NETLIST INC
Form 10-Q
August 15, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 1, 2017

or

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

For the transition period from to

Commission file number 001-33170

NETLIST, INC.

(Exact name of registrant as specified in its charter)

Delaware	95-4812784
State or other jurisdiction of incorporation or organization	(I.R.S. Employer Identification No.)

175 Technology Drive, Suite 150

Irvine, CA 92618

(Address of principal executive offices) (Zip Code)

(949) 435-0025

(Registrant's telephone number, including area code)

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

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares outstanding of the registrant's common stock as of the latest practicable date:

Common Stock, par value $0.001 per share

61,919,646 shares outstanding at August 10, 2017

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NETLIST, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE AND SIX MONTHS ENDED JULY 1, 2017

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NETLIST, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(in thousands, except par value)

	July 1, 2017 (unaudited)	December 31, 2016 (audited)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 4,496	$ 9,476
Restricted cash	3,100	3,100
Accounts receivable, net of reserves of $90 (2017) and $151 (2016)	1,819	1,751
Inventories	4,908	3,160
Prepaid expenses and other current assets	1,851	1,766
Total current assets	16,174	19,253
Property and equipment, net	554	645
Other assets	83	70
Total assets	$ 16,811	$ 19,968
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current Liabilities:		
Accounts payable	$ 6,648	$ 4,028
Revolving line of credit	1,332	676
Accrued payroll and related liabilities	789	1,085
Accrued expenses and other current liabilities	263	270
Notes payable and capital lease obligation, current	141	151
Total current liabilities	9,173	6,210
Convertible promissory note, net of debt discount, and accrued interest	14,509	14,251
Long-term warranty liability	45	36
Total liabilities	23,727	20,497
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, $0.001 par value - 10,000 shares authorized; no shares issued and outstanding	-	-
Common stock, $0.001 par value - 150,000 shares authorized; 61,870 (2017) and 61,653 (2016) shares issued and outstanding	62	62
Additional paid-in capital	144,837	144,035

Accumulated deficit	(151,815)	(144,626)
Total stockholders' deficit	(6,916)	(529)
Total liabilities and stockholders' deficit	$ 16,811	$ 19,968

See accompanying notes.

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NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Net product revenues	$ 11,404	$ 3,500	$ 20,830	$ 4,671
Non-recurring engineering revenues	-	3,428	-	6,857
Total net revenues	11,404	6,928	20,830	11,528
Cost of sales(1)	10,760	3,267	19,506	4,416
Gross profit	644	3,661	1,324	7,112
Operating expenses:				
Research and development(1)	1,487	1,831	2,983	3,477
Intellectual property legal fees	915	1,023	1,381	1,846
Selling, general and administrative(1)	1,951	2,159	3,865	4,424
Total operating expenses	4,353	5,013	8,229	9,747
Operating loss	(3,709)	(1,352)	(6,905)	(2,635)
Other expense, net:				
Interest expense, net	(138)	(132)	(286)	(269)
Other income (expense), net	-	(10)	2	(2)
Total other expense, net	(138)	(142)	(284)	(271)
Loss before provision for income taxes	(3,847)	(1,494)	(7,189)	(2,906)
Provision for income taxes	-	-	-	1
Net loss	$ (3,847)	$ (1,494)	$ (7,189)	$ (2,907)
Net loss per common share:				
Basic and diluted	$ (0.06)	$ (0.03)	$ (0.12)	$ (0.06)
Weighted-average common shares outstanding:				
Basic and diluted	61,844	51,080	61,763	50,723

(1) Amounts include stock-based compensation expense as follows:

Cost of sales	$ 13	$ 13	$ 29	$ 28
Research and development	114	55	180	190
Selling, general and administrative	254	235	436	543
Total stock-based compensation	$ 381	$ 303	$ 645	$ 761

See accompanying notes.

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NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Six Months Ended	
	July 1, 2017	July 2, 2016
Cash flows from operating activities:		
Net loss	$ (7,189)	$ (2,907)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	144	126
Interest accrued on convertible promissory note	150	-
Amortization of debt discount	108	108
Stock-based compensation	645	761
Changes in operating assets and liabilities:		
Restricted cash	-	(200)
Accounts receivable	(68)	(306)
Inventories	(1,748)	(312)
Prepaid expenses and other assets	122	191
Accounts payable	2,620	1,026
Accrued payroll and related liabilities	(296)	(191)
Accrued expenses and other liabilities	2	44
Deferred revenue	-	(6,857)
Net cash used in operating activities	(5,510)	(8,517)
Cash flows from investing activities:		
Acquisition of property and equipment	(53)	(274)
Net cash used in investing activities	(53)	(274)
Cash flows from financing activities:		
Net borrowings under line of credit	656	-
Payments on debt	(230)	(137)
Proceeds from exercise of stock options	157	47
Net cash provided by (used in) financing activities	583	(90)
Net change in cash and cash equivalents	(4,980)	(8,881)
Cash and cash equivalents at beginning of period	9,476	19,684
Cash and cash equivalents at end of period	$ 4,496	$ 10,803

See accompanying notes.

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NETLIST, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

July 1, 2017

Note 1—Description of Business

Netlist, Inc. together with its wholly owned subsidiaries (hereinafter collectively referred to as the "Company" or "Netlist," unless the context or the use of the term indicates otherwise), is a leading provider of high-performance modular memory subsystems serving customers in diverse industries that require superior memory performance to empower critical business decisions. The Company has a long history of introducing disruptive new products, such as one of the first load-reduced dual in-line memory modules ("LRDIMM") based on its distributed buffer architecture, which has been adopted by the industry for DDR4 LRDIMM. The Company was also one of the first to bring NAND flash memory ("NAND flash") to the memory channel with its NVvault® non-volatile dual in-line memory modules ("NVDIMM") using software-intensive controllers and merging dynamic random access memory integrated circuits ("DRAM ICs" or "DRAM") and NAND flash to solve data bottleneck and data retention challenges encountered in high-performance computing environments. The Company recently introduced a new generation of storage class memory products called HybriDIMM™ to address the growing need for real-time analytics in Big Data applications and in memory databases.

Due to the ground-breaking product development of its engineering teams, Netlist has built a robust portfolio of over 100 issued and pending U.S. and foreign patents, many seminal, in the areas of hybrid memory, storage class memory, rank multiplication and load reduction. Since its inception, the Company has dedicated substantial resources to the development and protection of technology innovations essential to its business. The Company's early pioneering work in these areas has been broadly adopted in industry-standard LRDIMM and in NVDIMM. Netlist's objective is to continue to innovate in its field and invest further in its intellectual property portfolio, with the goal of monetizing its intellectual property through a combination of product revenues and licensing, royalty or other revenue-producing arrangements, which may result from joint development or similar partnerships or defense of our patents through enforcement actions against parties we believe are infringing them.

Netlist was incorporated in June 2000 and is headquartered in Irvine, California. In 2007, the Company established a manufacturing facility in the People's Republic of China (the "PRC"), which became operational in July 2007 upon the successful qualification of certain key customers.

Liquidity

The Company incurred net losses of $3.8 million and $7.2 million for the three and six months ended July 1, 2017, respectively, and $11.2 million and $20.5 million for the fiscal years ended December 31, 2016 and January 2, 2016, respectively. The Company has historically financed its operations primarily through issuances of equity and debt securities and revenues generated from operations, including product revenues and a non-recurring engineering ("NRE") fee from its Joint Development and License Agreement ("JDLA") with Samsung Electronics Co., Ltd. ("Samsung"), discussed below. The Company has also funded its operations with a revolving line of credit and term loans under a bank credit facility, a funding arrangement for costs associated with certain of its legal proceedings and, to a lesser extent, equipment leasing arrangements (see Notes 4, 5 and 7).

On November 12, 2015, the Company entered into the JDLA with Samsung, pursuant to which the Company and Samsung have agreed to work together to jointly develop new storage class memory technologies including a standardized product interface for NVDIMM-P memory modules in order to facilitate broad industry adoption of this new technology. The JDLA also includes comprehensive cross-licenses to the Company's and Samsung's patent portfolios for the purpose of developing this product interface, grants Samsung a right of first refusal to acquire the Company's HybriDIMM technology before it offers the technology to a third party, and grants the Company access to competitively priced DRAM and NAND flash raw materials. The Company believes Samsung represents an important strategic partner with a high level of technical capability in memory that can facilitate bringing its HybriDIMM technology to market. In connection with the JDLA, the Company received an $8.0 million NRE fee from Samsung for the joint development and received gross proceeds of $15.0 million for its issuance of a Senior Secured Convertible Note

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(“SVIC Note”) and Stock Purchase Warrant (“SVIC Warrant”) to SVIC No. 28 New Technology Business Investment L.L.P., an affiliate of Samsung Venture Investment Co. (“SVIC”) (see Note 5).

On September 23, 2016, the Company completed a registered firm commitment underwritten public offering (the “2016 Offering”), pursuant to which it sold 9,200,000 shares of its common stock at a price to the public of $1.25 per share. The net proceeds to the Company from the 2016 Offering were $10.3 million, after deducting underwriting discounts and commissions and offering expenses paid by the Company.

