest. The cost of goods sold on our business with NetAPP improved from the six months ended June 30, 2007 as compared to the six months ended June 30, 2008 primarily for the same reasons as for the Series 2000 products. The product we sell to NetAPP does not include higher margin value added features such as RAID controllers. As we continue to transition our net revenue from Sun and other SANnet II customers with higher margins to HP and NetAPP and other customers with lower margins, we anticipate cost of goods sold will continue to be a higher percentage of net revenue throughout 2008 in comparison to corresponding periods in the prior year.

Gross Profit

	Six Months Ended June 30, 2007		Six Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Gross Profit	$ 13,598	12.4%	$ 11,388	9.2%	$ (2,211)	(16.3)%

The decrease in gross profit in both absolute dollars and as a percentage of net revenue for the six months ended June 30, 2008 compared to the six months ended June 30, 2007 was primarily attributable to the $2.3 million reduction in net revenue, representing the fair value of the warrant issued to HP to induce them to enter into the agreement with us and secondarily due to an increase in net revenue of $14.2 million or 13.0% and a change in product mix. Net revenue on our highest margin product, sold to Sun, declined as a percentage of total net revenue from 70.7% of net revenue for the six months ended June 30, 2007 to 35.1% of net revenue for the six months ended

June 30, 2008. This was replaced by lower margin net revenue from our Series 2000 products and net revenue from NetAPP. Net revenue from our Series 2000 products sold primarily to HP and net revenue from NetAPP represented 18.8% of our net revenue for the six months ended June 30, 2007 compared to 56.2% of our net revenue for the six months ended June 30, 2008.

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Sales and Marketing Expenses

	Six Months Ended June 30, 2007		Six Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Sales and Marketing Expenses	$ 7,779	7.1%	$ 7,919	6.4%	$ 140	1.8%

The slight increase in sales and marketing expenses in both absolute dollars and as a percentage of net revenue was primarily attributable to an increase of $0.2 million in severance costs related to employees in our Netherlands office, a $0.1 million increase in salaries and a $0.1 million increase in share-based compensation expense. These increases were offset by a decrease in intangible asset amortization. Intangible asset amortization decreased by $0.3 million due to the asset becoming fully amortized in 2007.

Research and Development Expenses

	Six Months Ended June 30, 2007		Six Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Research and Development Expenses	$ 10,871	9.9%	$ 14,549	11.8%	$ 3,678	33.8%

The increase in research and development expenses both in absolute dollars and as a percentage of net revenue was primarily due to a $1.4 million increase in project materials, as well as a $0.6 million increase in outside testing and tooling to support development projects for our OEM customer HP. Consulting expense increased $0.3 million primarily due to the development of an ASIC chip. Additionally, Salaries increased $0.3 million due to increased headcount to support HP and other projects and an increase in general overhead expense of $0.5 million. The six months ended June 30, 2008 included the benefit of $0.3 million of non-recurring engineering recovery billed to NetAPP.

General and Administrative Expenses

	Six Months Ended June 30, 2007		Six Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
General and Administrative Expenses	$ 6,992	6.4%	$ 6,982	5.6%	$ (10)	(0.1)%

Although there was an overall slight decrease in general and administrative expenses there were some significant fluctuations in individual expense items. Legal fees decreased $1.0 million as a result of the Special Litigation Committee completing the majority of its work in early 2007. Additionally the six months ended June 30, 2008 included a reimbursement for legal fees from our insurance carrier of $0.3 million. This decrease was offset by increases in share-based compensation of $0.4 million, recruiting of $0.3 million and consultants of $0.2 million. Share-based compensation increased due to the granting of a larger number of stock options in the

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first half of 2008 relative to 2007. Recruiting increased due to fees incurred while locating and hiring key talent within the organization. The increase in consulting/other professional fees is primarily due to expenses associated with IT consultants for our Oracle production environment.

Legal Settlement

	Six Months Ended Jun 30, 2007		Six Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Legal settlement	$	0.0%	$ (3,836)	(3.1)%	$ (3,836)	(100.0)%

The proceeds from the legal settlement of $3.8 million is from a February 2007 claim we filed for arbitration in Denver, Colorado alleging that the representative of the Chaparral shareholders was wrongfully withholding escrow funds due to us as a result of damages incurred by us relating to a completed patent infringement lawsuit filed by Crossroads. Such amount is reported as a reduction in operating expenses.

Other Income, net

	Six Months Ended Jun 30, 2007		Six Months Ended June 30, 2008			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Other Income, net	$ 2,539	2.3%	$ 1,145	0.9%	$ (1,394)	(55.0)%

The decrease in other income, net is primarily due to a decrease in interest income of $1.4 million. The decrease in interest income is primarily attributable to a lower overall cash balance and declining interest rates. Cash and cash equivalents decreased from $88.4 million as of June 30, 2007 to $62.1 million as of June 30, 2008.

Income Taxes

We recorded an income tax expense of $0.2 million for the six months ended June 30, 2007 compared to an income tax expense of $0.4 million for the six months ended June 30, 2008. Our effective income tax rate of 3.04% for the six months ended June 30, 2008 differs from the U.S. federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

On January 1, 2007, we adopted FASB, Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-An Interpretation of FASB Statement No.109*, or FIN 48. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues.

The cumulative effects of adopting FIN 48 resulted in an increase of $0.5 million to accumulated deficit and an increase in other long term liabilities of $0.5 million of tax benefits that, if recognized, would affect the effective tax rate. At December 31, 2007 we had cumulative unrecognized tax benefits of approximately $4.5 million, of which approximately $0.2 million are included in other long term liabilities that, if recognized, would affect the effective tax rate. The remaining $4.3 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, 2007, the total amount of accrued income tax related interest and penalties included in the consolidated balance sheet was less than $0.1 million. We do not expect that our unrecognized tax benefit will change significantly within the next 12 months. There have been no material changes to the unrecognized tax benefit during the three month period ending June 30, 2008.

Due to net operating losses and other tax attributes carried forward, we are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending March 31, 1994 through December 31, 2007. With few exceptions, our state income tax returns are open to audit for the years ended December 31, 1999 through 2007.

