Discovery Communications, Inc.
Form 8-K
November 15, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 8-K

CURRENT REPORT
Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): 11/12/2010

Discovery Communications, Inc.
(Exact name of registrant as specified in its charter)

Commission File Number: 001-34177

Delaware	**35-2333914**
(State or other jurisdiction of incorporation)	**(IRS Employer Identification No.)**

One Discovery Place
Silver Spring, Maryland 20910
(Address of principal executive offices, including zip code)

240-662-2000
(Registrant s telephone number, including area code)

(Former name or former address, if changed since last report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

[ ] **Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)**

[ ] **Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)**

[ ] **Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))**

[ ] **Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))**

Item 8.01. Other Events

On November 12, 2010, Discovery Communications, Inc. ("Discovery") and BBC Worldwide entered into several new agreements to restructure their relationship. As part of the restructured relationship, Discovery has acquired BBC Worldwide's 50 percent interest in the BBC Worldwide-Discovery joint ventures for Animal Planet and Liv (formerly People + Arts) for a total purchase price of $156 million. Discovery and the BBC also agreed to extend their programming relationship for co-productions and program acquisitions to 2014, with Discovery reducing its minimum guaranteed purchase obligation under the arrangement.

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 hereunto duly authorized.

Discovery Communications, Inc.

Date: November 15, 2010

By: /s/ Joseph A. LaSala, Jr.

Joseph A. LaSala, Jr.
Senior Executive Vice President, General Counsel and Secretary

"1" face="Times New Roman" style="font-size:8.0pt;font-weight:bold;">July 2,

July 3,

July 2,

July 3,

2011

2010

2011

2010

Customer:

Customer A

64

%

49

%

67

%

44

%

Customer B

*

%

32

%

*

%

32

%

* less than 10% of net sales

The Company s accounts receivable are concentrated with two customers at July 2, 2011 and January 1, 2011, representing approximately 63% and 10% and 75% and 13%, respectively, of aggregate gross receivables. A significant reduction in sales to, or the inability to collect receivables from, a significant customer could have a material adverse impact on the Company. The Company mitigates risk associated with foreign receivables by purchasing comprehensive foreign credit insurance.

Cash Flow Information

The following table sets forth supplemental disclosures of cash flow information and non-cash investing and financing activities (in thousands):

	Six Months Ended July 2, 2011		Six Months Ended July 3, 2010	
Supplemental disclosure of non-cash investing and financing activities:				
Purchase of equipment not paid for at the end of the period	$	(6)	$	44
Debt financed acquisition of assets	$	169	$	
Change in unrealized (gain) loss from investments in marketable securities	$	(66)	$	47

Note 4 Fair Value Measurements

The following tables detail the fair value measurements within the fair value hierarchy of the Company s assets (in thousands):

	Fair Value at July 2, 2011		Fair Value Measurements at July 2, 2011 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)	
Money market mutual funds	$	7,083	$	7,083	$		$	
Auction and variable floating rate notes		456						456
Total	$	7,539	$	7,083	$		$	456

	Fair Value at January 1, 2011		Fair Value Measurements at January 1, 2011 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)	
Money market mutual funds	$	12,654	$	12,654	$		$	
Corporate notes and bonds		824				824		
Auction and variable floating rate notes		890						890
Total	$	14,368	$	12,654	$	824	$	890

The following tables summarize the Company s assets measured at fair value on a recurring basis as presented in the Company s condensed consolidated balance sheets at July 2, 2011 and January 1, 2011:

	Fair Value at July 2, 2011	Fair Value Measurements at July 2, 2011 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	$ 7,083	$ 7,083	$	$
Long-term marketable securities	456			456
Total assets measured at fair value	$ 7,539	$ 7,083	$	$ 456

	Fair Value at January 1, 2011	Fair Value Measurements at January 1, 2011 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	$ 12,654	$ 12,654	$	$
Short-term marketable securities	824		824	
Long-term marketable securities	890			890
Total assets measured at fair value	$ 14,368	$ 12,654	$ 824	$ 890

Fair value measurements using Level 3 inputs in the table above relate to the Company s investments in auction rate securities. Level 3 inputs are unobservable inputs used to estimate the fair value of assets or liabilities and are utilized to the extent that observable inputs are not available.

The following table provides a reconciliation of the beginning and ending balances for the Company s assets measured at fair value using Level 3 inputs (in thousands):

	Six Months Ended July 2, 2011	July 3, 2010
Beginning balance	$ 890	$ 941
Proceeds from sales of available-for-sale marketable securities	(441)	
Realized loss included in other income (expense), net	(59)	
Unrealized loss transferred from other comprehensive loss to earnings	59	
Unrealized (loss) gain included in other comprehensive loss	7	(39)
Ending balance	$ 456	$ 902

Note 5 Investments in Marketable Securities

Investments in marketable securities consist of the following (in thousands):

	July 2, 2011		
	Amortized Cost	Net Unrealized Gain (Loss)	Fair Value
Auction and variable floating rate notes	$ 500	$ (44)	$ 456

	January 1, 2011 Amortized Cost	January 1, 2011 Net Unrealized Gain (Loss)	January 1, 2011 Fair Value
Corporate notes and bonds	$ 824	$	$ 824
Auction and variable floating rate notes	1,001	(111)	890
	$ 1,825	$ (111)	$ 1,714

Realized gains and losses on the sale of investments in marketable securities are determined using the specific identification method. Net realized gains and losses recorded were not significant in any of the periods reported upon.

The following table provides the breakdown of investments in marketable securities with unrealized losses (in thousands):

	July 2, 2011 Continuous Unrealized Loss			
	Less than 12 months		12 months or greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Auction and variable floating rate notes	$	$	$ 456	$ (44)

	January 1, 2011 Continuous Unrealized Loss			
	Less than 12 months		12 months or greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Auction and variable floating rate notes	$	$	$ 890	$ (111)

As of July 2, 2011, the Company held one investment that was in an unrealized loss position. As of January 1, 2011, the Company held two investments that were in an unrealized loss position.