Inadequate working capital would have a material adverse effect on the Company’s business and operations and could cause the Company to fail to execute its business plan, fail to take advantage of future opportunities or fail to respond to competitive pressures or customer requirements. A lack of sufficient funding may also require the Company to significantly modify its business model and/or reduce or cease our operations, which could include implementing cost-cutting measures or delaying, scaling back or eliminating some or all of its ongoing and planned investments in corporate infrastructure, research and development projects, business development initiatives and sales and marketing activities, among other activities. While the Company’s estimates of its operating revenues and expenses and working capital requirements could be incorrect and the Company may use its cash resources faster than it anticipates, management believes the Company’s existing cash balance, together with cash provided by the Company’s operations and borrowing availability under a bank credit facility (see Note 4) and taking into account cash expected to be used in operations and the funding to be received for certain litigation expenses (see Note 7), will be sufficient to meet the Company’s anticipated cash needs for at least the next 12 months.

Note 2—Summary of Significant Accounting Policies

Significant Accounting Policies

Basis of Presentation

The accompanying interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and the instructions to the Securities and Exchange Commission’s (“SEC”) Form 10-Q and Article 8 of the SEC’s Regulation S-X. These condensed consolidated financial statements do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. Therefore, these unaudited condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and notes thereto as of and for the year ended December 31, 2016, included in the Company’s Annual Report on Form 10-K filed with the SEC on March 31, 2017.

The accompanying condensed consolidated financial statements as of and for the three and six months ended July 1, 2017 are unaudited; however, they contain all normal recurring accruals and adjustments that, in the opinion of the Company’s management, are necessary to present fairly the condensed consolidated financial position of the Company and its wholly-owned subsidiaries as of July 1, 2017 and the condensed consolidated statements of operations and statements of cash flows for the six months ended July 1, 2017 and July 2, 2016. The results of operations for the three and six months ended July 1, 2017 are not necessarily indicative of the results to be expected for any full year or any other interim period.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of Netlist, Inc. and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

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Fiscal Year

The Company operates under a 52 or 53-week fiscal year ending on the Saturday closest to December 31. For 2017, the Company's fiscal year is scheduled to end on December 30, 2017 and will consist of 52 weeks, and each of the Company's quarters within such fiscal year will be comprised of 13 weeks.

Use of Estimates

The preparation of the accompanying condensed consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements, and the reported amounts of net revenues and expenses during the reporting period. By their nature, these estimates and assumptions are subject to an inherent degree of uncertainty. Significant estimates made by management include, among others, provisions for uncollectible receivables and sales returns, warranty liabilities, valuation of inventories, fair value of financial instruments, recoverability of long-lived assets, valuation of stock-based transactions, estimates for completion of NRE revenue milestones, and realization of deferred tax assets. The Company bases its estimates on its historical experience, knowledge of current conditions and the Company's belief of what could occur in the future considering available information. The Company reviews its estimates on an on-going basis. Actual results may differ materially from these estimates which may result in material adverse effects on the Company's consolidated operating results and financial position.

The Company believes the following critical accounting policies involve its more significant assumptions and estimates used in the preparation of the accompanying condensed consolidated financial statements: provisions for uncollectible receivables and sales returns; warranty liabilities; valuation of inventories; fair value of financial instruments; recoverability of long-lived assets; valuation of stock-based transactions; estimates for completion of NRE and other revenue milestones; and realization of deferred tax assets.

Revenue Recognition

The Company generates revenue from sales of products and performance of engineering services.

Net Product Revenues

Net product revenues primarily consist of sales of high-performance modular memory subsystems to original equipment manufacturers (“OEMs”), Hyperscale data center operators and storage vendors.

The Company recognizes revenues in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 605. Accordingly, the Company recognizes revenues when there is persuasive evidence that an arrangement exists, product delivery and acceptance have occurred, the sales price is fixed or determinable, and collectability of the resulting receivable is reasonably assured.

The Company generally uses customer purchase orders and/or contracts as evidence of an arrangement. Delivery occurs when goods are shipped for customers with shipping point terms and upon receipt for customers with destination terms, at which time title and risk of loss transfer to the customer. Shipping documents are used to verify delivery and customer acceptance. The Company assesses 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. The Company offers a standard product warranty to its customers and has no other post-shipment obligations. The Company assesses collectability based on the creditworthiness of the customer as determined by credit checks and evaluations, as well as the customer’s payment history.

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

Engineering Services

The Company provides engineering services to its customers. The Company recognizes revenue from these services when all of the following conditions are met: (1) evidence existed of an arrangement with the customer, typically consisting of a purchase order or contract; (2) the Company's services were performed and risk of loss passed to the customer; (3) the Company completed all of the necessary terms of the contract; (4) the amount of revenue to which the Company was entitled was fixed or determinable; and (5) the Company believed it was probable that it would be able to collect the amount due from the customer. To the extent that one or more of these conditions has not been satisfied, the Company defers recognition of revenue.

Deferred Revenue

From time-to-time the Company receives pre-payments from its customers related to future services. Engineering development fee revenues, including NRE fees, are deferred and recognized ratably over the period the engineering work is completed.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash and short-term investments with original maturities of three months or less.

Restricted Cash

Restricted cash consists of cash to secure standby letters of credit. Restricted cash was $3.1 million as of both July 1, 2017 and December 31, 2016, and related to two standby letters of credit.

Fair Value of Financial Instruments

The Company's financial instruments consist principally of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued expenses and debt instruments. The fair value of the Company's cash equivalents is determined based on quoted prices in active markets for identical assets or Level 1 inputs. The Company recognizes transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. The Company believes 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

The Company performs credit evaluations of our customers' financial condition and limits the amount of credit extended to its customers as deemed necessary, but generally requires no collateral. The Company evaluates the collectability of accounts receivable based on a combination of factors. In cases where the Company is aware of circumstances that may impair a specific customer's ability to meet its financial obligations subsequent to the original sale, the Company will record an allowance against amounts due, and thereby reduce the net recognized receivable to the amount the Company reasonably believes will be collected. For all other customers, the Company records 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 its historical experience. Uncollectible accounts are charged against the allowance for doubtful accounts when all cost-effective commercial means of collection have been exhausted. Generally, the Company's credit losses have been within expectations and the provisions established. However, the Company cannot guarantee that it will continue to experience credit loss rates similar to those experienced in the past.

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The Company's 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 the Company's accounts receivable, liquidity and future operating results.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents, and accounts receivable.

The Company invests its cash equivalents primarily in money market mutual funds. Cash equivalents are maintained with high quality institutions, the composition and maturities of which are regularly monitored by management. At times, deposits held with financial institutions may exceed the amount of insurance provided by the Federal Deposit Insurance Corporation and the Securities Investor Protection Corporation.

The Company's trade accounts receivable are primarily derived from sales to OEMs in the server, high-performance computing and communications markets, as well as from sales to storage customers, appliance customers, system builders and cloud and datacenter customers. The Company performs credit evaluations of its customers' financial condition and limits the amount of credit extended when deemed necessary, but generally requires no collateral. The Company believes that the concentration of credit risk in its trade receivables is moderated by its credit evaluation process, relatively short collection terms, a high level of credit worthiness of its customers (see Note 3), foreign credit insurance, and letters of credit issued in its favor. Reserves are maintained for potential credit losses, and such losses historically have not been significant and have been within management's expectations.

Inventories

Inventories are valued at the lower of 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. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. At each balance sheet date, the Company evaluates its ending inventory quantities on hand and on order and records a provision for excess quantities and obsolescence. Among other factors, the Company considers 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, the Company considers changes in the market value of components in determining the net realizable value of its inventory. Once established, lower of cost or market write-downs are considered permanent adjustments to the cost basis of the excess or obsolete inventories.

Property and Equipment

Property and equipment are recorded at cost and depreciated on a straight-line basis over their estimated useful lives, which generally range from three to seven years. Leasehold improvements are recorded at cost and amortized on a straight-line basis over the shorter of their estimated useful lives or the remaining lease term. Expenditures for repairs and maintenance are expensed as incurred. Upon retirement or sale, the cost and related accumulated depreciation and amortization of disposed assets are removed from the accounts and any resulting gain or loss is included in other expense, net.

Deferred Financing Costs, Debt Discount and Detachable Debt-Related Warrants

Costs incurred to issue debt are deferred and recorded as a reduction to the debt balance in the accompanying condensed consolidated balance sheets. The Company amortizes debt issuance costs over the expected term of the related debt using the effective interest method. Debt discounts relate to the relative fair value of warrants issued in conjunction with the debt and are also recorded as a reduction to the debt balance and accreted over the expected term of the debt to interest expense using the effective interest method.

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Impairment of Long-Lived Assets

The Company evaluates the recoverability of the carrying value of long-lived assets held and used by the Company in its 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, the Company compares 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 the Company's 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. The Company's management believes there is no impairment of long-lived assets as of July 1, 2017. However, market conditions could change or demand for the Company's products could decrease, which could result in future impairment of long-lived assets.

Warranty Liability

The Company offers product warranties generally ranging from one to three years, depending on the product and negotiated terms of any purchase agreements with its customers. Such warranties require the Company to repair or replace defective product returned to the Company during the warranty period at no cost to the customer. Warranties are not offered on sales of excess component inventory. The Company records an estimate for warranty related costs at the time of sale based on its historical and estimated future product return rates and expected repair or replacement costs (see Note 3). While such costs have historically been within management's expectations and the provisions established, unexpected changes in failure rates could have a material adverse impact on the Company, requiring additional warranty reserves and could adversely affect the Company's gross profit and gross margins.