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 June 30, 2008, based on the weight of available evidence, including cumulative losses in recent years and expectations regarding future taxable income, we determined that it was not more likely than not that our United States deferred tax assets would be realized and have a $67.3 million valuation allowance associated with our United States deferred tax assets compared to $65.9 million at December 31, 2007.

As of December 31, 2007, we had federal and state net operating losses of approximately $144.0 million and $77.0 million, which begin to expire in the tax years ending 2013 and 2008, respectively. In addition, we had federal tax credit carryforwards of $3.9 million, of which approximately $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $3.4 million will begin to expire in the tax year ending 2008. We also had state tax credit carryforwards of $4.1 million, of which $3.8 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.3 million began to expire in the tax year ending 2008.

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

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

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

Liquidity and Capital Resources

The two primary drivers affecting liquidity and cash are working capital requirements and net profits or losses. 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 payment terms ranging between net thirty and net forty-five days. If in the longer term our net revenues increase, it is likely that our accounts receivable balance will also increase. Our accounts receivable could further increase if customers delay their payments or if we grant extended payment terms to customers. Furthermore, we have had to maintain only a small amount of inventory, as our customers for the most part took delivery of products directly from our contract manufacturer s facility. Beginning in the latter half of 2007, however, we started to hub inventory for some of our larger customers and consequently the growth in inventory has started to become a use of cash. In the future, our inventory levels will continue to be determined based upon the level of purchase orders we receive, our ability, and the ability of our customers (specifically NetAPP, HP and Fujitsu Siemens), to manage inventory under hubbing arrangements, as well as competitive situations in the marketplace. Such considerations are balanced against the risk of obsolescence or potentially excess inventory levels.

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As of June 30, 2008, we had $62.1 million of cash and cash equivalents and $81.0 million of working capital. Cash equivalents include highly liquid investments purchased with an original maturity of three months or less and consist principally of money market funds and commercial paper.

For the six months ended June 30, 2008, net cash used in operating activities was $20.1 million compared to cash used in operating activities of $10.0 million for the six months ended June 30, 2007. Net cash used in operating activities for the six months ended June 30, 2008 was attributable to the net loss of $13.5 million consisting of cash and non cash activities. The operating activities that affected cash consisted primarily of lower gross profit, lower interest income and increased research and development expense. The non cash operating activities included in the net loss that did not affect cash consisted of the following; depreciation and amortization of $3.0 million; share-based compensation expense of $1.6 million, issuance of warrants to a customer of $2.3 million offset by the provision for doubtful accounts of $0.1 million. Cash flows from operations reflects the positive impact of $7.4 million related to an overall increase in accounts payable due to increased inventory and the timing of payments to our vendors, and $3.8 million in proceeds from our Chaparral escrow legal settlement and income taxes of $0.3 million. Cash flows from operations was negatively impacted by a $13.8 million increase in accounts receivable due to higher net revenues during the quarter ended June 30, 2008 as compared to the quarter ended December 31, 2007. Additionally, there was a $4.5 million increase in inventory primarily due to the creation of new hub inventory locations and the build up of inventory at our existing hub locations for certain of our customers, a $1.4 million decrease in accrued compensation and expenses primarily due to a $0.6 million reduction in restructuring costs as a result of the closing of our Netherlands office and a $1.2 million reduction in other accrued manufacturing costs. Furthermore, there was a $0.5 million increase in prepaid and other assets primarily due to an increase in raw material component sales to our contract manufacturers to support our HP build plan, and a $0.5 million decrease in other long term liabilities primarily consisting of deferred rent for our Carlsbad, California and Longmont, Colorado facilities.

Cash used in investing activities for the six months ended June 30, 2008 was $0.9 million compared to $1.9 million of cash used in investing activities for the six months ended June 30, 2007. Cash used during the six months ended June 30, 2008 was for the addition of computer hardware assets.

Cash provided by financing activities for the six months ended June 30, 2008 was $0.7 million compared to cash provided by financing activities of $0.6 million for the six months ended June 30, 2007. The cash provided by financing activities is attributable to the proceeds received from the exercises of stock options under our equity incentive plans and warrants of $0.5 million, and the proceeds received from the sale of common stock to employees under our employee stock purchase plan of $0.2 million.

We presently expect cash, cash equivalents and cash generated from operations to be sufficient to meet our operating and capital requirements for at least the next 12 months and for operating periods in excess of 12 months. In addition, this will enable us to pursue acquisitions or capital improvements. The actual amount and timing of working capital and capital expenditures that we may incur in future periods may vary significantly and will depend upon numerous factors, including the amount and timing of the receipt of net revenues from continued operations, the overall level of net profits or losses, our ability to manage our relationships with our contract manufacturers, the potential growth in inventory to support NetAPP, HP and Fujitsu Siemens, the status of our relationships with key customers, partners and suppliers, the timing and extent of the introduction of new products and services and growth in personnel and operations.

Effective July 1, 2007, we amended our credit agreement with Wells Fargo Bank, National Association, or Wells Fargo, which allows us to borrow up to $30.0 million under a revolving line of credit that expires July 1, 2009. Amounts loaned under the credit agreement bear interest at our option at a fluctuating rate per annum equal to the Prime Rate in effect from time to time, or at a fixed rate per annum determined by Wells Fargo to be 0.65% above LIBOR in effect on the first day of the applicable fixed rate term. In connection with the credit agreement, to the extent we have outstanding borrowings, we have granted Wells Fargo a security interest in our investment management account maintained with Wells Capital Management Incorporated. As of December 31, 2007 and June 30, 2008, there were no balances outstanding under this line of credit. The credit agreement limits any new borrowings, loans, or advances outside of the credit agreement to an amount less than $1.0 million and annual capital expenditures to an amount less than $10.0 million. On August 4, 2008, we terminated our credit agreement with Wells

Fargo Bank. The effective date for this termination is August 6, 2008.

In August, 2008, Dot Hill entered into a credit agreement with Silicon Valley Bank to provide for a revolving credit facility for cash advances and letters of credit of up to an aggregate of $30 million based upon an advance rate of 85% of eligible accounts receivable. The credit agreement expires three years from the effective date. Borrowings under the credit facility bear interest at the prime rate and are secured by substantially all of Dot Hill s accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on Dot Hill s inventory and intellectual property, subject to certain exceptions, and contains usual and customary covenants for an arrangement of its type, including an obligation of Dot Hill to maintain at all times a net worth of $55 million (subject to certain increases). The agreement also includes provisions to increase the financing facility by $20 million subject to Dot Hill 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 Dot Hill s 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.