Auction Rate Securities

Disruptions in the credit market continue to adversely affect the liquidity and overall market for auction rate securities. As of July 2, 2011, the Company held one investment in a Baa1 rated auction rate debt securities of a municipality with a total purchase cost of $0.5 million. An additional A3 rated debt obligation backed by pools of student loans guaranteed by the U.S. Department of Education with a total purchase cost of $0.5 was owned at January 1, 2011, and disposed of in June 2011 for a realized loss of $59,000.

The Company does not believe that the current illiquidity of its remaining investment in auction rate securities will materially impact its ability to fund its working capital needs, capital expenditures or other business requirements. The Company, however, remains uncertain as to when full liquidity will return to the auction rate markets, whether other secondary markets will become available or when the underlying security may be called by the issuer. Given these and other uncertainties, the Company s investments in auction rate securities have been classified as long-term investments in marketable securities in the accompanying unaudited condensed consolidated balance sheets. The Company has concluded that the estimated gross unrealized losses on these investments, which totaled approximately $44,000 and $111,000 at July 2, 2011 and January 1, 2011, respectively, are temporary because (i) the Company believes that the liquidity limitations that have occurred are due to general market conditions, (ii) the remaining auction rate security continues to be of a high credit quality and interest is paid as due and (iii) the Company has the intent and ability to hold this investment until a recovery in the market occurs.

Other Investments in Marketable Securities

The Company maintains an investment portfolio of various holdings, types and maturities. The Company invests in instruments that meet high quality credit standards, as specified in its investment policy guidelines. These guidelines generally limit the amount of credit exposure to any one issue, issuer or type of instrument. Excluding its auction rate securities, there were no unrealized gains or losses at July 2, 2011 or January 1, 2011.

The following table presents the amortized cost and fair value of the Company s investments in marketable securities classified as available-for-sale at July 2, 2011 by contractual maturity (in thousands):

	July 2, 2011	
	Amortized Cost	**Fair Value**
Maturity		
Greater than two years*	$ 500	$ 456

* Comprised of auction rate securities which generally have reset dates of 90 days or less but final contractual maturity dates in excess of 15 years.

Note 6 Credit Agreement

On October 31, 2009, the Company entered into a credit agreement with Silicon Valley Bank, which was amended on March 24, 2010, June 30, 2010, September 30, 2010, May 11, 2011 and August 10, 2011 (the Credit Agreement). Currently, the Credit Agreement provides that the Company can borrow up to the lesser of (i) 80% of eligible accounts receivable, or (ii) $10.0 million. The Company has the option to increase credit availability to $15.0 million at any time through the maturity date of September 30, 2013, subject to the conditions of the Credit Agreement.

The Credit Agreement contains an overall sublimit of $10.0 million to collateralize the Company s contingent obligations under letters of credit, foreign exchange contracts and cash management services. Amounts outstanding under the overall sublimit reduce the amount available pursuant to the Credit Agreement. At July 2, 2011, letters of credit in the amount of $2.8 million were outstanding. The letters of credit expire on various dates through October 31, 2011.

Interest on the line of credit provided by the Credit Agreement is payable monthly at either (i) prime plus 1.25%, as long as the Company maintains $8.5 million in revolving credit availability plus unrestricted cash on deposit with the bank, or (ii) prime plus 2.25%. Additionally, the Credit Agreement requires payments for an unused line, as well as anniversary and early termination fees, as applicable.

The following table presents details of interest expense related to borrowings on revolving credit lines, along with certain other applicable information (in thousands):

	Three Months Ended		Six Months Ended	
	July 2, 2011	**July 3, 2010**	**July 2, 2011**	**July 3, 2010**
Interest expense	$	$ 13	$ 2	$ 24

	July 2, 2011	**January 1, 2011**
Availability under the revolving line of credit	$ 7,200	$ 5,100
Outstanding borrowings on the revolving line of credit		
Amounts reserved under credit sublimits	(2,800)	(2,900)
Unutilized borrowing availability under the revolving line of credit	$ 4,400	$ 2,200

17

In connection with the September 30, 2010 amendment to the Credit Agreement, Silicon Valley Bank extended a $1.5 million term loan, which bears interest at a rate of prime plus 1.75% (Term Loan I). The Company is required to make monthly principal payments of $41,666 of over the 36 month term of the loan, or $0.5 million annually. Term Loan I matures in September 2013. In May 2011, Silicon Valley Bank extended an additional $3.0 million term loan (Term Loan II), and extended the term of the existing credit facility through September 2013. The Term Loan II bears interest at a rate of prime plus 2.5%, and is payable in equal installments of $125,000 over the 24 month term of the loan, or $1.5 million annually. Term Loan II matures in May 2013.

The term loans are classified in long-term debt in the accompanying condensed consolidated balance sheets.

Obligations under the Credit Agreement are secured by a first priority lien on the Company s tangible and intangible assets.

The Credit Agreement subjects the Company to certain affirmative and negative covenants, including financial covenants with respect to the Company s liquidity and tangible net worth and restrictions on the payment of dividends. As of July 2, 2011, the Company was in compliance with its financial covenants.

Note 7 Long-Term Debt

Long-term debt consists of the following (in thousands):

	July 2, 2011	January 1, 2011
Term Loan I	$ 1,083	$ 1,375
Term Loan II, net of unamortized issuance cost of $57	2,693	
Obligations under capital leases	257	362
Note payable to others	49	
	4,082	1,737
Less current portion	(1,971)	(674)
	$ 2,111	$ 1,063

Notes payable to others represents short-term financing of annual insurance premiums.

Interest expense related to long-term debt is presented in the following table (in thousands):

Three Months Ended		Six Months Ended	
July 2, 2011	July 3, 2010	July 2, 2011	July 3, 2010

Interest expense	$ 54	$ 2	$ 82	$ 5

Note 8 Income Taxes

The following table sets forth the Company s benefit of income taxes, along with the corresponding effective tax rates (in thousands, except percentages):

	Three Months Ended		Six Months Ended	
	July 2, 2011	**July 3, 2010**	**July 2, 2011**	**July 3, 2010**
Provision (benefit) for income taxes	$ 1	$ 2	$ 1	$ (725)
Effective tax rate	(0.1)%	(0.1)%	(0.0)%	9.5%

The Company evaluates whether a valuation allowance should be established against its deferred tax assets based on the consideration of all available evidence using a more likely than not standard. Due to uncertainty of future utilization, the Company has provided a full valuation allowance as of July 2, 2011 and January 1, 2011. Accordingly, no benefit has been recognized for net deferred tax assets, including net operating losses that cannot be realized currently via carryback to periods of taxable income.