Stock-Based Compensation

The Company accounts for equity issuances to non-employees in accordance with FASB 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 estimated 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 FASB 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 accompanying condensed consolidated statements of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. The Company estimates its forfeitures at the time of grant and revises such estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company's estimated average forfeiture rates are based on historical forfeiture experience and estimated future forfeitures.

The estimated 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 the Company's 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 Securities and Exchange Commission ("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 the Company's 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 dividend assumption is based on the Company's history and management's expectation regarding dividend payouts. 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.

The Company recognizes 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 the Company's 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, the Company 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 the Company grants 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, calculated at currently effective tax rates, of future deductible or taxable amounts attributable to events that have been recognized on a cumulative basis in the accompanying condensed consolidated financial statements. A valuation allowance related to a net deferred tax asset is recorded when it is more likely than not that some portion of the deferred tax asset will not be realized. Deferred tax liabilities, deferred tax assets and valuation allowances are classified as non-current in the accompanying condensed consolidated balance sheets.

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 the Company 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 may 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 the Company's estimates, which could require the Company to record additional tax liabilities or to reduce previously recorded tax liabilities, as applicable.

Research and Development Expenses

Research and development expenditures are expensed in the period incurred.

Interest Expense

Interest expense consists primarily of interest associated with our debt instruments, including fees related to the term loans, accretion of debt discounts and amortization of debt issuance costs. The Company recognizes the accretion of debt discounts and the amortization of interest costs using the effective interest method.

Risks and Uncertainties

The Company is subject to a number of risks and uncertainties, including its ability to achieve profitable operations due to the Company's history of losses and accumulated deficits, the Company's dependence on a small number of customers for a substantial portion of its net product revenues, risks related to intellectual property matters, market acceptance of and demand for the Company's products, and the risks described below. These risks could have a material adverse effect on the Company's condensed consolidated financial position, results of operations and cash flows.

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The Company has dedicated substantial resources to the development and protection of technology innovations essential to its business, and the Company expects these activities to continue for the foreseeable future. The Company also intends to aggressively pursue monetization avenues for its intellectual property portfolio, potentially including licensing, royalty or other revenue-producing arrangements. However, the Company's revenues are currently generated by its product revenues, and it may never be successful in generating a revenue stream from its intellectual property, in which case the Company's investments of time, capital and other resources into its intellectual property portfolio may not provide adequate, or any, returns.

The Company also dedicates substantial resources to protecting its intellectual property, including its pending patent infringement litigation and U.S. International Trade Commission ("ITC") proceedings against SK hynix Inc., a South Korean memory semiconductor supplier ("SK hynix"), and its efforts to defend its patents against challenges made by way of reexamination and review proceedings at the U.S. Patent and Trademark Office ("USPTO") and Patent Trial and Appeal Board ("PTAB") (see Note 7). The Company expects these activities to continue for the foreseeable future, without any guarantee that any ongoing or future patent protection or litigation activities will be successful. The Company is also subject to litigation based on claims that it has infringed the intellectual property rights of others, against which the Company intends to defend itself vigorously. Moreover, any litigation, regardless of its outcome, would involve a significant dedication of resources, including time and costs, would divert management's time and attention and could negatively impact the Company's results of operations. As a result, any current or future infringement claims by or against third parties could materially adversely affect the Company's business, financial condition or results of operations.

The Company has also invested significant research and development time and costs into the design of application-specific integrated circuit ("ASIC") and hybrid devices, including its NVvault family of products and most recently its next-generation HybriDIMM memory subsystem. The Company believes that market acceptance of these products or derivative products that incorporate its core memory subsystem technology is critical to its success. However, these products are subject to increased risks as compared to the Company's legacy products. For example, the Company is dependent on a limited number of suppliers for the DRAM and ASIC devices that are essential to the functionality of these products and in the past it has experienced supply chain disruptions and shortages of DRAM and NAND flash required to create its NVvault family of products, and the Company's products are generally subject to a product approval and qualification process with customers before purchases are made and the Company has experienced a longer qualification cycle than anticipated with some of these products, including its HyperCloud memory subsystems. These and other risks attendant to the production of the Company's memory subsystem products could impair its ability to obtain customer or market acceptance of these products or obtain such acceptance in a timely manner, which would reduce the Company's achievable revenues from these products and limit the Company's ability to recoup its investments in the products.

The Company's manufacturing operations in the PRC are subject to various political, geographic and economic risks and uncertainties inherent to conducting business in the PRC. These include, among others, (i) volatility and other potential changes in economic conditions in the region, (ii) managing a local workforce and overcoming other practical barriers, such as language and cultural differences, that may subject the Company to uncertainties or unfamiliar practices or regulatory policies, (iii) risks imposed by the geographic distance between the Company's headquarters and its PRC operations, including difficulties maintaining the desired amount of control over production capacity and timing, inventory levels, product quality, delivery schedules, manufacturing yields and costs, (iv) the Company's limited experience creating and overseeing foreign operations generally, (v) changes in the laws and policies of the Chinese government that affect business practices generally or restrict local operations by foreign companies, and (vi) changes in the laws and policies of the U.S. government regarding the conduct of business in foreign countries generally or in the PRC in particular, which may be more uncertain following the results of the 2016 U.S. presidential election. Additionally, the Chinese government controls the procedures by which its local currency, the Chinese Renminbi ("RMB"), is converted into other currencies, which generally requires government consent, and imposes legal and regulatory restrictions on the movement of funds outside of the PRC. As a result, RMB may not be freely convertible into other currencies at all times and the Company may need to comply with regulatory procedures to repatriate funds from its Chinese operations. Any changes to currency conversion requirements or any failure by the Company to comply with repatriation procedures and regulations could adversely affect its operating results, liquidity and financial condition.

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In addition, fluctuations in the exchange rate between RMB and U.S. dollars may adversely affect the Company's expenses and results of operations, the value of its assets and liabilities and the comparability of its period-to-period results. The liabilities of the Company's subsidiary in the PRC exceeded its assets as of July 1, 2017 and July 2, 2016.

Foreign Currency Remeasurement

The functional currency of the Company's foreign subsidiaries is the U.S. dollar. Local currency financial statements are remeasured into U.S. dollars at the exchange rate in effect as of the balance sheet date for monetary assets and liabilities and the historical exchange rate for nonmonetary assets and liabilities. Expenses are remeasured using the average exchange rate for the period, except items related to nonmonetary assets and liabilities, which are remeasured using historical exchange rates. All remeasurement gains and losses are included in determining net loss. Transaction gains and losses were not significant during the three and six months ended July 1, 2017 and July 2, 2016.

Net Loss Per Share

Basic net loss per share is calculated by dividing net loss by the weighted-average common shares outstanding during the period, excluding unvested shares issued pursuant to restricted share awards under the Company's share-based compensation plans. Diluted net loss per share is calculated by dividing the net loss by the weighted-average shares and dilutive potential common shares outstanding during the period. Dilutive potential shares consist of dilutive shares issuable upon the exercise or vesting of outstanding stock options, warrants and restricted stock awards, respectively, computed using the treasury stock method and shares issuable upon conversion of the SVIC Note (see Note 5). In periods of losses, basic and diluted loss per share are the same, as the effect of stock options and unvested restricted share awards on loss per share is anti-dilutive.

Going Concern

In accordance with ASC Subtopic 205-40, Presentation of Financial Statements-Going Concern, management evaluates whether relevant conditions and events, when considered in the aggregate, indicate that it is probable the Company will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued. When relevant conditions or events, considered in the aggregate, initially indicate that it is probable that the Company will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (and therefore they raise substantial doubt about the Company's ability to continue as a going concern), management evaluates whether its plans that are intended to mitigate those conditions and events, when implemented, will alleviate substantial doubt about the Company's ability to continue as a going concern. Management's plans are considered only to the extent that (1) it is probable that the plans will be effectively implemented and (2) it is probable that the plans will mitigate the conditions or events that raise substantial doubt about the Company's ability to continue as a going concern. See the discussion under "Liquidity" in Note 1 for information about the Company’s liquidity position.

Recently Adopted Accounting Standards

In July 2015, the FASB issued Accounting Standards Update (“ASU”) No. 2015-11, Simplifying the Measurement of Inventory (“ASU 2015-11”), which requires entities to measure inventory at the lower of cost or net realizable value. Current guidance requires inventory to be measured at the lower of cost or market, with market defined as replacement cost, net realizable value, or net realizable value less a normal profit margin. This ASU simplifies the subsequent measurement of inventory by replacing the lower of cost or market test with a lower of cost or net realizable value test. The Company adopted this guidance in the first quarter of 2017 and there was no material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation-Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting (“ASU 2016-09”), which is intended to simplify several aspects of the accounting for share-based payment award transactions. ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, including interim periods. The Company adopted this guidance in the first quarter of 2017 and

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elected to continue to estimate forfeitures expected to occur to determine the amount of compensation cost to be recognized in each period; as a result there was no material impact on its consolidated financial statements.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”), which was subsequently amended by ASUs 2015-14, 2016-08, 2016-10, 2016-12, and 2016-20. ASU 2014-09, as amended, supersedes the revenue recognition requirements in ASC Topic 605, Revenue Recognition, and creates a new ASC Topic 606 (ASC 606). ASU 2014-9, as amended, implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. The amendment also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. Other major provisions include the capitalization and amortization of certain contract costs, ensuring the time value of money is considered in the transaction price, and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain circumstances. Entities can transition to the standard either retrospectively or as a cumulative-effect adjustment as of the date of adoption. ASC 606 is effective for public entities for annual periods beginning after December 15, 2017 (fiscal year 2018 for the Company), and interim periods within the year of adoption. The Company has not yet selected a transition method and is currently assessing the impact the adoption of ASC 606 will have on its consolidated financial statements and disclosures.