The following table summarizes our contractual obligations as of June 30, 2008 (in thousands).

Contractual Obligations	Total	2008	2009	2010	2011	2012	2013
Operating Lease Obligations	$ 7,062	$ 786	$ 1,474	$ 1,455	$ 1,471	$ 1,507	$ 369

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

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

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

Off Balance Sheet Arrangements

At June 30, 2008, we did not have any relationship with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance variable interest, or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving non-exchange traded contracts. As a result, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. We do not have relationships and transactions with persons and entities that derive benefits from their non-independent relationship with us or our related parties except as disclosed herein.

Recent Accounting Pronouncements

In December 2007 the FASB issued FASB Statement No. 141(R), *Business Combinations*. FASB Statement No. 141(R) establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. FASB Statement No. 141(R) is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combinations we engage in will be recorded and disclosed following existing GAAP until January 1, 2009. We are in the process of assessing the impact of the adoption of this standard on our future consolidated financial statements.

In April 2008, the FASB issued FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets*. FSP FAS 142-3 amends FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to improve the consistency between the useful life of a recognized intangible asset under FASB Statement No. 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No 141, *Business Combinations*, and other U.S. GAAP. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008. The guidance for determining the useful life of a recognized intangible asset is to be applied prospectively, therefore, the impact of the implementation of this pronouncement cannot be determined until the transactions occur.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate and Credit Risk

Our exposure to market rate risk for changes in interest rates relates to our investment portfolio. Our primary investment strategy is to preserve the principal amounts invested, maximize investment yields subject to other investment objectives and maintain liquidity to meet projected cash requirements. Accordingly, we invest in instruments such as money market funds, certificates of deposit, United States government/agencies bonds, notes, bills and municipal bonds that meet high credit quality standards, as specified in our investment policy guidelines. Our investment policy also limits the amount of credit exposure to any one issue, issuer and type of instrument. We do not currently use derivative financial instruments in our investment portfolio and we do not enter into market risk sensitive instruments for trading purposes. We do not expect to incur any material losses with respect to our investment portfolio.

The following table provides information about our investment portfolio at December 31, 2007 and June 30, 2008. For investment securities, the table presents carrying values at December 31, 2007 and June 30, 2008. These investment securities are not subject to maturity dates.

	December 31, 2007	June 30, 2008
	(amounts in thousands)	
Cash equivalents	$78,157	$ 60,509
Average interest rate	4.8%	2.4%

We have a line of credit agreement, which accrues interest on any outstanding balances at a variable rate. As of June 30, 2008, we had no balance under this line. Were we to incur a balance under this line of credit, we would be exposed to interest rate risk on such debt.

Foreign Currency Exchange Rate Risk

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

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Controls

There was no change in our internal control over financial reporting that occurred during the period covered by this quarterly report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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Part II. Other Information

Item 1. Legal Proceedings

Crossroads Systems Litigation

On October 17, 2003, Crossroads Systems, Inc., or Crossroads, filed a lawsuit against us in the United States District Court in Austin, Texas, alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of Small Computer Systems Interface, or SCSI, storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004.

On June 28, 2006 we entered into a Settlement and License Agreement with Crossroads that settles the lawsuit and licenses to us the family of patents from which it stemmed. We concurrently entered into an Agreement between Dot Hill Systems and Infortrend Re Settlement of Crossroads Lawsuit with Infortrend Technology, Inc. In accordance with the Crossroads and Infortrend agreements, July 14, 2006, we paid $3.35 million to Crossroads for alleged past damages and Crossroads agreed to dismiss, with prejudice, all patent claims against us. In addition, Infortrend paid Crossroads an additional $7.15 million on our behalf, from which $1.43 million was withheld for Taiwan taxes and is included in income tax expense on our statement of operations. Going forward, Crossroads will receive a running royalty of 2.5% based on a percentage of net sales of RAID products sold by us, but only those with functionality that is covered by United States Patents No. 5,941,972 and No. 6,425,035 and other patents in the patent family. For RAID products that use a controller sourced by Infortrend, we will pay 0.8125% of the 2.5% royalty, and Infortrend will be responsible for the remainder. For RAID products that use our proprietary controller, we alone will be paying the 2.5% running royalty. No royalty payments will be required with respect to the sale of storage systems that do not contain RAID controllers, known as JBOD systems, or systems that use only the SCSI protocol end-to-end, even those that perform RAID. Further, royalty payments with respect to the sale of any products that are made, used and sold outside of the United States will only be required if and when Crossroads is issued patents that cover the products and that are issued by countries in which the products are manufactured, used or sold.

On July 24 and 25th, 2006, respectively, Crossroads filed another lawsuit against us in the United States District Court for the Western District of Texas as well as a Motion to Enforce in the aforementioned lawsuit. Both the new lawsuit and motion alleged that Dot Hill had breached the June 28, 2006 Settlement and License Agreement by deducting $1.43 million of the lump sum payment of $10.50 million as withholding against any potential Taiwan tax liability arising out of Dot Hill s indemnification by Infortrend, a Taiwan company. On September 28, 2006 the Court indicated that it would grant Crossroads Motion to Enforce. On October 5, 2006, Crossroads and Dot Hill amended the original Settlement and License Agreement to state that Dot Hill would pay to Crossroads $1.43 million, plus $45,000 in late fees, and would not make deductions based on taxes on royalty payments in the future. The payment of the $1.475 million was made on October 5, 2006. As required by the amended settlement, Crossroads has dismissed with prejudice the original patent action as well as the second lawsuit based on the enforcement of the original settlement.