During the six months ended July 3, 2010, the Company carried back approximately $1.7 million of gross net operating losses under the Worker, Homeownership, and Business Act and received a federal income tax refund of approximately $0.7 million.

The Company had unrecognized tax benefits at July 2, 2011 and January 1, 2011 of approximately $0.1 million that, if recognized, would affect the Company s annual effective tax rate.

Note 9 Commitments and Contingencies

Patent Claims

In May 2008, the Company initiated discussions with Google, Inc. (Google) regarding the Company s claim that Google has infringed on a U.S. patent owned by the Company, U.S. Patent No. 7,289,386 (the 386 patent), which relates generally to rank multiplication in memory modules. On August 29, 2008, Google filed a declaratory judgment lawsuit against the Company in the U.S. District Court for the Northern District of California, seeking a declaration that Google did not infringe the 386 patent and that the 386 patent is invalid. Google is not seeking any monetary damages. On November 18, 2008, the Company filed a counterclaim for infringement of the 386 patent by Google. Claim construction proceedings were held on November 14, 2009, and the Company prevailed on every disputed claim construction issue. On June 1, 2010, the Company filed a motion for summary judgment of patent infringement and a motion for summary judgment to dismiss Google s affirmative defenses based on Netlist s activities in the JEDEC standard-setting organization. The hearings for these motions have been postponed indefinitely by the Court. On September 1, 2010, the United States Patent and Trademark Office (USPTO) granted Google s request for reexamination of the 386 patent. On September 14, 2010, the Court granted Google s request to stay the litigation pending the conclusion of the reexamination by the USPTO. On October 20, 2010, Smart Modular, Inc. (SMOD) filed a request for reexamination of the 386 patent with the USPTO. In January 2011, the USPTO granted SMOD s request for reexamination. The two reexaminations requested by Google and SMOD were merged by the USPTO into a single proceeding on March 3, 2011 and a Non-Final Action was issued by the USPTO on April 6, 2011. The Company filed its response to the Non-Final Action on July 6, 2011 and intends to vigorously pursue its infringement claims against Google and to continue to vigorously defend its patent rights in the USPTO.

On September 22, 2009, the Company filed a patent infringement lawsuit against Inphi Corporation (Inphi) in the U.S. District Court for the Central District of California. The suit alleges that Inphi is contributorily infringing and actively inducing the infringement of a U.S. patent owned by the Company**,** U.S. Patent No. 7,532,537 (the 537 patent), which relates generally to memory modules with load isolation and memory domain translation capabilities. The Company is seeking damages and injunctive relief based on Inphi s use of its patented technology. On December 22, 2009, the Company filed an Amended Complaint against Inphi asserting claims of patent infringement based on two additional patents, U.S. Patent No. 7,619,912 (the 912 patent), which is related to the 386 patent and relates generally to rank multiplication, and U.S. Patent No. 7,636,274 (the 274 patent), which is related to the 537 patent and relates generally to load isolation and memory domain translation technologies. Inphi has denied infringement and has asserted that the patents-in-suit are invalid. On April 19, 2010, Inphi filed requests for reexamination of the three patents-in-suit, and on April 21, 2010, Inphi filed a paper with the USPTO intended to provoke an interference proceeding on the three patents-in-suit. Inphi then filed a motion to stay the lawsuit, which was granted on May 18, 2010. On September 1, 2010, in the reexamination of the 912 patent, the USPTO confirmed the patentability of all fifty-one claims of the 912 patent.

On December 4, 2009, the Company filed a patent infringement lawsuit against Google in the U.S. District Court for the Northern District of California, seeking damages and injunctive relief based on Google s infringement of the 912 patent. On February 11, 2010, Google answered the Company s complaint and asserted counterclaims against the Company seeking a declaration that the patent is invalid and not infringed, and claiming that the Company committed fraud, negligent misrepresentation and breach of contract based on Netlist s activities in the JEDEC standard-setting organization. The counterclaim seeks unspecified compensatory damages. On October 20 and October 21, 2010, respectively, SMOD and Google each filed requests for reexamination of the 912 patent, which were each granted in January 2011. On January 26, 2011, the Court granted the parties joint request to stay the patent infringement lawsuit against Google until the completion of the reexamination proceedings. On February 28, 2011, the USPTO merged the latter two reexaminations and the Inphi reexamination into a single proceeding. A Non-Final Action in the merged reexamination proceeding dated April 4, 2011 stated that the USPTO rejected claims 1-20 and 22-51 and confirmed the patentability of claim 21 of the 912 patent. The Company filed its response to the Non-Final Action on July 5, 2011 and intends to vigorously pursue its infringement claims against Inphi and to continue to vigorously defend its patent rights in the USPTO.

With regard to the 537 patent, Inphi s request for reexamination was granted and a Non-Final Action was issued on September 8, 2010 by the USPTO. The Company filed its response on October 8, 2010, Inphi filed its comments on November 9, 2010, and the USPTO issued an Action Closing Prosecution (ACP) on June 21, 2011. The Company is preparing its response to the ACP and intends to vigorously pursue its infringement claims against Inphi and to continue to vigorously defend its patent rights in the USPTO.

With regard to the 274 patent, Inphi s request for reexamination was granted on August 27, 2010. To date, there have not been further developments in the USPTO regarding this reexamination.

On November 30, 2009, Inphi filed a patent infringement lawsuit against the Company in the U.S. District Court for the Central District of California alleging infringement of two Inphi patents generally related to memory module output buffers. On April 18, 2011 the Court dismissed the entire case without prejudice pursuant to a joint stipulation filed by Inphi and the Company under which each party agreed to bear its own costs and attorney s fees. The case is now closed.

On March 24, 2010, Ring Technologies Enterprises filed a patent infringement lawsuit in the U.S. District Court for the Eastern District of Texas against Dell and its suppliers. The suit alleged that the Company and forty-two (42) other defendants infringed on its U.S. Patent No. 6,879,526. On July 18, 2011 the Court dismissed all claims in this action against the Company, without prejudice, with each party to bear its own costs, expenses and attorney s fees. The case against the Company is now closed.