In February 2016, the FASB issued ASU No. 2016-02, Leases (“ASU 2016-02”). Under ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: a lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and a right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018 (fiscal year 2019 for the Company), including interim periods within those fiscal years. Early application is permitted. Lessees must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees may not apply a full retrospective transition approach. The Company is currently evaluating the impact of adopting ASU 2016-02 on its consolidated financial statements and disclosures.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”), which is intended to reduce the existing diversity in practice in how certain cash receipts and cash payments are classified in the statement of cash flows. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017 (fiscal year 2018 for the Company), including interim periods within those fiscal years with early adoption permitted, provided that all of the amendments are adopted in the same period. The Company is currently evaluating the impact of adopting ASU 2016-15 on its consolidated financial statements and disclosures.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740), Intra-Entity Transfers of Assets Other Than Inventory (“ASU 2016-16”), which requires entities to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. This amends current U.S. GAAP which prohibits recognition of current and deferred income taxes for all types of intra-entity asset transfers until the asset has been sold to an outside party. ASU 2016-16 is effective for fiscal years beginning after December 15, 2017 (fiscal year 2018 for the Company), including interim periods therein with early application permitted. Upon adoption, the Company must apply a modified retrospective transition approach through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. The Company is currently evaluating the impact of this new standard on its consolidated financial statements and disclosures, as well as its planned adoption date.

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230), Restricted Cash (“ASU 2016-18”), which enhances and clarifies the guidance on the classification and presentation of restricted cash in the statement of cash flows. ASU 2016-18 is effective for fiscal periods beginning after December 15, 2018 (fiscal year 2019 for the Company), including interim periods therein with early application permitted. The Company is currently evaluating the impact of this standard on its consolidated financial statements and disclosures.

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Note 3—Supplemental Financial Information

Inventories

Inventories consisted of the following as of the dates presented:

	July 1, 2017	December 31, 2016
	(in thousands)	
Raw materials	$ 1,242	$ 884
Work in process	62	47
Finished goods	3,604	2,229
	$ 4,908	$ 3,160

Warranty Liabilities

The following table summarizes activity related to warranty liabilities in the periods presented:

	Six Months Ended	
	July 1, 2017	July 2, 2016
	(in thousands)	
Beginning balance	$ 100	$ 122
Estimated cost of warranty claims charged to cost of sales	14	22
Cost of actual warranty claims	(1)	(86)
Ending balance	113	58
Less current portion	(68)	(35)
Long-term warranty liability	$ 45	$ 23

The allowance for warranty liabilities expected to be incurred within one year is included as a component of accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheets. The allowance for warranty liability expected to be incurred after one year is classified as long-term warranty liability in the accompanying condensed consolidated balance sheets.

Computation of Net Loss Per Share

The following table sets forth the computation of basic and diluted net loss per share, including the numerator and denominator used in the calculation of basic and diluted net loss per share, for the periods presented:

	Three Months Ended		Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
	(in thousands, except per share data)			
Basic and diluted net loss per share:				
Numerator: Net loss	$ (3,847)	$ (1,494)	$ (7,189)	$ (2,907)
Denominator: Weighted-average common shares outstanding, basic and diluted	61,844	51,080	61,763	50,723
Basic and diluted net loss per share	$ (0.06)	$ (0.03)	$ (0.12)	$ (0.06)

The table below sets forth potentially dilutive common share equivalents, consisting of shares issuable upon the exercise or vesting of outstanding stock options and restricted stock awards, respectively, and the exercise of warrants, computed using the treasury stock method, and shares issuable upon conversion of the SVIC Note (see Note 5) using the

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“if converted” method. These potential common shares have been excluded from the diluted net loss per share calculations above as their effect would be anti-dilutive for the periods presented:

	Three Months Ended		Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
	(in thousands)		(in thousands)	
Common share equivalents	13,006	12,976	13,155	12,892

The above common share equivalents would have been included in the calculation of diluted net loss per share had the Company reported net income for the periods presented.

Major Customers and Products

The Company’s product revenues have historically been concentrated in a small number of customers. The following table sets forth the percentage of the Company’s net product revenues made to customers that each comprise 10% or more of the Company’s net product revenues in the periods presented:

	Three Months Ended				Six Months Ended			
	July 1, 2017		July 2, 2016		July 1, 2017		July 2, 2016	
Customer:								
Customer A	*	%	*	%	*	%	12	%
Customer B	*	%	47	%	*	%	35	%
Customer C	*	%	*	%	11	%	*	%
Customer D	16	%	*	%	*	%	*	%
Customer E	*	%	11	%	*	%	*	%

*less than 10% of net product revenues during the period.

The Company’s accounts receivable are concentrated with one customer at July 1, 2017, representing 33% of aggregate gross receivables. At December 31, 2016, two customers represented 27% and 11% of aggregate gross receivables, respectively. The loss of any of the Company’s significant customers or a reduction in sales to or difficulties collecting payments from any of these customers could significantly reduce the Company’s net product revenues and adversely affect its operating results. The Company tries to mitigate risks associated with foreign receivables by purchasing comprehensive foreign credit insurance.

The Company resells certain Samsung products that it purchases under the terms of the JDLA with Samsung to certain end-customers that are not reached in Samsung’s distribution model, including storage customers, appliance customers, system builders and cloud and datacenter customers. In the three and six months ended July 1, 2017 and July 2, 2016, resales of these products represented approximately 91%, 91%, 34% and 21%, respectively, of the Company’s net product revenues.

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Cash Flow Information

The following table sets forth supplemental disclosures of cash flow information and non-cash financing activities for the periods presented:

	Six Months Ended	
	July 1, 2017	July 2, 2016
	(in thousands)	
Supplemental disclosure of non-cash financing activities:		
Debt financing of insurance	$ 220	$ 224
Acquisition of equipment through capital lease	$ -	$ 179
Issuance of shares for cashless warrant exercise	$ -	$ 1

Note 4—Credit Agreement

SVB Credit Agreement

On October 31, 2009, the Company and Silicon Valley Bank ("SVB") entered into a credit agreement (as amended, the "SVB Credit Agreement"). Pursuant to the terms of the SVB Credit Agreement, the Company is eligible to borrow, in a revolving line of credit, up to the lesser of (i) 80% of its eligible accounts receivable, or (ii) $5.0 million, subject to certain adjustments as set forth in the SVB Credit Agreement. The SVB Credit Agreement requires letters of credit to be secured by cash, which is classified as restricted cash in the accompanying condensed consolidated balance sheets. As of July 1, 2017, and December 31, 2016, (i) letters of credit were outstanding in the amount of $3.1 million (ii) the Company had outstanding borrowings of $1.3 million and $0.7 million, respectively, and (iii) availability under the revolving line of credit was $0.3 million and $0.8 million, respectively.

On January 29, 2016, the Company and SVB entered into an amendment to the SVB Credit Agreement to, among other things, adjust the rate at which advances under the SVB Credit Agreement accrue interest to the Wall Street Journal "prime rate" plus 2.75% (prior to such amendment, advances accrued interest at a rate equal to SVB's most recently announced "prime rate" plus 2.75%).

On March 27, 2017, the Company and SVB entered into another amendment to the SVB Credit Agreement to, among other things, (i) extend the maturity date of advances under the SVB Credit Agreement to April 1, 2018, (ii) modify the Company's financial covenants under the SVB Credit Agreement to remove all prior financial standards and replace them with a liquidity ratio standard, (iii) remove or amend certain termination, anniversary and unused facility fees payable by the Company under the SVB Credit Agreement, and (iv) make certain other administrative changes. On April 12, 2017, the Company and SVB entered into a further amendment to the SVB Credit Agreement to, among other things, obtain SVB's consent in connection with the Company's rights agreement with Computershare Trust Company, N.A., as rights agent (see Note 8), and make certain administrative changes in connection with the Company's funding arrangement with TR Global Funding V, LLC, an affiliate of TRGP Capital Management, LLC ("TRGP") (see Note 7).

As of April 2, 2017, the beginning of the quarterly period covered by this report, all obligations under the SVB Credit Agreement were secured by a first priority security interest in the Company's tangible and intangible assets, other than its patent portfolio, which was subject to a first priority security interest held by SVIC (see Note 5). Certain of these lien priorities were modified by certain intercreditor agreements entered into in May 2017 in connection with the Company's establishment of a funding arrangement with TRGP for certain of the Company's litigation expenses in connection with its legal proceedings against SK hynix. On May 3, 2017, TRGP entered into an intercreditor agreement with each of SVIC and SVB, and on April 20, 2017 SVIC and SVB entered into an intercreditor agreement with each other (such intercreditor agreements, collectively, the "Intercreditor Agreements"). Pursuant to the terms of the Intercreditor Agreements, SVB's security interests in the Company's assets have been modified as follows: SVB has a first priority security interest in all of the Company's tangible and intangible assets other than its patent portfolio and its claims underlying and any proceeds it may receive from the SK hynix proceedings; a second priority security interest in the Company's patent portfolio other than the patents that are the subject of the SK hynix proceedings; and a third

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priority security interest in the Company's patents that are the subject of the SK hynix proceedings. See Note 7 for additional information about the funding arrangement with TRGP, the Intercreditor Agreements and the Company's legal proceedings against SK hynix.