Thereafter, we gave notice to Infortrend of our intent to bring a claim alleging breach of the settlement agreement seeking reimbursement of $1.475 million from Infortrend. On November 13, 2006, Infortrend filed a lawsuit in the Superior Court of California, County of Orange for declaratory relief. The complaint seeks a court determination that Infortrend is not obligated to reimburse Dot Hill for $1.475 million. On December 12, 2006, we answered the complaint and filed a cross complaint alleging breach of contract, fraud, breach of implied covenant of good faith and fair dealing, breach of fiduciary duty and declaratory relief. Infortrend demurred to the cross complaint. The Court denied the demurrer as to the fraud cause of action and sustained the demurrer as to the claims for breach of the covenant of good faith and fair dealing and breach of fiduciary duty. We have entered into a settlement, the terms of which are confidential, and a stipulation for dismissal of the entire action has been filed with the court. The amount of this settlement will have an immaterial effect on the condensed consolidated financial statements. The outcome of this action is uncertain, and no amounts have been accrued as of June 30, 2008.

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

In late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints allege violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004, and seeking damages therefore. The complaints were consolidated into a single action, and the Court appointed as lead plaintiff a group comprised of the Detroit Police and Fire Retirement System and the General Retirement System of the City of Detroit. The consolidated complaint was filed on August 25, 2006, and we filed a motion to dismiss on October 5, 2006. The Court granted our motion to dismiss on March 15, 2007. Plaintiffs filed their Second Amended Consolidated Complaint on April 20, 2007. We filed a motion to dismiss the Second Amended Consolidated Complaint on May 1, 2008 and a hearing is set for August 14, 2008. The outcome of these actions is uncertain, and no amounts have been accrued as of June 30, 2008.

In addition, three complaints purporting to be derivative actions have been filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. Our demurrer to two of those cases, in which we sought dismissal, was overruled (i.e., denied). We formed a Special Litigation Committee, or SLC, of disinterested directors to investigate the alleged wrongdoing. On January 12, 2007, another derivative action similar to the previous derivative actions with the addition of allegations regarding purported stock option backdating was served on us. On April 16, 2007, the SLC concluded its investigation and based on its findings directed us to file a motion to dismiss the derivative matters. On June 27, 2007, the parties stipulated to consolidate all of the derivative matters for pre-trial proceedings. We filed a motion to dismiss the consolidated matters pursuant to the SLC s directive on May 30, 2008 and a hearing is set for November 18, 2008. The outcome of these actions is uncertain, and no amounts have been accrued as of June 30, 2008.

In August 2007, a securities lawsuit was filed in California state court by a single former stockholder against certain of our directors and executive officers. This complaint is based on the same facts and circumstances described in the federal class action and state derivative complaints, and generally alleges that Dot Hill and the named officers and directors committed fraud and violated state securities laws. The complaint seeks $500,000 in damages, as well as attorneys fees and costs. On November 1, 2007, we filed a motion to dismiss the complaint, which was granted on February 15, 2008. On February 25, 2008, the plaintiff filed his First Amended Complaint. We filed a motion to dismiss the First Amended Complaint on March 6, 2008, which was granted on May 16, 2008. Plaintiffs were granted leave to amend. The outcome of this action is uncertain, and no amounts have been accrued as of June 30, 2008.

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

Other Litigation

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

Item 1A. Risk Factors

The following sets forth risk factors that may affect our future results, including certain revisions to the risk factors included in our annual report on Form 10-K for the fiscal year ending December 31, 2007. 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-Q, including our financial statements and related notes.

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

Our business is highly dependent on a limited number of OEM customers. For example, sales to Sun accounted for 63.2% and 35.1% of our net revenues for the year ended December 31, 2007 and the six months ended June 30, 2008. In addition, sales to NetAPP accounted for 12.5% and 22.7% of our net revenues for the year ended December 31, 2007 and for the six months ended June 30, 2008. Furthermore, for the six months ended June 30, 2008, HP accounted for 20.9% of net revenues. For the six months ended June 30, 2007, shipments to HP were negligible. We expect Sun, NetAPP and HP each represent greater than 10% of our overall revenues for the year ending December 31, 2008. If our relationships with Sun, NetAPP, HP, Fujitsu Siemens, or certain of our other OEM customers were disrupted, we would lose a significant portion of our anticipated net revenue and our business could be materially harmed. We cannot guarantee that our relationship with Sun, NetAPP, HP, Fujitsu Siemens or our other OEM customers will expand or not otherwise be disrupted. Factors that could influence our relationship with our significant OEM customers, including Sun, NetAPP, HP and Fujitsu Siemens include:

- our ability to maintain our products at prices that are competitive with those of other storage system suppliers;
- our ability to maintain quality levels for our products sufficient to meet the expectations of our OEM customers;
- our ability to produce, ship and deliver a sufficient quantity of our products in a timely manner to meet the needs of our OEM customers;
- our ability to continue to develop and launch new products that our OEM customers feel meet their needs and requirements, with respect to cost, timeliness, features, performance and other factors;
- our ability to provide timely, responsive and accurate customer support to our OEM customers; and
- the ability of Sun, NetAPP, HP, Fujitsu Siemens or our other OEM customers to effectively launch, ramp, ship, sell and market their own solutions based on our products.

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

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

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

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

Our efforts to accommodate our customers aggressive launch and ramp schedules can divert management s attention from the rest of our business and force us to allocate product volumes across many customers due to component shortages, all of which could harm

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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 revenue and margin as well as increased operating expenses which could have an impact on our business, financial condition or results of operations.

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

None of our contracts with our existing customers, including Sun, NetAPP, HP and Fujitsu Siemens, contain any minimum purchasing commitments and our customers may cancel purchase orders at any time. 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 purchasing commitments. Changes in the timing, or volume of purchases by our major customers, could result in lower revenue. For example, we cannot be certain that our sales to Sun will continue at historical levels or sales to NetAPP, HP, or any of our OEM customers, will ramp to expected levels. In fact, sales to Sun have continued to decrease compared to earlier levels. In addition, our existing contracts do not require our OEM customers to purchase our products exclusively or on a preferential basis over the products of any of our competitors. Consequently, our OEM customers may sell the products of our competitors. We cannot be certain if, when or to what extent any customer might cancel purchase orders, cease making purchases or elect not to renew the applicable contract upon the expiration of the current term. The decision by any of our OEM customers to cancel purchase orders, cease making purchases or terminate their respective contracts could cause our revenues to decline substantially, and our business and results of operations could be significantly harmed.