Other Contingent Obligations

During its normal course of business, the Company has made certain indemnities, commitments and guarantees under which it may be required to make payments in relation to certain transactions. These include (i) intellectual property indemnities to the Company s customers and licensees in connection with the use, sales and/or license of Company products; (ii) indemnities to vendors and service providers pertaining to claims based on the Company s negligence or willful misconduct; (iii) indemnities involving the accuracy of representations and warranties in certain contracts; (iv) indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware; and (v) certain real estate leases, under which the Company may be required to indemnify property owners for environmental and other liabilities, and other claims arising from the Company s use of the applicable premises. The duration of these indemnities, commitments and guarantees varies and, in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees do not provide for any limitation of the maximum potential for future payments the Company could be obligated to make. Historically, the Company has not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these indemnities, commitments and guarantees in the accompanying condensed consolidated balance sheets.

Commitment to Purchase Component Inventory

In September, 2010, the Company entered into a $2.5 million commitment to purchase ASIC devices for use in certain of its high-performance memory modules that are in the evaluation process with OEM and end-user customers, providing a $1.1 million letter of credit to secure payment for the purchase commitment. At January 1, 2011, the Company had made a prepayment of $0.7 million as additional security for the commitment. The prepayment is included in prepaid expenses and other current assets in the accompanying condensed consolidated balance sheet. As of July 2, 2011, the Company had received all ASIC devices under the purchase commitment, with the prepayment applied to the purchase obligation. The letter of credit issued to the vendor expired in April 2011.

Note 10 Stockholders Equity

Common Stock

During the six months ended July 2, 2011, the Company cancelled 19,730 shares of common stock valued at approximately $47,000 in connection with its obligation to holders of restricted stock to withhold the number of shares required to satisfy the holders tax liabilities in connection with the vesting of such shares.

Stock-Based Compensation

The Company has stock-based compensation awards outstanding pursuant to the Amended and Restated 2000 Equity Incentive Plan (the 2000 Plan) and the Amended and Restated 2006 Equity Incentive Plan (the 2006 Plan), under which a variety of option and direct stock-based awards may be granted to employees and nonemployees of the Company. Further grants under the 2000 Plan were suspended upon the adoption of the 2006 Plan. In addition to awards made pursuant to the 2006 Plan, the Company periodically issues inducement grants outside the 2006 Plan to certain new hires.

Subject to certain adjustments, as of July 2, 2011, the Company was authorized to issue a maximum of 4,205,566 shares of common stock pursuant to awards under the 2006 Plan. That maximum number will automatically increase on the first day of each subsequent calendar year by the lesser of (i) 5.0% of the number of shares of common stock that are issued and outstanding as of the first day of the calendar year, and (ii) 1,200,000 shares of common stock, subject to adjustment for certain corporate actions. At July 2, 2011, the Company had 113,429 shares available for grant under the 2006 Plan. At July 2, 2011, an additional 180,000 shares were reserved for issuance upon exercise of inducement grants. Options granted under the 2000 Plan, the 2006 Plan and outside the equity incentive plans primarily vest at a rate of at least 25% per year over four years and expire 10 years from the date of grant. Restricted stock awards vest in eight equal increments at intervals of approximately six months from the date of grant.

A summary of the Company s common stock option activity for the six months ended July 2, 2011 is presented below (shares in thousands):

	Options Outstanding		
	Number of Shares		**Weighted-Average Exercise Price**
Options outstanding at January 1, 2011	4,634	$	2.57
Options granted	1,388		2.23
Options exercised	(90)		0.45
Options cancelled	(118)		3.96
Options outstanding at July 2, 2011	5,814	$	2.51

The intrinsic value of options exercised in the six months ended July 2, 2011 was $0.2 million.

A summary of the Company s restricted stock awards as of and for the six months ended July 2, 2011 is presented below (shares in thousands):

	Restricted Stock Outstanding		
	Number of Shares		**Weighted-Average Grant-Date Fair Value per Share**
Balance outstanding at January 1, 2011	426	$	3.46
Restricted stock forfeited	(10)		3.26
Restricted stock vested	(60)		3.46
Balance outstanding at July 2, 2011	356	$	3.47

21

The following table presents details of the assumptions used to calculate the weighted-average grant date fair value of common stock options granted by the Company:

	Six Months Ended	
	July 2, 2011	July 3, 2010
Expected term (in years)	6.0	5.5
Expected volatility	136%	146%
Risk-free interest rate	2.20%	2.43%
Expected dividends		
Weighted-average grant date fair value per share	$ 2.28	$ 3.30

The fair value per share of restricted stock grants is calculated based on the fair value of the Company s common stock on the respective grant dates. The weighted-average fair value per share of the restricted stock granted in the six months ended July 3, 2010 was $3.48, calculated based on the fair market value of the Company s common stock on the respective grant dates. There was no restricted stock granted in the six month period ended July 2, 2011.

At July 2, 2011, the amount of unearned stock-based compensation currently estimated to be expensed from fiscal 2011 through fiscal 2014 related to unvested common stock options and restricted stock awards is approximately $4.3 million, net of estimated forfeitures. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 3.1 years. If there are any modifications or cancellations of the underlying unvested awards, the Company may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense.

Note 11 Segment and Geographic Information

The Company operates in one reportable segment: the design and manufacture of high-performance memory subsystems for the server, high-performance computing and communications markets. The Company evaluates financial performance on a Company-wide basis.

At July 2, 2011 and January 1, 2011, approximately $1.9 million and $2.3 million, respectively, of the Company s net long-lived assets were located in the PRC.

Note 12 Subsequent Event

On August 10, 2011, the Company and Silicon Valley Bank amended the Credit Agreement to reset the financial covenants with respect to the Company s liquidity and tangible net worth.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Statement

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our Unaudited Condensed Consolidated Financial Statements and the related notes thereto contained in Part I, Item 1 of this Report. The information contained in this Quarterly Report on Form 10-Q is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the fiscal year ended January 1, 2011 and subsequent reports on Form 8-K, which discuss our business in greater detail.