The SVB Credit Agreement subjects the Company to certain affirmative and negative covenants, including financial covenants with respect to the Company's liquidity and restrictions on the payment of dividends. As of July 1, 2017 the Company was in compliance with its covenants under the SVB Credit Agreement.

Note 5—Debt

The Company's debt consisted of the following as of the dates presented:

	July 1, 2017	December 31, 2016
	(in thousands)	
Convertible promissory note, SVIC, net of debt discount of $976 and $1,084 in 2017 and 2016, respectively	$ 14,024	$ 13,916
Accrued interest on convertible promissory note with SVIC	485	335
Notes payable and capital lease obligation	141	151
	$ 14,650	$ 14,402
Less current portion	(141)	(151)
	$ 14,509	$ 14,251

On November 18, 2015, in connection with entering into the JDLA with Samsung, the Company sold to SVIC the SVIC Note and the SVIC Warrant. The SVIC Note has an original principal amount of $15.0 million, accrues interest at a rate of 2.0% per year, is due and payable in full on December 31, 2021, and is convertible into shares of the Company's common stock at a conversion price of $1.25 per share, subject to certain adjustments, on the maturity date of the SVIC Note. Upon a change of control of the Company prior to the maturity date of the SVIC Note, the SVIC Note may, at the Company's option, be assumed by the surviving entity or be redeemed upon the consummation of such change of control for the principal and accrued but unpaid interest as of the redemption date. The SVIC Warrant grants SVIC a right to purchase 2,000,000 shares of the Company's common stock at an exercise price of $0.30 per share, subject to certain adjustments, is only exercisable in the event the Company exercises its right to redeem the SVIC Note prior to its maturity date, and expires on December 31, 2025.

The SVIC Warrant was valued at $1,165,000, based on its relative fair value, and was recorded as a debt discount. The Company also recorded $154,000 as a debt discount for professional service fees rendered in connection with the transaction. These amounts are being amortized over the term of the SVIC Note using the effective interest method.

For the three and six months ended July 1, 2017 and July 2, 2016, the Company amortized $54,000, $108,000, $54,000 and $108,000, respectively, to interest expense in the accompanying condensed consolidated statements of operations.

In connection with the SVIC Note, SVIC was granted a first priority security interest in the Company’s patent portfolio and a second priority security interest in all of the Company’s other tangible and intangible assets. Upon issuance of the SVIC Note, the Company, SVB and SVIC entered into an Intercreditor Agreement pursuant to which SVB and SVIC agreed to their relative security interests in the Company’s assets. In May 2017, SVIC, SVB and TRGP entered into additional Intercreditor Agreements to modify certain of these lien priorities (see Note 7). Additionally, upon issuance of the SVIC Note and the SVIC Warrant, the Company and SVIC entered into a Registration Rights Agreement pursuant to which the Company is obligated to register with the SEC, upon demand by SVIC, the shares of the Company’s common stock issuable upon conversion of the SVIC Note or upon exercise of the SVIC Warrant.

The SVIC Note subjects the Company to certain affirmative and negative operating covenants. As of July 1, 2017 the Company was in compliance with its covenants under the SVIC Note.

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Capital Lease and Notes Payable

The Company has purchased computer equipment through a capital lease. As of July 1, 2017, the lease requires monthly payments of approximately $12,000 and matures in December 2017.

The Company finances certain of its insurance policies. As of July 1, 2017, required payments are approximately $29,000 per month and the related financing agreements mature at various dates through September 2017.

Interest expense, including amortization of debt discounts and debt issuance costs, net of interest income, was as follows during the periods presented:

	Three Months Ended		Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
	(in thousands)		(in thousands)	
Interest expense:				
SVB	$ 8	$ 7	$ 21	$ 18
SVIC	129	129	258	258
Others	4	1	16	2
	141	137	295	278
Interest income	(3)	(5)	(9)	(9)
	$ 138	$ 132	$ 286	$ 269

Note 6—Income Taxes

The following table sets forth the Company's provision for income taxes, along with the corresponding effective tax rates, for the periods presented:

	Three Months Ended		Six Months Ended	
	July 1,	July 2,	July 1,	July 2,

	2017	2016	2017	2015
	(in thousands)		(in thousands)	
Provision for income taxes	$ -	$ -	$ -	$ 1
Effective tax rate	- %	- %	- %	(0.03) %

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. In making such judgments, significant weight is given to evidence that can be objectively verified. Due to uncertainty of future utilization, the Company has provided a full valuation allowance as of July 1, 2017 and December 31, 2016. Accordingly, no benefit has been recognized for net deferred tax assets. The Company’s effective tax rate differs from the federal statutory tax rate of 34% for the six months ended July 1, 2017 and July 2, 2016 due to providing the full valuation allowance against net deferred tax assets.

The Company did not have any unrecognized tax benefits as of July 1, 2017 and December 31, 2016.

Note 7—Commitments and Contingencies

TRGP Agreement and Related Intercreditor Agreements

On May 3, 2017, the Company and TRGP entered into an investment agreement (the “TRGP Agreement”), which generally provides that TRGP will directly fund the costs incurred by or on behalf of the Company in connection with its legal proceedings against SK hynix (see “Litigation and Patent Reexaminations” in this Note 7 below), including costs incurred since January 1, 2017 and costs to be incurred in the future (all such funded costs, collectively, the “Funded Costs”). In exchange for such funding, the Company has agreed that, if the Company recovers any proceeds in connection with the SK hynix proceedings, it will pay to TRGP the amount of the Funded Costs paid by TRGP plus an escalating premium based on when any such proceeds are recovered, such that the premium will equal a specified low-to-mid double-digit percentage of the amount of the Funded Costs and such percentage will increase by a specified low double-digit amount each quarter after a specified date until any such proceeds are recovered. In addition, pursuant to the terms of a separate security agreement between the Company and TRGP dated May 3, 2017 (the "Security Agreement"), the Company has granted to TRGP (i) a first priority lien on, and security in, the claims underlying the SK hynix proceedings and any proceeds that may be received by the Company in connection with these proceedings, and (ii) a second priority lien on, and security in, the Company's patents that are the subject of the SK hynix proceedings.

The TRGP Agreement does not impose financial covenants on the Company. Termination events under the TRGP Agreement include, among others, any failure by the Company to make payments to TRGP thereunder upon receipt of recoveries in the SK hynix proceedings; the occurrence of certain bankruptcy events; certain breaches by the Company of its covenants under the TRGP Agreement or the related Security Agreement; and the occurrence of a change of control of the Company. If any such termination event occurs, subject to certain cure periods for certain termination events, TRGP would have the right to terminate its obligations under the TRGP Agreement, including its obligation to make any further payments of Funded Costs after the termination date. In the event of any such termination by TRGP, the Company would continue to be obligated to pay TRGP the portion of any proceeds the Company may recover in connection with the SK hynix proceedings that TRGP would have been entitled to receive absent such termination, as described above, and TRGP may also be entitled to seek additional remedies pursuant to the dispute resolution provisions of the TRGP Agreement.

In connection with the TRGP Agreement, in May 2017, TRGP, SVIC and SVB entered into the Intercreditor Agreements. Pursuant to the terms of the Intercreditor Agreements, TRGP, SVB and SVIC have agreed to their relative security interest priorities in the Company's assets, such that: (i) TRGP has a first priority security interest in the Company's claims underlying the SK hynix proceedings and any proceeds that may be received by the Company in connection with these proceedings, and a second priority security interest in the Company's patents that are the subject of the SK hynix proceedings, (ii) SVIC has a first priority security interest in the Company's complete patent portfolio and a second priority security interest in all of the Company's other tangible and intangible assets (other than the Company's claims underlying and any proceeds it may receive from the SK hynix proceedings), and (iii) SVB has a first priority security interest in all of the Company's tangible and intangible assets other than its patent portfolio and its claims underlying and any proceeds it may receive from the SK hynix proceedings, a second priority security interest in the Company's patent portfolio other than the patents that are the subject of the SK hynix proceedings, and a third priority security interest in the Company's patents that are the subject of the SK hynix proceedings. The Company consented and agreed to the terms of each of the Intercreditor Agreements.

Legal expenses incurred by the Company but paid by TRGP pursuant to the terms of the TRGP Agreement are excluded from the Company's consolidated financial statements in each period in which the TRGP Agreement remains in effect. In the six months ended July 1, 2017, the Company excluded legal expenses of $6.0 million as a result of TRGP's payment of these expenses under the TRGP Agreement. Any settlement or other cash proceeds the Company may recover in the future in connection with the SK hynix proceedings would be reduced by the aggregate amount of legal expenses excluded by the Company as a result of TRGP's payment of these expenses under the TRGP Agreement, plus the premium amount due to TRGP under the terms of the TRGP Agreement at the time of any such recovery.