The requirement of a few of our larger OEM customers to locate finished goods inventory in vendor managed hubs could result in a reduction in working capital and cash.

A few of our larger OEM customers including NetAPP, HP and Fujitsu Siemens deploy vendor managed inventory, or VMI hubs, whereby vendors, including us, are required to store up to several weeks of finished goods inventory. This inventory is typically located at hubs close to our OEM customer s final assembly facilities. Net inventory increased from $9.0 million as of December 31, 2007 to $13.5 million as of June 30, 2008, primarily resulting from inventory hubbing requirements with NetAPP, Fujitsu Siemens and HP. If our business with these customers increases, we expect inventory levels at these hubs could grow, which could result in a reduction of cash and increasing inventory loss and obsolescence risk, all of which could harm our business and results of operations.

Our revenues may be affected by changes in IT spending levels.

In the past, unfavorable or uncertain macroeconomic conditions and reduced global IT spending rates have adversely affected the markets in which we operate. The current recession could reduce the demand for our products and negatively impact revenues and operating profit. We are unable to predict changes in general macroeconomic conditions and when global IT spending rates will be affected. 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 revenues, operating results and financial condition may be adversely affected.

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

For the three months ended June 30, 2008, we incurred a net loss of $7.4 million. For the remainder of 2008, we expect our business to remain volatile as we are unable to reliably predict revenues from Sun, NetAPP, HP, Fujitsu Siemens and our other OEM customers. Revenue levels achieved from HP and our other customers, the mix of products sold to our customers, our ability to introduce new products as planned and our ability to reduce product costs and manage our operating expenses and manufacturing variances will affect our financial results for 2008. Consequently, we cannot assure you that we will be profitable in any future period.

Our available cash and cash equivalents as of June 30, 2008 totaled $62.1 million. We presently expect cash and cash equivalents, and cash generated from operations to be sufficient to meet our operating and capital requirements through at least the next 12 months. Our future capital requirements will depend on, and could increase substantially as a result of many factors, including:

the increased working capital requirements due to contractual requirements with NetAPP, HP and Fujitsu Siemens;

Our need to utilize a significant amount of cash to support additional finished goods inventory for our customers and to make incremental investments in organizational capabilities and test infrastructure to support their product launches;

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- our ability to continue to maintain adequate lines of credit and favorable payment terms from our contract manufacturers,
- our ability to meet product delivery schedules for HP and other customers which could result in increased air freight, expedite and overtime charges;
- our plans to maintain and enhance our engineering, research, development and product testing programs;
- our need for additional tooling to support increased volumes or in support of disaster recovery plans;
- our ability to achieve targeted gross profit margins and cost reduction objectives;
- our ability to contain operating expenses and manufacturing variances;
- our ability to reach break-even or profitability;
- the extent to which we rationalize our facilities or organization;
- the success of our manufacturing strategy;
- the success of our sales and marketing efforts;
- the amount of field failures resulting in product replacements or recalls;
- the extent and terms of any development, marketing or other arrangements;
- changes in economic, regulatory or competitive conditions;
- costs of filing, prosecuting, defending and enforcing intellectual property rights; and
- costs of litigating and defending law suits.

We may not be able to raise additional funds on commercially reasonable terms or at all. Any sales of convertible debt or equity securities in the future may have a substantial dilutive effect on our existing stockholders. In our agreement with Silicon Valley Bank, we have pledged substantially all of our accounts receivable and are restricted from pledging inventory and intellectual properties. Consequently, any issuance of convertible debt would have to be on an unsecured basis and our ability to borrow more money on a secured basis would be impaired. As such, we may not be able to issue secured debt on commercially reasonable terms at all.

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

We may have to take further measures to reduce expenses if revenue declines and we experience greater operating losses or do not achieve a stable net income. A number of factors could preclude us from successfully bringing costs and expenses in line with our net revenue, such as the fact that our expense levels are based in part on our expectations as to future sales, and that a significant percentage of our expenses are fixed, which limits our ability to reduce expenses quickly in response to any shortfalls in net revenue or margin. As a result, if net revenue, product margin or gross margin do not meet our projections, operating results may be negatively affected. We may experience shortfalls in net revenue or margins for various reasons, including:

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

sudden shortages of raw materials or fabrication, test or assembly capacity constraints that lead our suppliers and manufacturers to allocate available supplies or capacity to others, which, in turn, may harm our ability to meet our sales obligations or we may have to incur additional charges to expedite product shipments to customers;

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product supply shortages due to increased demands of our OEM customers, which could also harm our relationships with our customers;

the reduction, rescheduling or cancellation of customer orders;

our inability to drive down component costs or adequately manage price variances on components;

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

product defects or quality issues that may result in higher product return rates and failure rates.

In addition, we typically plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. Our customer s forecasts have not historically demonstrated a high degree of accuracy. From time to time, in response to anticipated long lead times to obtain inventory and materials from our outside suppliers, we may order materials in advance of anticipated customer demand. This advance ordering may result in excess inventory levels or unanticipated inventory write-downs due to expected orders that fail to materialize.

The transition of manufacturing of our products and potentially other products to MiTAC and SYNNEX could impact our operating results.

Our decision to enter into a manufacturing agreement with MiTAC and SYNNEX in February 2007 was partly based upon our belief that we could achieve lower manufacturing and product transformation costs. While this transition is now completed for our Series 2000 and successor products we need to refine and expand processes, tooling and manufacturing infrastructure. Consequently, there could be additional costs or capacity constraints that could negatively impact expected gross margins and revenues. We are currently evaluating migrating the manufacturing of products for NetAPP to MiTAC and SYNNEX from Flextronics. During this transition, we could also have surplus raw materials and finished goods, at Flextronics, which could result in write-downs and/or lower margins. In addition, if we experience any product quality or manufacturing capacity issues, we could impact revenues from customers as well as their satisfaction with our products.

The pricing we received from contract manufacturers was predicated on volume expectations. If however, we are unable to give any of our contract manufacturers sufficient volumes of products to manufacture on our behalf, our contract manufacturers are likely to become less responsive to us and seek to increase prices, which could potentially negatively impact margins and profits.