This report contains forward-looking statements regarding future events and our future performance. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those expected or projected. These risks and uncertainties include, but are not limited to continuing development, qualification and volume production of EXPRESSvault , NVvault and HyperCloud ; the rapidly-changing nature of technology; risks associated with intellectual property, including the costs and unpredictability of litigation over infringement of our intellectual property and the possibility of our patents being reexamined by the USPTO; volatility in the pricing of DRAM ICs and NAND; changes in and uncertainty of customer acceptance of, and demand for, our existing products and products under development, including uncertainty of and/or delays in product orders and product qualifications; delays in our and our customers product releases and development; introductions of new products by competitors; changes in end-user demand for technology solutions; our ability to attract and retain skilled personnel; our reliance on suppliers of critical components and vendors in the supply chain; fluctuations in the market price of critical components; evolving industry standards; and the political and regulatory environment in the PRC. Other risks and uncertainties are described under the heading Risk Factors in Part II, Item IA of this Quarterly Report on Form 10-Q, and similar discussions in our other SEC filings. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Overview

We design, manufacture and sell high-performance, intelligent memory subsystems for datacenter server and high-performance computing and communications markets. Our memory subsystems consist of combinations of dynamic random access memory integrated circuits (DRAM ICs or DRAM), NAND flash memory (NAND), application-specific integrated circuits (ASICs) and other components assembled on printed circuit boards (PCBs). We primarily market and sell our products to leading original equipment manufacturer (OEM) customers. Our solutions are targeted at applications where memory plays a key role in meeting system performance requirements. We leverage a portfolio of proprietary technologies and design techniques, including efficient planar design, alternative packaging techniques and custom semiconductor logic, to deliver memory subsystems with high memory density, small form factor, high signal integrity, attractive thermal characteristics and low cost per bit. Unless the context otherwise requires, all references in this Report to we, us, our, the Company, or Netlist refer to Netlist, Inc. and it subsidiaries.

Products

In November 2009, we introduced HyperCloud DDR3 memory technology. HyperCloud utilizes an ASIC chipset that incorporates Netlist patented rank multiplication technology that increases memory capacity and load reduction functionality that increases memory bandwidth. We expect that this technology will make possible improved levels of performance for memory intensive datacenter applications and workloads, including enterprise virtualization, cloud computing infrastructure, business intelligence real-time data analytics, and high performance computing. HyperCloud memory is being evaluated by several of our OEM customers for use in their server products. HyperCloud is interoperable with JEDEC standard DDR3 memory modules. Our HyperCloud products are designed to allow for installation in servers without the need for a BIOS change. As such, their anticipated sales launch is not dependent on the design plans or product cycle of our OEM customers. However, we have experienced a longer qualification cycle than anticipated.

In February 2010, we announced general availability of NVvaultTM battery-free, a non-volatile cache memory subsystem targeting RAID storage applications. NVvaultTM battery-free provides server and storage OEMs a solution for enhanced datacenter fault recovery. Unlike our traditional battery-powered fault tolerant cache product which relied solely on batteries to power the cache, NVvaultTM battery-free utilizes a combination of DRAM for high throughput performance and flash for extended data retention. The introduction of NVvaultTM battery-free, as well as the launch of the current version of the battery-powered module in connection with Dell introduction of the PERC 7 line of servers in December 2009, has resulted in RAID controller subsystem revenues of $17.2 million, or 61% of total revenues for the six months ended July 2, 2011, including $10.4 million of NVvault . This compares favorably with $7.0 million in RAID controller subsystem revenues, or 41% of total revenues for the six months ended July 3, 2010. Although revenues in 2011 and 2010 have been primarily for shipments to Dell, in the fourth quarter of 2010 we qualified NVvault TM battery-free with other OEMs, and continue to pursue further qualifications. We are also pursuing end-user opportunities with the introduction of EXPRESSvault in March 2011.

The remainder of our revenues arose primarily from OEM sales of custom memory modules, the majority of which were utilized in data center and industrial applications. When developing custom modules for an equipment product launch, we engage with our OEM customers from the earliest stages of new product definition, providing us unique insight into their full range of system architecture and performance requirements. This close collaboration has also allowed us to develop a significant level of systems expertise. We leverage a portfolio of proprietary technologies and design techniques, including efficient planar design, alternative packaging techniques and custom semiconductor logic, to deliver memory subsystems with high speed, capacity and signal integrity, small form factor, attractive thermal characteristics and low cost per bit. Revenues from custom modules have declined as a result of certain of our OEM product placements nearing the end of their product life. The reversal of this trend is dependent on our ability to qualify our memory modules on new platforms as current platforms reach the end of their life cycles, and on the state of the global economy.

Consistent with the concentrated nature of the OEM customer base in our target markets, a small number of large customers have historically accounted for a significant portion of our net sales. One customer represented approximately 67% of our net sales for the six months ended July 2, 2011. Two customers represented approximately 44% and 32%, respectively, of our net sales for the six months ended July 3, 2010.

Key Business Metrics

The following describes certain line items in our condensed consolidated statements of operations that are important to management s assessment of our financial performance:

Net Sales. Net sales consist primarily of sales of our high performance memory subsystems, net of a provision for estimated returns under our right of return policies, which generally range up to 30 days. We generally do not have long-term sales agreements with our customers. Although OEM customers typically provide us with non-binding forecasts of future product demand over specific periods of time, they generally place orders with us approximately two weeks in advance of scheduled delivery. Selling prices are typically negotiated monthly, based on competitive market conditions and the current price of DRAM ICs and NAND. Purchase orders generally have no cancellation or rescheduling penalty provisions. We often ship our products to our customers international manufacturing sites. All of our sales to date, however, are denominated in U.S. dollars. We also sell excess component inventory of DRAM ICs and NAND to distributors and other users of memory ICs. As compared to previous years, component inventory sales remain a relatively small percentage of net sales as a result of our efforts to diversify both our customer and product line bases. This diversification effort has also allowed us to use components in a wider range of memory subsystems. We expect that component inventory sales will continue to represent a minimal portion of our net sales in future periods.