Litigation and Patent Reexaminations

The Company owns numerous patents and continues to seek to grow and strengthen its patent portfolio, which covers different aspects of the Company's technology innovations with various claim scopes. The Company plans to pursue avenues to monetize its intellectual property portfolio, in which it would generate revenue by selling or licensing its technology, and it intends to vigorously enforce its patent rights against alleged infringers of such rights. The Company dedicates substantial resources to protecting its intellectual property, including its efforts to defend its patents against challenges made by way of reexamination proceedings at the PTAB or USPTO. These activities are likely to continue for the foreseeable future, without any guarantee that any ongoing or future patent protection and litigation activities will be successful, or that the Company will be able to monetize its intellectual property portfolio. The

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Company is also subject to litigation claims that it has infringed on the intellectual property of others, against which the Company intends to defend itself vigorously.

Litigation, whether or not eventually decided in the Company's favor or settled, is costly and time-consuming and could divert management's attention and resources. Thus, because of the nature and inherent uncertainties of litigation, even if the outcome of any proceeding is favorable, the Company's business, financial condition, results of operations or cash flows could be materially and adversely affected. Additionally, the outcome of pending litigation, and related patent reexaminations, as well as any delay in their resolution, could affect the Company's ability to continue to sell its products, protect against competition in the current and expected markets for its products or license its intellectual property in the future.

Google Litigation

On December 4, 2009, the Company filed a patent infringement lawsuit against Google, Inc. ("Google") in the U.S. District Court for the Northern District of California (the "Northern District Court"), seeking damages and injunctive relief based on Google's alleged infringement of the Company's U.S. Patent No. 7,619,912 (the "'912 patent"), which relates generally to technologies to implement rank multiplication. In February 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 the Company's activities in the Joint Electron Device Engineering Council ("JEDEC") standard-setting organization. The counterclaim seeks unspecified compensatory damages. Accruals have not been recorded for loss contingencies related to Google's counterclaim because it is not probable that a loss has been incurred and the amount of any such loss cannot be reasonably estimated. In October 2010, Google requested and was later granted an Inter Partes Reexamination of the '912 patent by the USPTO. The reexamination proceedings are described below. In connection with the reexamination request, the Northern District Court granted the Company's and Google's joint request to stay the '912 patent infringement lawsuit against Google until the completion of the reexamination proceedings.

Inphi Litigation

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 "Central District Court"). The complaint, as amended, alleges that Inphi is contributorily infringing and actively inducing the infringement of U.S. patents owned by the Company, including the '912 patent, U.S. Patent No. 7,532,537 (the "'537 patent"), which relates generally to memory modules with load isolation and memory domain translation capabilities, 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. The Company is seeking damages and injunctive relief based on Inphi's use of the Company's patented technology. Inphi denied infringement and claimed that the three patents are invalid. In June 2010, Inphi requested and was later granted Inter Partes Reexaminations of the '912, '537 and '274 patents by the USPTO. The reexamination proceedings are described below (except for the reexamination proceeding related to the '537 patent, which have concluded with the confirmation of all of the claims of such patent). In connection with the reexamination requests, Inphi filed a motion to stay the patent infringement lawsuit with the Central District Court until completion of the reexamination proceedings, which was granted.

‘912 Patent Reexamination

As noted above, in April 2010, June 2010 and October 2010, Google and Inphi submitted requests for an Inter Partes Reexamination of the ‘912 patent by the USPTO, claiming that the ‘912 patent is invalid and requesting that the USPTO reject the patent’s claims and cancel the patent. Additionally, in October 2010, Smart Modular, Inc. (“Smart Modular”) submitted another such reexamination request. On January 18, 2011, the USPTO granted such reexamination requests, and in February 2011, the USPTO merged the Inphi, Google and Smart Modular ‘912 patent reexaminations into a single proceeding. On March 21, 2014, the USPTO issued an Action Closing Prosecution (“ACP”), an office action that states the USPTO examiner’s position on patentability and closes further prosecution, and on June 18, 2014 the USPTO issued a Right of Appeal Notice (“RAN”), a notice that triggers the rights of the involved parties to file a notice of appeal to the ACP, each of which confirmed the patentability of 92 of the ‘912 patent’s claims and rejected the patent's 11 other claims. The parties involved filed various notices of appeal, responses and requests, and on November 24, 2015, the PTAB held a hearing on such appeals. On May 31, 2016, the PTAB issued a decision affirming certain of the examiner's decisions and reversing others. On February 9, 2017, the PTAB granted the Company's request to reopen prosecution before the USPTO examiner and remanded the consolidated proceeding to the Examiner to consider the patentability of certain of the pending claims in view of the PTAB's May 31, 2016 decision and comments from the parties. The Examiner will next issue a determination as to the patentability of the claims, at which point the proceeding will return to the PTAB for reconsideration and issuance of a new decision. Accruals have not been recorded for loss contingencies related to the '912 patent reexamination proceedings because it is not probable that a loss has been incurred and the amount of any such loss cannot be reasonably estimated.

'627 Patent Reexamination

In September 2011, Smart Modular submitted a request for an Inter Partes Reexamination by the USPTO of the Company's U.S. Patent No. 7,864,627 (the "'627 patent"), related to the '912 patent, claiming that the '627 patent is invalid and requesting that the USPTO reject the patent's claims and cancel the patent. On November 16, 2011, the request was granted. On March 27, 2014 and June 27, 2014, the USPTO issued an ACP and a RAN, respectively, each of which rejected all of the '627 patent's claims. The parties involved filed various notices of appeal, responses and requests, and on November 24, 2015, the PTAB held a hearing on such appeals. On May 31, 2016, the PTAB issued a decision affirming the decisions of the examiner. On February 9, 2017, the PTAB granted the Company's request to reopen prosecution before the USPTO examiner and remanded the proceeding to the examiner to consider the patentability of certain of the pending claims in view of the PTAB's May 31, 2016 decision and comments from the parties. The examiner will next issue a determination as to the patentability of the claims, at which point the proceeding will return to the PTAB for reconsideration and issuance of a new decision. Accruals have not been recorded for loss contingencies related to the '627 patent reexamination proceedings because it is not probable that a loss has been incurred and the amount of any such loss cannot be reasonably estimated.

'274 Patent Reexamination

As noted above, in April 2010 and June 2010, Inphi submitted requests for an Inter Partes Reexamination of the '274 patent by the USPTO. On August 27, 2010, the request was granted. In March 2012 and June 2012, the USPTO issued an ACP and a RAN, respectively, each of which confirmed the patentability of many of the '274 patent's claims. The parties involved filed various notices of appeal, responses and requests, and on November 20, 2013, the PTAB held a hearing on such appeals. On January 16, 2014, the PTAB issued a decision affirming the examiner in part, but reversing the examiner on new grounds and rejecting all of the patent's claims. On September 11, 2015, the USPTO examiner issued a determination rejecting the amended claims. On January 23, 2017, the USPTO granted-in-part the Company's petition to enter comments in support of its positions in the proceeding. On May 9, 2017, the PTAB issued a decision on appeal affirming the rejection of all claims. Netlist requested rehearing of the PTAB's decision and expects a rehearing decision later in 2017. Accruals have not been recorded for loss contingencies related to the '274 patent reexamination proceedings because it is not probable that a loss has been incurred and the amount of any such loss cannot be reasonably estimated.

Smart Modular ‘295 Patent Litigation and Reexamination

In September 13, 2012, Smart Modular, Inc. (“Smart Modular”) filed a patent infringement lawsuit against the Company in the U.S. District Court for the Eastern District of California (the “Eastern District Court”). The complaint alleges that the Company willfully infringes and actively induces the infringement of certain claims of U.S. Patent No. 8,250,295 (“the ‘295 patent”) issued to Smart Modular and seeks damages and injunctive relief. The Company answered Smart Modular’s complaint in October 2012, denying infringement of the ‘295 patent, asserting that the ‘295 patent is invalid and unenforceable, and asserting counterclaims against Smart Modular.

On December 7, 2012, the USPTO granted the Company’s request for the reexamination of the ‘295 patent. On April 29, 2014, the USPTO examiner issued an ACP confirming some claims and rejecting others, and on August 4, 2015, the examiner issued a RAN confirming all pending claims. On September 4, 2015, the Company appealed to the PTAB. The parties involved filed various notices of appeal, responses and requests, and on September 22, 2016, the PTAB held a hearing on such appeals. On November 14, 2016, the PTAB issued a decision reversing the examiner and

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rejected all of the pending claims. On January 23, 2017, Smart Modular filed a request to reopen prosecution. The parties will next have the opportunity present evidence and arguments and the examiner will then issue a new determination. The examiner's determination will then go back to the PTAB for another decision.

On May 30, 2013, the Eastern District Court issued an order granting the Company's motion to stay pending completion of the reexamination of the '295 patent and denied Smart Modular's motion for preliminary injunction. On May 5, 2016, Smart Modular filed a motion to lift the stay which was granted by the Eastern District Court on September 21, 2016. On February 15, 2017, the Company filed a new motion to stay pending completion of the reexamination of the '295 patent, which was denied by the Eastern District Court on June 26, 2017.

Smart Modular and SanDisk Litigation

On July 1 and August 23, 2013, the Company filed complaints against Smart Modular, Smart Storage Systems ("Smart Storage") (which was subsequently acquired by SanDisk Corporation ("SanDisk")), Smart Worldwide Holdings ("Smart Worldwide") and Diablo Technologies ("Diablo") in the Central District Court, seeking, among other things, damages and other relief for alleged infringement of several of the Company's patents by the defendants based on the manufacture and sale of the ULLtraDIMM memory module, alleged antitrust violations by Smart Modular and Smart Worldwide, and alleged trade secret misappropriation and trademark infringement by Diablo. The trade secret misappropriation and trademark infringement claims against Diablo were fully adjudicated on August 17, 2016 and are no longer pending.