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

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

Our gross margins are determined in large part based on our manufacturing costs, our component costs and our ability to include RAID controllers, and low cost value added features into our products, as well as the prices at which we sell our products. If we are unable to lower production costs to be consistent with our projections or any decline in selling prices, our gross margins and operating results will suffer. Several of the new products we are currently shipping or expect to begin shipping are in the early stages of their lifecycle. Our historical experience indicates that gross margins on new products are low initially and increase over time as a result of maturing manufacturing processes, component cost reductions and engineering the products to reduce costs. If we fail to achieve these margin improvements, our gross margins will be negatively impacted and our business, financial condition and results of operations could be significantly harmed. 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;

ongoing revaluation of the Chinese RMB compared to the US dollar;

increases in material or labor costs;

excess inventory, inventory shrinkages and losses and inventory holding charges;

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

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

our inability to sell our higher performance Series 5000 and Series 2000 products and our data management services software;

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

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

increases in headcount and expenses required to support our new customers.

Some of our strategies to offset gross margin erosion include:

shifting our manufacturing to lower cost suppliers such as MiTAC and SYNNEX, as we did with our Series 2000 and 5000 products, and transitioning the manufacturing of other products to MiTAC and SYNNEX;

leveraging our volumes created by our new design wins to secure additional component cost and manufacturing transformation cost reductions;

bundling our data management services software into our products; and

increasing adoption of our higher performance Series 5000 and Series 2000 Turbo products.

We cannot assure you that we will be successful in executing these strategies to mitigate gross margin erosion. All of these factors, together with increasing pricing pressures, could further adversely affect our gross margins and operating results.

Our financial condition will be materially harmed if we do not maintain competitiveness and gain acceptance of our products.

The markets in which we compete involve rapidly changing technology, evolving industry standards and continuing improvements in products and services. Our future success depends, in part, on our ability to:

enhance our current products and develop and introduce in a timely manner new products that keep pace with technological developments and industry standards;

compete effectively on the basis of price and performance; and

adequately address OEM and end-user customer requirements and achieve market acceptance.

We believe that to remain competitive, we will need to continue to develop new products, which will require a significant investment in new product development. Our competitors are developing alternative technologies, which may adversely affect the market acceptance of our products. If alternative technologies and interface protocols are adopted by the industry that we have not incorporated into our products, we may become uncompetitive and not have product offerings for select market segments. Even if our new products are developed on time, we may not be able to manufacture them at competitive prices or in sufficient volumes.

Liquidity problems or bankruptcy of some our small OEM customers could increase exposure to losses from bad debts, increase accounts receivable and could have a material adverse effect on our business, financial condition and results of operations.

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

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

Our new integrated storage systems, as well as our legacy products, may contain undetected errors, or failures, that become epidemic failure, which may be discovered after shipment, resulting in a loss of revenue, or a loss or delay in market acceptance, which could harm our business. The product failure or recall could be the result of components purchased from our suppliers not meeting the required specifications, manufacturing defects or from our own design deficiencies. During the first half of 2007, we experienced several product quality issues associated with our then recently introduced Series 2000 products. The cost of rectifying these issues had a negative impact on margins during the first half of 2007.

Even if the errors are detected before shipment, such errors could result in the halting of production, the delay of shipments, recovery costs, loss of goodwill, tarnishment of reputation and/or a substantial decrease in revenue. Our standard warranty provides that if our systems do not function to published specifications, we will repair or replace the defective component or system without charge generally for a period of about three years. Significant warranty costs, particularly those that exceed reserves, could decrease our margin and negatively impact our business, results of operations and financial condition. In addition, defects in our products could result in our customers claiming property damages, consequential damages, or bodily injury, which could also result in our loss of customers and goodwill. None of our customers have thus far asserted claims, but may in the future assert claims, that our products have failed to meet agreed-to specifications or that they have sustained injuries from our products, and we may be subject to lawsuits relating to these claims. There is a risk that these claims or liabilities may exceed, or fall outside of the scope of our insurance coverage. Any such claim could distract management s attention from operating our business and, if successful, result in damage claims against us that might not be covered by our insurance.

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

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

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

Quarter	Net Revenues	Net Income (Loss)
Second Quarter 2004	69.0	6.7
Third Quarter 2004	57.0	3.5
Fourth Quarter 2004	65.5	4.0
First Quarter 2005	58.0	2.1
Second Quarter 2005	65.9	3.3
Third Quarter 2005	53.6	(1.3)
Fourth Quarter 2005*	56.3	22.5
First Quarter 2006	58.7	(5.0)
Second Quarter 2006	66.3	(6.6)
Third Quarter 2006**	54.8	(60.1)
Fourth Quarter 2006	59.4	(9.1)
First Quarter 2007	53.4	(6.0)
Second Quarter 2007	56.2	(3.7)
Third Quarter 2007	45.7	(4.1)
Fourth Quarter 2007***	51.8	(46.4)
First Quarter 2008	52.8	(6.1)
Second Quarter 2008	71.0	(7.4)

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

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

*** Includes write off of $40.7 in goodwill

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

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

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

- the size, timing, cancellation or rescheduling of significant customer orders;
- our ability to reduce fixed expenses;
- our customer policies pertaining to desired inventory levels of our products and the levels of inventory our customers require us to maintain in their designated inventory hub locations;
- changes in the mix or average selling prices of our products;
- market acceptance of our new products and product enhancements and new product announcements or introductions by our competitors;
- product configuration, mix and quality issues;
- changes in pricing by us or our competitors;

the cost of litigation and settlements involving intellectual property and other issues;

deferrals of customer orders in anticipation of new products or product enhancements;

our ability to ramp our manufacturing to keep up with demand from our customers;

our ability to develop, introduce and market new products and product enhancements on a timely basis;

hardware component costs and availability, particularly with respect to hardware components obtained from sole-source providers and major component suppliers such as disk drives, memory, sole source semiconductors and legacy RAID controllers;

our success in creating brand awareness and in expanding our sales and marketing programs;

the level of competition;

gain or loss of customers;

potential increases or reductions in inventories held by OEM customers;

slowing sales of the products of our OEM customers;

technological changes in the open systems storage market, some of which could potentially be breakthrough technologies that may provide competitors cost or performance advantages;