Cost of Sales. Our cost of sales includes the cost of materials, manufacturing costs, depreciation and amortization of equipment, inventory valuation provisions, stock-based compensation, and occupancy costs and other allocated fixed costs. The DRAM ICs and NAND incorporated into our products constitute a significant portion of our cost of sales, and thus our cost of sales will fluctuate based on the current price of

DRAM ICs and NAND. We attempt to pass through such DRAM IC and NAND flash memory cost fluctuations to our customers by frequently renegotiating pricing prior to the placement of their purchase orders. However, the sales prices of our memory subsystems can also fluctuate due to competitive situations unrelated to the pricing of DRAM ICs and NAND, which affects gross margins. The gross margin on our sales of excess component DRAM IC and NAND inventory is much lower than the gross margin on our sales of our memory subsystems. As a result, fluctuations in DRAM IC and NAND inventory sales as a percentage of our overall sales could impact our overall gross margin. We assess the valuation of our inventories on a quarterly basis and record a provision to cost of sales as necessary to reduce inventories to the lower of cost or net realizable value.

Research and Development. Research and development expense consists primarily of employee and independent contractor compensation and related costs, stock-based compensation, non-recurring engineering fees, computer-aided design software licenses, reference design development costs, patent filing and protection legal fees, depreciation or rental of evaluation equipment, and occupancy and other allocated overhead costs. Also included in research and development expense are the costs of material and overhead related to the production of engineering samples of new products under development or products used solely in the research and development process. Our customers typically do not separately compensate us for design and engineering work involved in developing application-specific products for them. All research and development costs are expensed as incurred. We anticipate that research and development expenditures will increase in future periods as we seek to expand new product opportunities, increase our activities related to new and emerging markets and continue to develop additional proprietary technologies.

Selling, General and Administrative. Selling, general and administrative expenses consist primarily of employee salaries and related costs, stock-based compensation, independent sales representative commissions, professional services, promotional and other selling and marketing expenses, and occupancy and other allocated overhead costs. A significant portion of our selling effort is directed at building relationships with OEMs and other customers and working through the product approval and qualification process with them. Therefore, the cost of material and overhead related to products manufactured for qualification is included in selling expenses. As we continue to service existing and establish new customers, we anticipate that our sales and marketing expenses will increase.

Critical Accounting Policies

The preparation of our condensed consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of net sales and expenses during the reporting period. By their nature, these estimates and assumptions are subject to an inherent degree of uncertainty. We base our estimates on our historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. We review our estimates on an on-going basis. Actual results may differ from these estimates, which may result in material adverse effects on our operating results and financial position. We believe the following critical accounting policies involve our more significant assumptions and estimates used in the preparation of our condensed consolidated financial statements:

Revenue Recognition. We recognize revenues in accordance with the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 605. Accordingly, we recognize revenues when there is persuasive evidence that an arrangement exists, product delivery and acceptance have occurred, the sales price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured.

We generally use customer purchase orders and/or contracts as evidence of an arrangement. Delivery occurs when goods are shipped for customers with FOB Shipping Point terms and upon receipt for customers with FOB Destination terms, at which time title and risk of loss transfer to the customer. Shipping documents are used to verify delivery and customer acceptance. We assess whether the sales price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund. Customers are generally allowed limited rights of return for up to 30 days, except for sales of excess component inventories, which contain no right-of-return privileges. Estimated returns are provided for at the time of sale based on historical experience or specific identification of an event necessitating a reserve. We offer a standard product warranty to our customers and have no other post-shipment obligations. We assess collectibility based on the creditworthiness of the customer as determined by credit checks and evaluations, as well as the customer s payment history.

All amounts billed to customers related to shipping and handling are classified as net sales, while all costs incurred by us for shipping and handling are classified as cost of sales.

Fair Value of Financial Instruments. Our financial instruments consist principally of cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable, accrued expenses and debt instruments. Other than for certain investments in auction rate securities and short-term corporate bonds, the fair value of our cash equivalents and investments in marketable securities is determined based on quoted prices in active markets for identical assets or Level 1 inputs. Because of their short-term nature, short-term corporate bonds are not frequently traded. Although there are observable quotes for these securities, the markets are not considered active. Accordingly, the fair values of these investments are based on Level 2 inputs. The fair value of our auction rate securities is determined based on Level 3 inputs. We recognize transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. We believe that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

Allowance for Doubtful Accounts. We perform credit evaluations of our customers financial condition and limit the amount of credit extended to our customers as deemed necessary, but generally require no collateral. We evaluate the collectibility of accounts receivable based on a combination of factors. In cases where we are aware of circumstances that may impair a specific customer s ability to meet its financial obligations subsequent to the original sale, we will record an allowance against amounts due, and thereby reduce the net recognized receivable to the amount that we reasonably believe will be collected. For all other customers, we record allowances for doubtful accounts based primarily on the length of time the receivables are past due based on the terms of the originating transaction, the current business environment and our historical experience. Uncollectible accounts are charged against the allowance for doubtful accounts when all cost effective commercial means of collection have been exhausted. Generally, our credit losses have been within our expectations and the provisions established. However, we cannot guarantee that we will continue to experience credit loss rates similar to those we have experienced in the past.

Our accounts receivable are highly concentrated among a small number of customers, and a significant change in the liquidity or financial position of one of these customers could have a material adverse effect on the collectability of our accounts receivable, our liquidity and our future operating results.

Inventories. We value our inventories at the lower of the actual cost to purchase or manufacture the inventory or the net realizable value of the inventory. Cost is determined on an average cost basis which approximates actual cost on a first-in, first-out basis and includes raw materials, labor and manufacturing overhead. At each balance sheet date, we evaluate ending inventory quantities on hand and record a provision for excess quantities and obsolescence. Among other factors, we consider historical demand and forecasted demand in relation to the inventory on hand, competitiveness of product offerings, market conditions and product life cycles when determining obsolescence and net realizable value. In addition, we consider changes in the market value of DRAM ICs and NAND in determining the net realizable value of our raw material inventory. Once established, any write downs are considered permanent adjustments to the cost basis of our excess or obsolete inventories.

A significant decrease in demand for our products could result in an increase in the amount of excess inventory quantities on hand. In addition, our estimates of future product demand may prove to be inaccurate, in which case we may have understated or overstated the provision required for excess and obsolete inventory. In the future, if our inventories are determined to be overvalued, we would be required to recognize additional expense in our cost of sales at the time of such determination. Likewise, if our inventories are determined to be undervalued, we may have over-reported our costs of sales in previous periods and would be required to recognize additional gross profit at the time such inventories are sold. In addition, should the market value of DRAM ICs or NAND decrease significantly, we may be required to lower our selling prices to reflect the lower current cost of our raw materials. If such price decreases reduce the net realizable value of our inventories to less than our cost, we would be required to recognize additional expense in our cost of sales in the same period. Although we make every reasonable effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand, technological developments or the market value of DRAM ICs or NAND could have a material effect on the value of our inventories and our reported operating results.