On August 23, 2013, Smart Modular and Diablo each filed a complaint in the San Francisco Division of the Northern District Court seeking declaratory judgment of non-infringement and invalidity of the patents asserted in the Company's complaint. Based on various motions filed by the parties, on November 26, 2013, the Central District Court severed and transferred the patent claims related to the ULLtraDIMM memory module to the Northern District Court.

On February 12, 2014, the Northern District Court granted the parties' joint stipulation dismissing Smart Modular without prejudice. Between June 18, 2014 and August 23, 2014, SanDisk, Diablo, and Smart Modular filed numerous petitions in the USPTO requesting Inter Partes Review of the Company's asserted patents. All of the reviews associated with U.S. Patent Nos. 8,516,187; 8,301,833; 8,516,185 have been resolved in the Company's favor and are no longer pending. The reviews associated with U.S. Patent Nos. 8,001,434; 8,359,501; 7,881,150; and 8,081,536 have concluded before the PTAB and the parties have appealed the decisions in these reviews to the Court of Appeals for the Federal Circuit and are awaiting decisions. On April 9, 2015, the Northern District Court stayed the infringement proceedings as to the Company's patents asserted against the ULLtraDIMM pending resolution of the patent review decisions on appeal.

SK hynix Litigation

On September 1, 2016, the Company filed legal proceedings for patent infringement against SK hynix Inc., a South Korean memory semiconductor supplier (“SK hynix”), in the U.S. International Trade Commission (“ITC”) and the Central District Court. The proceedings are based on the alleged infringement by SK hynix’s registered dual in-line memory module (“RDIMM”) and load reduced dual in-line memory module (“LRDIMM”) enterprise memory products of six of the Company’s U.S. patents. In the ITC proceedings, the Company is seeking an exclusion order that directs U.S. Customs and Border Protection to stop allegedly infringing SK hynix RDIMM and LRDIMM products from entering the United States. In the Central District Court proceedings, the Company is primarily seeking damages.

On October 3, 2016, the ITC instituted an investigation of the trade practices of SK hynix and certain of its subsidiaries related to its importation, sale for importation, and/or sale after importation of RDIMM and LRDIMM enterprise memory products. On November 10, 2016, the ITC set a 16-month target date of February 7, 2018, for the investigation with a final initial determination being filed no later than October 10, 2017. Based on this target date, the ITC scheduled a hearing on the merits of the investigation which began on May 8, 2017 and concluded on May 11, 2017. On January 4, 2017, the Central District Court issued a scheduling order setting various dates including a trial date of July 10, 2018.

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On October 5, 2016 and October 28, 2016, SK hynix filed motions in the Central District Court and the ITC, respectively, to disqualify the Company's litigation counsel. The Company opposed both motions. On December 5, 2016, the Central District Court granted SK hynix's motion to disqualify. On December 8, 2016, the Company's substitute counsel entered appearances in the ITC and the Central District Court.

Between December 30, 2016 and January 20, 2017, SK hynix filed numerous petitions in the USPTO requesting Inter Partes Review of certain of the Company's patents, including the patents asserted in the ITC and Central District Court. In a series of decisions issued in May, June and July, 2017, the PTAB instituted reviews of certain of these patents, including the patents currently asserted in the ITC and Central District Court, the last of which is scheduled to conclude no later than July 2018. On July 17, 2017, the Central District court granted in part SK hynix's request to stay the infringement proceedings pending further order of the court, and ordered the parties to file a joint status report shortly after the ITC issues its final initial determination.

On July 11, 2017, the Company filed legal proceedings for patent infringement against SK hynix, and certain of its distributors in the courts of Germany and China based on the alleged infringement by SK hynix's LRDIMM of the Company's patents in those jurisdictions. The courts in Germany and China are currently handling service of process and have not yet issued a schedule in either jurisdiction.

Morgan Joseph Litigation

On March 31, 2016, Morgan Joseph Triartisan LLC ("Morgan Joseph") filed a complaint in the Supreme Court of the State of New York against the Company and certain of its officers for breach of contract and related causes of action. The complaint alleges that the Company refused to honor its payment obligations under a written agreement with Morgan Joseph related to the provision of financial advisory and investment banking services. Morgan Joseph is seeking compensatory damages in the amount of $1,012,500, plus punitive damages in an amount not less than $1 million, together with pre-judgment interest, costs, and fees.

On September 15, 2016, the Company filed a motion to dismiss Morgan Joseph's complaint for failure to state a claim. On February 15, 2017, the court granted the Company's motion to dismiss as to all causes of action brought by Morgan Joseph.

Other Contingent Obligations

In the ordinary course of its business, the Company has made certain indemnities, commitments and guarantees pursuant to 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, sale 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; (v) indemnities to SVIC and SVB pertaining to all obligations, demands, claims, and liabilities claimed or asserted by any other party in connection with transactions contemplated by the applicable loan documents; and (vi) indemnities or other claims related to certain real estate leases, under which the Company may be required to indemnify property owners for environmental and other liabilities or may face 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 as a result of these obligations, and no liabilities have been recorded for these indemnities, commitments and guarantees in the accompanying condensed consolidated balance sheets.

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Note 8—Stockholders’ Equity

Serial Preferred Stock

The Company’s authorized capital stock includes 10,000,000 shares of serial preferred stock, with a par value of $0.001 per share. No shares of preferred stock were outstanding at July 1, 2017 or December 31, 2016.

On April 17, 2017, the Company entered into a rights agreement (the “Rights Agreement”) with Computershare Trust Company, N.A., as rights agent. In connection with the adoption of the Rights Agreement and pursuant to its terms, the Company’s board of directors authorized and declared a dividend of one right (each, a “Right”) for each outstanding share of the Company’s common stock to stockholders of record at the close of business on May 18, 2017 (the “Record Date”), and authorized the issuance of one Right for each share of the Company’s common stock issued by the Company (except as otherwise provided in the Rights Agreement) between the Record Date and the Distribution Date (as defined below).

Each Right entitles the registered holder, subject to the terms of the Rights Agreement, to purchase from the Company, when exercisable and subject to adjustment, one unit consisting of one one-thousandth of a share (a “Unit”) of Series A Preferred Stock of the Company (the “Preferred Stock”), at a purchase price of $6.56 per Unit, subject to adjustment. Subject to the provisions of the Rights Agreement, including certain exceptions specified therein, a distribution date for the Rights (the “Distribution Date”) will occur upon the earlier of (i) 10 business days following a public announcement that a person or group of affiliated or associated persons (an “Acquiring Person”) has acquired or otherwise obtained beneficial ownership of 15% or more of the then outstanding shares of the Company’s common stock, and (ii) 10 business days (or such later date as may be determined by the Company’s board of directors) following the commencement of a tender offer or exchange offer that would result in a person or group becoming an Acquiring Person. The Rights are not exercisable until the Distribution Date and, unless earlier redeemed or exchanged by the Company pursuant to the terms of the Rights Agreement, will expire on the earlier of (i) the close of business on April 17, 2018, the first anniversary of the adoption of the Rights Agreement, and (ii) the date of any settlement, adjudication, dismissal with prejudice, abandonment by the Company or other conclusive and final resolution of the Company’s legal proceedings against SK hynix (see Note 7).

In connection with the adoption of the Rights Agreement, the Company’s board of directors approved a Certificate of Designation of the Series A Preferred Stock (the “Certificate of Designation”) designating 1,000,000 shares of the Company’s serial preferred stock as Series A Preferred Stock and setting forth the rights, preferences and limitations of the Preferred Stock. The Company filed the Certificate of Designation with the Secretary of State of the State of Delaware on April 17, 2017.

Common Stock

On May 31, 2017, the Company's stockholders approved an amendment to the Company's Restated Certificate of Incorporation to increase the number of shares of the Company's common stock that it is authorized to issue from 90,000,000 to 150,000,000.

On September 23, 2016, the Company completed the 2016 Offering, pursuant to which it sold 9,200,000 shares of its common stock at a price to the public of $1.25 per share. The net proceeds to the Company from the 2016 Offering were $10.3 million, after deducting underwriting discounts and commissions and offering expenses paid by the Company.

Stock-Based Compensation

The Company has stock-based compensation awards outstanding pursuant to its Amended and Restated 2006 Equity Incentive Plan, as re-approved by the Company's stockholders on June 8, 2016 (the "Amended 2006 Plan"), under which a variety of stock-based awards, including stock options, may be granted to employees and non-employee service providers of the Company. In addition to awards granted pursuant to the Amended 2006 Plan, the Company

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periodically grants equity-based awards outside the Amended 2006 Plan to certain new hires as an inducement to enter into employment with the Company.

Subject to certain adjustments, as of July 1, 2017, the Company was authorized to issue a maximum of 10,205,566 shares of its common stock pursuant to awards granted under the Amended 2006 Plan. Pursuant to the terms of the Amended 2006 Plan, the maximum number of shares of common stock subject to the plan automatically increased on the first day of each calendar year from January 1, 2007 through January 1, 2016, by the lesser of (i) 5.0% of the number of shares of common stock issued and outstanding as of the first day of the applicable calendar year, and (ii) 1,200,000 shares of common stock, subject to adjustment for certain corporate actions. Beginning January 1, 2017, the automatic annual increase to the number of shares of common stock that may be issued pursuant to awards granted under the Amended 2006 Plan is equal to the lesser of (i) 2.5% of the number of shares of common stock issued and outstanding as of the first day of the applicable calendar year, and (ii) 1,200,000 shares of common stock, subject to adjustment for certain corporate actions. As of July 1, 2017, the Company had 651,159 shares of common stock available for issuance pursuant to future awards to be granted under the Amended 2006 Plan. Stock options granted under the Amended 2006 Plan generally vest at a rate of at least 25% per year over four years and expire 10 years from the date of grant.