levels of expenditures on research, engineering and product development;

levels of expenditures in our manufacturing and support organization and our ability to manage variances in component costs and inventory levels of components held by our manufacturing partners;

longer than anticipated product integration cycles for our products;

the quality and timeliness of products being manufactured by Flextronics, MiTAC and SYNNEX and compliance with environmental regulations or related requirements of our OEM customers;

changes in our business strategies;

actual events, circumstances, outcomes and amounts differing from judgments, assumptions and estimates used in determining the value of certain assets (including the amounts of related valuation allowances and valuation of goodwill), liabilities and other items reflected in our consolidated financial statements;

restructuring costs associated with facilities closures, consolidations, and headcount reductions;

changes in accounting rules or changes in our accounting policies;

changes in effective income tax rates, including those resulting from changes in tax laws;

personnel changes; and

general economic and other conditions affecting the timing of customer orders and capital spending or conditions in the global economy that impact IT spending.

Due to these factors, as well as other unanticipated factors, it is likely that in some future quarter, or quarters, our operating results will be below the expectations of public market analysts or investors, and as a result, the price of our common stock could significantly decrease.

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

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

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. Due to the unpredictable timing of customer orders, we may ship products representing a significant portion of our net sales for a quarter during the last month of that quarter. In addition, our expense levels are based, in part, on our expectations as to future sales. As a result, if sales levels are below expectations, our operating results may be disproportionately affected. We cannot assure you that our sales will not decline in future periods.

Manufacturing and supplier disruptions could harm our business.

We rely on third parties to manufacture all of our products. If our agreements with Flextronics, MiTAC or SYNNEX are terminated, or if they do not perform their obligations under our agreement, or if we otherwise determine to transition manufacturing of our products to another third party manufacturer, it could take several months to establish and qualify alternative manufacturing for our products and we may not be able to fulfill our customers orders in a timely manner. In addition, Flextronics recently acquired Solectron and there is no assurance that the combined company will not terminate, or otherwise seek to modify the terms of our agreement with Flextronics, and any such termination or modification may also require us to establish and qualify alternative manufacturing for our products. Any such transition would also require a significant amount of our management s attention. Under our OEM agreements with Sun and NetAPP, they have the right to require that we use a third party to manufacture our products. Such an external manufacturer must meet the engineering, qualification and logistics requirements of both Sun and NetAPP. If our agreements with Flextronics, MiTAC or SYNNEX terminate, we cannot be certain that we will be able to identify a suitable alternative manufacturing partner that meets the requirements of our OEM customers and one that is cost competitive. Failure to identify a suitable alternative manufacturing partner could impact our customer relationships and our financial condition.

Due to our use of third-party manufacturers, our ability to control the timing of shipments could decrease. Delayed shipment could result in the deferral or cancellation of purchases of our products. Any significant deferral or cancellation of these sales would harm our results of operations in any particular quarter. Net revenue for a period may be lower than predicted if large orders forecasted for that period are delayed or are not realized, which could impact cash flow or result in a decline in our stock price. To the extent we establish a relationship with an alternative manufacturer for our products, we may be able to partially mitigate potential disruptions to our business. We may also suffer manufacturing disruptions as we ramp up manufacturing processes for our new integrated storage systems, which could result in delays in delivery of these products to our OEM customers and adversely affect our results of operations. Additionally, production of our products could be disrupted as a result of geo-political events in Asia and other manufacturing locations.

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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 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 operating results and financial condition.

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

Our third party manufacturers rely on other third parties to supply key components of our storage products. Many of these components are available only from limited sources in the quantities and quality we require. From time to time there is significant market demand for disk drives, semiconductors, RAID controllers, memory and other components, and we may experience component shortages, selective supply allocations and increased prices of such components. In such event, we may be required to purchase our components from alternative suppliers, and we cannot be certain that alternative sources of supplies will be available at competitive terms. Even if alternative sources of supply for critical components such as disk drives and controllers become available, incorporating substitute components into our products could delay our ability to deliver our products in a timely manner. For example, we estimate that replacing key components we currently use in our products with those of another supplier, could involve several months of hardware and software modification, which could significantly harm our ability to meet our customers orders for our products, damage our customer relationships and result in a loss of sales.

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

Demand for disk drives and memory has at times surpassed supply, forcing drive, memory and component suppliers, including those who supply the components that are integrated into many of our storage products, to manage allocation of their inventory. If such a shortage were prolonged, we may be forced to pay higher prices for disk drives, memory or components or may be unable to purchase sufficient quantities of these components to meet our customers demand for our storage products in a timely manner or at all. Similar circumstances could occur with respect to other necessary components.

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

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

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources than us. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service and access to more customers than we do. Other large companies with significant resources could become direct competitors, either through acquiring a competitor or through internal efforts. Additionally, a number of new, privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. Any of these existing or potential competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, devote greater resources to the development, promotion and sale of products or deliver competitive products at lower prices than us.

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

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

Accordingly, it is possible that new competitors, or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition is likely to result in price reductions, and may reduce operating margins and create a potential loss of market share, any of which could harm our business. We believe that the principal competitive factors affecting the storage systems market include:

- performance, features, scalability and reliability;
- price;
- product breadth;
- product availability and quality;
- timeliness of new product introductions; and
- interoperability and ease of management.

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

The open systems storage market is rapidly changing and we may be unable to keep pace with or properly prepare for the effects of those changes.

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

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.

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In addition, third parties may assert infringement claims against us, which would require us to incur substantial license fees, legal fees and other expenses, and distract management from the operations of our business. For example, in 2003, Crossroads Systems filed a lawsuit against us alleging that our products infringe two United States patents assigned to Crossroads. In 2006, we entered into a Settlement and License Agreement with Crossroads that settles the lawsuit and licenses to us the family of patents from which it stemmed. We incurred significant legal expenses in connection with these matters. Other third parties may assert additional infringement claims against us in the future, which would similarly require us to incur substantial license fees, legal fees and other expenses, and distract management from the operations of our business.

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

Environmental compliance costs could adversely affect our net income.