Impairment of Long-Lived Assets. We evaluate the recoverability of the carrying value of long-lived assets held and used in our operations for impairment on at least an annual basis or whenever events or changes in circumstances indicate that their carrying value may not be recoverable. When such factors and circumstances exist, we compare the projected undiscounted future net cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. These projected future cash flows may vary significantly over time as a result of increased competition, changes in technology, fluctuations in demand, consolidation of our customers and reductions in average selling prices. If the carrying value is determined not to be recoverable from future operating cash flows, the asset is deemed impaired and an impairment loss is recognized to the extent the carrying value exceeds the estimated fair value of the asset. The fair value of the asset or asset group is based on market value when available, or when unavailable, on discounted expected cash flows.

Warranty Reserve. We offer product warranties generally ranging from one to three years, depending on the product and negotiated terms of purchase agreements with our customers. Such warranties require us to repair or replace defective product returned to us during the warranty period at no cost to the customer. Warranties are not offered on sales of excess inventory. Our estimates for warranty-related costs are recorded at the time of sale based on historical and estimated future product return rates and expected repair or replacement costs. While such costs have historically been consistent between periods and within our expectations and the provisions established, unexpected changes in failure rates could have a material adverse impact on us, requiring additional warranty reserves, and adversely affecting our gross profit and gross margins.

Stock-Based Compensation. We account for equity issuances to non-employees in accordance with ASC Topic 505. All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date used to determine the fair value of the equity instrument issued is the earlier of the date on which the third-party performance is complete or the date on which it is probable that performance will occur.

In accordance with ASC Topic 718, employee and director stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest during the period. Given that stock-based compensation expense recognized in the condensed consolidated statements of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. ASC Topic 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Our estimated average forfeiture rates are based on historical forfeiture experience and estimated future forfeitures.

The fair value of common stock option awards to employees and directors is calculated using the Black-Scholes option pricing model. The Black-Scholes model requires subjective assumptions regarding future stock price volatility and expected time to exercise, along with assumptions about the risk-free interest rate and expected dividends, all of which affect the estimated fair values of our common stock option awards. The expected term of options granted is calculated as the average of the weighted vesting period and the contractual expiration date of the option. This calculation is based on the safe harbor method permitted by the SEC in instances where the vesting and exercise terms of options granted meet certain conditions and where limited historical exercise data is available. The expected volatility is based on the historical volatility of our common stock. The risk-free rate selected to value any particular grant is based on the U.S. Treasury rate that corresponds to the expected term of the grant effective as of the date of the grant. The expected dividends assumption is based on our history and our expectations regarding dividend payouts. We evaluate the assumptions used to value our common stock option awards on a quarterly basis. If factors change and we employ different assumptions, stock- based compensation expense may differ significantly from what we have recorded in prior periods. Compensation expense for common stock option awards with graded vesting schedules is recognized on a straight-line basis over the requisite service period for the last separately vesting portion of the award, provided that the accumulated cost recognized as of any date at least equals the value of the vested portion of the award.

We recognize the fair value of restricted stock awards issued to employees and outside directors as stock-based compensation expense on a straight-line basis over the vesting period for the last separately vesting portion of the awards. Fair value is determined as the difference between the closing price of our common stock on the grant date and the purchase price of the restricted stock award, if any, reduced by expected forfeitures.

If there are any modifications or cancellations of the underlying vested or unvested stock-based awards, we may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense, or record additional expense for vested stock-based awards. Future stock-based compensation expense and unearned stock- based compensation may increase to the extent that we grant additional common stock options or other stock-based awards.

Income Taxes. Deferred tax assets and liabilities are recognized to reflect the estimated future tax effects of future deductible or taxable amounts attributable to events that have been recognized on a cumulative basis in the condensed consolidated financial statements, calculated at enacted tax rates for expected periods of realization. We regularly review our deferred tax assets for recoverability and establish a valuation allowance, when determined necessary, based on historical taxable income, projected future taxable income, and the expected timing of the reversals of existing temporary differences. Because we have operated at a loss for an extended period of time, we did not recognize deferred tax assets related to losses incurred in 2011. Benefits recognized in 2010 were limited to those made available as a one-time carry-back through economic recovery legislation. In the future, if we realize a deferred tax asset that currently carries a valuation allowance, we may record an income tax benefit or a reduction to income tax expense in the period of such realization.

ASC Topic 740 prescribes a recognition threshold and measurement requirement for the financial statement recognition of a tax position that has been taken or is expected to be taken on a tax return and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Under ASC Topic 740 we may only recognize or continue to recognize tax positions that meet a more likely than not threshold.

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.

Results of Operations

The following table sets forth certain condensed consolidated statements of operations data as a percentage of net sales for the periods indicated:

	Three Months Ended		Six Months Ended	
	July 2, 2011	**July 3, 2010**	**July 2, 2011**	**July 3, 2010**
Net sales	100%	100%	100%	100%
Cost of sales	69	80	69	79
Gross profit	31	20	31	21
Operating expenses:				
Research and development	23	34	27	36
Selling, general and administrative	16	28	20	30
Total operating expenses	40	62	46	66
Operating loss	(9)	(43)	(15)	(45)
Other (expense) income:				
Interest (expense) income, net				
Other (expense) income, net				1
Total other (expense) income, net				1
Loss before provision (benefit) for income taxes	(9)	(43)	(16)	(44)
Provision (benefit) for income taxes				(4)
Net loss	(9)%	(43)%	(15)%	(40)%

Three and Six Months Ended July 2, 2011 Compared to Three and Six Months Ended July 3, 2010

Net Sales, Cost of Sales and Gross Profit

The following table presents net sales, cost of sales and gross profit for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

	Three Months Ended			
	July 2, 2011	July 3, 2010	Change	% Change
Net sales	$ 16,001	$ 9,304	$ 6,697	72%
Cost of sales	11,064	7,486	3,578	48%
Gross profit	$ 4,937	$ 1,818	$ 3,119	172%
Gross margin	31%	20%	11%	

	Six Months Ended			
	July 2, 2011	July 3, 2010	Change	% Change
Net sales	$ 28,001	$ 17,194	$ 10,807	63%
Cost of sales	19,260	13,558	5,702	42%
Gross profit	$ 8,741	$ 3,636	$ 5,105	140%
Gross margin	31%	21%	10%	

Net Sales. The increase in net sales for the three months ended July 2, 2011 as compared with the three months ended July 3, 2010 resulted primarily from increases of approximately (i) $5.5 million in sales of NVvault non-volatile cache systems used in RAID controller subsystems, including $4.3 million from NVvault battery-free, the flash-based cache system that became generally available in 2010, and (ii) $1.0 million in sales of flash memory products, resulting from existing and new customer qualifications.