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

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

The European Union has enacted the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. The deadline for the individual member states of the European Union to enact the directive in their respective countries was August 13, 2004. Producers participating in the market became financially responsible for implementing these responsibilities beginning in August 2005. Similar legislation has been or may be enacted in other jurisdictions, including in the United States, Canada, Mexico, China and Japan, the cumulative impact of which could be significant.

Our success depends on our ability to attract and retain key personnel.

Our performance depends in significant part on our ability to attract and retain talented senior management and other key personnel. Our key personnel include Dana Kammersgard, our Chief Executive Officer and President, Hanif Jamal, our Senior Vice President and Chief Financial Officer, and James Kuenzel, our Senior Vice President of

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

In addition, should we decide to consolidate facilities, we may face difficulties retaining key employees at the facility subject to closure, which may adversely affect the transfer of knowledge and processes to any consolidated facility in a timely manner.

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

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

As of June 30, 2008, our executive officers, directors and their affiliates beneficially owned approximately 10.5% of our outstanding shares of common stock. These individuals may be able to influence matters requiring approval by our stockholders, including the election of a majority of our directors. The voting power of these stockholders under certain circumstances could have the effect of delaying or preventing a change in control of us. This concentration of ownership may also make it more difficult or expensive for us to obtain financing. Further, any substantial sale of shares by these individuals could depress the market price of our common stock and impair our ability to raise capital in the future through the sale of our equity securities.

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

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

Unanticipated changes in our tax provisions or adverse outcomes resulting from examination of our income tax returns could adversely affect our net income.

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

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

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

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

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

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

- differences between our actual operating results and the published expectations of analysts;
- quarterly fluctuations in our operating results;
- introduction of new products or changes in product pricing policies by our competitors or us;
- conditions in the markets in which we operate;
- changes in market projections by industry forecasters;
- changes in estimates of our earnings by industry analysts;
- overall market conditions for high technology equities;
- rumors or dissemination of false information; and
- general economic and geopolitical conditions.

It is often the case that securities class action litigation is brought against a company following periods of volatility in the market price of its securities. For example, in late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints seek damages based on alleged violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004. In addition, four complaints purporting to be derivative actions have been filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. Securities litigation could result in the expenditure of substantial funds, divert management s attention and resources, harm our reputation in the industry and the securities markets and reduce our profitability.

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

As of June 30, 2008, 37% of our common stock was owned by five institutional stockholders. As a result a substantial number of shares of our common stock may become available for resale. If these or other of our stockholders sell substantial amounts of our common stock in the public market, the market price of our common stock could decline. These sales might also make it more difficult for us to sell equity securities in the future at times and prices that we deem appropriate.

Geopolitical conditions, including military action, terrorist attacks and other acts of war, political risks, civil unrest widespread pandemics, and elongated interruptions of transoceanic telecommunications lines, may materially and adversely affect the markets on which our common stock trades, the markets in which we operate, our operations and our profitability.

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

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Compliance with Sarbanes-Oxley Act of 2002.

We are exposed to significant costs and risks associated with complying with increasingly stringent and complex regulations of corporate governance and disclosure standards. Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ Stock Market rules require growing expenditure of management time and external resources. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management s annual review and evaluation of our internal controls, and attestations of the effectiveness of our internal controls by our independent registered public accounting firm. This process has required us to hire additional personnel and outside advisory services and has resulted in significant accounting, audit and legal expenses. We expect to continue to incur significant expense in future periods to comply with regulations pertaining to corporate governance as described above. In 2006 we implemented an ERP system, which was an extremely complicated, time consuming and expensive process. We will continue to upgrade and enhance our ERP system and data extraction tools to help us manage an increasingly more complex business model and establish additional internal processes and controls, all of which could result in additional significant expenses. Despite our efforts to continually enhance our systems, we cannot guarantee that our systems will continue to adequately help us manage our business.

Computer viruses and other forms of tampering with our computer systems or servers may disrupt our operations and adversely affect net income.

Despite our implementation of network security measures, our servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems. Any such event could have a material adverse effect on our business, operating results or financial condition.

Our facilities and the facilities of our suppliers and customers are located in regions that are subject to natural disasters.

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

Item 4. Submission of Matters to a Vote of Security Holders

Our annual meeting of stockholders was held on Friday, May 9, 2008, in Carlsbad, California, at which the following matters were submitted to a vote of the stockholders:

Proposal 1. Votes regarding the election of the person named below as director for a term expiring in 2011 were as follows:

	FOR	AGAINST	ABSTENTIONS
Dana W. Kammersgard	38,038,623	1,620,134	

Charles F. Christ and Roderick M. Sherwood, III will continue as directors until our 2009 annual meeting of stockholders and Kimberly E. Alexy and Joseph D. Markee will continue as directors until our 2010 annual meeting of stockholders.

Proposal 2. To ratify the appointment of Deloitte & Touche LLP as independent auditors of the Company for the fiscal year ending December 31, 2008:

FOR	AGAINST	ABSTENTIONS	BROKER NON - VOTES
37,852,819	1,780,904	25,034	

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Item 6. Exhibits

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

Exhibit Number	Description
3.1	Certificate of Incorporation of Dot Hill Systems Corp. (1)
3.2	Amended and Restated Bylaws of Dot Hill Systems Corp. (2)
4.1	Certificate of Incorporation of Dot Hill Systems Corp. (1)
4.2	Amended and Restated Bylaws of Dot Hill Systems Corp. (2)
4.3	Form of Common Stock Certificate. (3)
4.4	Certificate of Designation of Series A Junior Participating Preferred Stock, as filed with the Secretary of State of Delaware on May 19, 2003. (4)
4.5	Form of Rights Certificate. (4)
4.6	Warrant to Purchase Shares of Common Stock dated January 4, 2008. (5)
31.1	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Confidential treatment has been requested from the SEC.

(1) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on September 26, 2001 and incorporated herein by reference.

(2) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 26, 2007 and incorporated herein by reference.

(3) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 14, 2003 and incorporated herein by reference.

(4) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on May 19, 2003 and incorporated herein by reference.

(5) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 7, 2008 and incorporated herein by reference.

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SIGNATURES

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

Date: August 11, 2008

Dot Hill Systems Corp.

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

Date: August 11, 2008

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

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