The increase in net sales for the six months ended July 2, 2011 as compared with the six months ended July 3, 2010 resulted from increases of approximately (i) $10.2 million in sales of NVvault non-volatile cache systems used in RAID controller subsystems, including $7.8 million from NVvault battery-free, the flash-based cache system, and (ii) $1.3 million in sales of flash memory products, offset by a decrease of $1.7 million in sales of memory modules used in industrial applications as one customer slowed production as a result of its product nearing the end of its life cycle.

Gross Profit and Gross Margin. The overall improvements in gross profit are due to increased sales and manufacturing volume, as well as a shift in sales toward higher margin products. Gross profit for the three months ended July 2, 2011 as compared to the three months ended July 3, 2010 increased due to the 72% increase in net sales between the two periods, resulting in variable cost profits earned on each unit sold, as well as an improved ability to absorb fixed manufacturing costs. These volume-based improvements were augmented by decreased DRAM prices, which positively affected margins in some product categories. Gross profits for the six months ended July 2, 2011 as compared to the six months ended July 3, 2010 were impacted by the same trends, including a 63% increase in net sales between the two periods.

29

Research and Development.

The following table presents research and development expenses for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

	Three Months Ended			
	July 2, 2011	**July 3, 2010**	**Change**	**% Change**
Research and development	$ 3,755	$ 3,190	$ 565	18%

	Six Months Ended			
	July 2, 2011	**July 3, 2010**	**Change**	**% Change**
Research and development	$ 7,439	$ 6,198	$ 1,241	20%

The increase in research and development expense in the three months ended July 2, 2011 as compared to the three months ended July 3, 2010 resulted primarily from increases of (i) $0.6 million in engineering expenses as a result of an increase in both internal engineering headcount and outside contractors engaged in new product development activities, (ii) $0.2 million in material expenses related to product builds and testing, primarily related to our HyperCloud and NVvault products , partially offset by a decrease of $0.2 million in legal and professional fees due to deferral of certain patent protection court cases while the Company responds to reexamination requests at the USPTO.

The increase in research and development expense in the six months ended July 2, 2011 as compared to the six months ended July 3, 2010 resulted primarily from increases of (i) $1.2 million in internal engineering and headcount and (ii) $0.4 million in material expenses related to product builds and testing, partially offset by a decrease of $0.4 million in legal and professional fees, all impacted by the same trends noted in the comparison for the second quarter.

Selling, General and Administrative.

The following table presents selling, general and administrative expenses for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

	Three Months Ended			
	July 2, 2011	**July 3, 2010**	**Change**	**% Change**
Selling, general and administrative	$ 2,583	$ 2,607	$ (24)	(1)%

	Six Months Ended			
	July 2,	**July 3,**		**%**

	2011	2010	Change	Change
Selling, general and administrative	$ 5,500	$ 5,177	$ 323	6%

Selling, general and administrative expense was flattish for the three months ended July 2, 2011 as compared to the three months ended July 3, 2010, as we improve operating efficiency through leveraging our selling and administrative expenditures.

The increase in selling, general and administrative expense in the six months ended July 2, 2011 as compared to the six months ended July 3, 2010 resulted primarily from increases of $0.5 million in product sample cost as a result of activities related to the OEM qualification process for HyperCloud and NVvault NV, offset by a decrease of $0.2 million in personnel-related expenses, primarily due to lower facilities cost.

Other (Expense) Income.

The following table presents other (expense) income for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

	Three Months Ended			
	July 2, 2011	July 3, 2010	Change	% Change
Interest (expense) income, net	$ (50)	$ 3	$ (53)	(1,767)%
Other (expense) income, net	(59)	4	(63)	(1,575)%
Total other (expense) income, net	$ (109)	$ 7	$ (116)	(1,657)%

	Six Months Ended			
	July 2, 2011	July 3, 2010	Change	% Change
Interest (expense) income, net	$ (75)	$ 4	$ (79)	(1,975)%
Other (expense) income, net	(59)	71	(130)	(183)%
Total other (expense) income, net	$ (134)	$ 75	$ (209)	(279)%

Net interest (expense) income for the three and six months ended July 2, 2011 and July 3, 2010 was comprised of nominal interest income, offset by nominal interest expense. The increase in interest expense for the three months ended July 2, 2011 compared with the three months ended July 3, 2010 was the result of our term loans, which were originated in September, 2010 and May 2011.

Other expense, net, for the three and six months ended July 2, 2011 was primarily comprised of a realized loss of $59,000 from the sale of an auction rate security that was purchased in 2008. Illiquidity in the market for auction rate securities had resulted in unrealized losses on two securities that we owned. The unrealized loss was recorded as a component of other comprehensive loss through the date of disposal. We were able to liquidate one of the securities at approximately its book value as a result of a tender request from the issuer. We continue to own one auction rate security which has been marked to its fair value through other comprehensive loss. Other income, net, for the six months ended July 3, 2010 was primarily comprised of cash proceeds from the early termination of a sublease of our headquarters facility.

Benefit of Income Taxes.

The following table presents the benefit of income taxes for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

	Three Months Ended			
	July 2, 2011	July 3, 2010	Change	% Change

Provision (benefit) for income taxes	$	1	$	2	$ (1)	(50)%

	Six Months Ended				
	July 2, 2011		July 3, 2010	Change	% Change
Provision (benefit) for income taxes	$	1	$	(725		