The following table summarizes the Company's stock option activity in the six months ended July 1, 2017:

	Options Outstanding	
	Number of Shares (in thousands)	Weighted-Average Exercise Price
Options outstanding at December 31, 2016	8,798	$ 1.46
Options granted	1,230	1.04
Options exercised	(217)	0.72
Options expired/forfeited	(534)	1.13
Options outstanding at July 1, 2017	9,277	$ 1.40

The intrinsic value of stock options exercised in the six months ended July 1, 2017 was $60,000.

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

	Six Months Ended	
	July 1, 2017	July 2, 2016
Expected term (in years)	6.3	6.2
Expected volatility	87 %	113 %
Risk-free interest rate	2.06 %	1.58 %
Expected dividends	-	-
Weighted-average grant date fair value per share	$ 0.76	$ 0.80

As of July 1, 2017, the amount of unearned stock-based compensation estimated to be expensed from the Company’s 2017 fiscal year through the Company’s 2019 fiscal year related to unvested stock options is approximately $2.2 million, net of estimated forfeitures. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 2.5 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 or calculate and record additional expense. Future stock-based compensation expense and unearned stock-based compensation expense will increase to the extent the Company grants additional stock options or other stock-based awards.

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Warrants

The following is a summary of the Company's warrant activity for the year ended December 31, 2016 and the six months ended July 1, 2017:

	Number of Shares (in thousands)	Weighted Average Exercise Price
Warrants outstanding - January 2, 2016	7,633	$ 0.59
Warrant granted	-	-
Warrants exercised	(2,709)	0.47
Warrants outstanding - December 31, 2016	4,924	$ 0.66
Warrant granted	-	-
Warrants exercised	-	-
Warrants outstanding - July 1, 2017	4,924	$ 0.66

Note 9—Segment and Geographic Information

The Company operates in one reportable segment, which is 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 1, 2017 and December 31, 2016, approximately $62,000 and $64,000, respectively, of the Company's long-lived assets, net of depreciation and amortization, were located in the PRC. Substantially all other long-lived assets were located in the United States.

Note 10—Subsequent Events

The Company has evaluated subsequent events through the filing date of the Quarterly Report on Form 10-Q in which these condensed consolidated financial statements are included and has determined that no subsequent events have occurred that would require recognition in the condensed consolidated financial statements or disclosures in the notes thereto, other than as discussed elsewhere in these notes.

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

The following discussion and analysis of our financial condition and results of operations (the “MD&A”) should be read together with our unaudited condensed consolidated financial statements and the related notes included in Part I, Item 1 of this report, as well as the MD&A included in our Annual Report on Form 10-K for our fiscal year ended December 31, 2016, including the audited consolidated financial statements and related notes included in such report (the “2016 Annual Report”), which was filed with the Securities and Exchange Commission (the “SEC”) on March 31, 2017. In preparing this MD&A, we presume that readers have access to and have read the MD&A included in the 2016 Annual Report, pursuant to Instruction 2 to paragraph (b) of Item 303 of Regulation S-K promulgated by the SEC.

Unless the context indicates otherwise, all references to “Netlist,” the “Company,” “we,” “us,” or “our” in this MD&A and elsewhere in this report refer to Netlist, Inc., together with its majority and wholly owned subsidiaries.

Forward-Looking Statements

This discussion and analysis includes “forward looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are statements other than historical facts and often address future events and our future performance. Words such as "anticipate," "estimate," "expect," "project," "intend," "may," “will,” “might,” "plan," "predict," "believe," "should," “could” and similar words or expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words. Forward-looking statements contained in this discussion and analysis include statements about, among other things: our plans relating to our intellectual property, including our strategy for monetizing, licensing, expanding, and defending our patent portfolio; our expectations with respect to strategic partners, including our relationship with Samsung Electronics Co., Ltd. (“Samsung”) and the potential for commercial licensing agreements; our expectations and strategies regarding outstanding legal proceedings and patent reexaminations relating to our intellectual property portfolio, including our pending proceedings against SK hynix Inc., a South Korean memory semiconductor supplier (“SK hynix”); our beliefs regarding the market and demand for our products or the component products we resell to customers directly; and our expectations regarding our strategy, business plans and objectives, our future operations and financial position, including future revenues, costs and prospects, and our liquidity and capital resources, including cash flows, sufficiency of cash resources, efforts to reduce expenses and the potential for future financings. All forward-looking statements reflect management’s present expectations regarding future events and are subject to known and unknown risks, uncertainties and assumptions that could cause actual results to differ materially from those expressed in or implied by any forward-looking statements. These risks and uncertainties include those described under “Risk Factors” in Part II, Item 1A of this report. Given these risks, uncertainties and other important factors, you should not place undue reliance on these forward-looking statements. These forward-looking statements represent our estimates and assumptions only as of the date made, and except as required by law, we undertake no obligation to revise or update any forward-looking statements for any reason.

Overview

We are a leading provider of high-performance modular memory subsystems serving customers in diverse industries that require superior memory performance to empower critical business decisions. We have a long history of introducing disruptive new products, such as one of the first load reduced dual in-line memory modules ("LRDIMM") based on our distributed buffer architecture, which has been adopted by the industry for DDR4 LRDIMM. We were also one of the first to bring NAND flash memory ("NAND flash") to the memory channel with our NVvault non-volatile dual in-line memory modules ("NVDIMM") using software-intensive controllers and merging dynamic random access memory integrated circuits ("DRAM ICs" or "DRAM") and NAND flash to solve data bottleneck and data retention challenges encountered in high-performance computing environments. We recently introduced a new generation of storage class memory products called HybriDIMM to address the growing need for real-time analytics in Big Data applications and in-memory databases.

Due to the ground-breaking product development of our engineering teams, we have built a robust portfolio of over 100 issued and pending U.S. and foreign patents, many seminal, in the areas of hybrid memory, storage class memory, rank multiplication and load reduction. Since our inception in 2000, we have dedicated substantial resources to

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the development and protection of technology innovations essential to our business. Our early pioneering work in these areas has been broadly adopted in industry-standard LRDIMM and in NVDIMM. Our objective is to continue to innovate in our field and invest further in our intellectual property portfolio, with the goal of monetizing our intellectual property through a combination of product revenues and licensing, royalty or other revenue-producing arrangements, which may result from joint development or similar partnerships or defense of our patents through enforcement actions against parties we believe are infringing them.

In November 2015, we entered into a joint development and license agreement ("JDLA") pursuant to which we and Samsung have agreed to work together to jointly develop new storage class memory technologies including a standardized product interface for NVDIMM-P memory modules in order to facilitate broad industry adoption of this new technology. The JDLA also includes comprehensive cross-licenses to our and Samsung's patent portfolios for the purpose of developing this product interface, grants Samsung a right of first refusal to acquire our HybriDIMM technology before we offer the technology to a third party, and grants us access to competitively priced DRAM and NAND flash raw materials. The JDLA also provided for an $8.0 million non-recurring engineering ("NRE") fee that we received from Samsung for the joint development and calls for potential marketing collaboration and for the exchange of potential monetary consideration as progress is made towards commercialization of our storage class memory product. Moreover, we believe Samsung represents an important strategic partner with a high level of technical capability in memory that can facilitate bringing our HybriDIMM technology to market. In connection with the JDLA, we also received gross proceeds of $15.0 million for our issuance of a Senior Secured Convertible Note ("SVIC Note") and Stock Purchase Warrant ("SVIC Warrant") to SVIC No. 28 New Technology Business Investment L.L.P., an affiliate of Samsung Venture Investment Co. ("SVIC"). See Note 5 to the condensed consolidated financial statements included in this report for additional information about the SVIC Note and the SVIC Warrant.

Further, in September 2016, we took action to protect and defend our innovations by filing legal proceedings for patent infringement against SK hynix and two of its subsidiaries in the U.S. International Trade Commission ("ITC") and in district court. We are seeking an exclusion order in the ITC that directs U.S. Customs and Border Protection to stop allegedly infringing SK hynix RDIMM and LRDIMM products from entering the United States. The evidentiary hearing in the ITC investigations will occur in May 2017, with a final initial determination expected to be issued by the ITC in October 2017. In the district court proceedings, we are primarily seeking damages. Our patents involved in the proceedings cover key features of RDIMM and LRDIMM, which we believe are strategic product lines for SK hynix that together account for a significant portion of SK hynix's total revenue and profits. We have recently taken steps to solidify our position and strategy in connection with our proceedings against SK hynix, including establishing a funding arrangement for our legal costs associated with these proceedings and adopting a rights agreement to implement a standard "poison pill," which are discussed further below. See Notes 7 and 8 to the condensed consolidated financial statements included in this report for additional information about our proceedings against SK hynix, the related funding arrangement and our poison pill implementation.

We recorded total net revenues of $11.4 million, $20.8 million, $6.9 million and $11.5 million for the three and six months ended and July 1, 2017 and July 2, 2016, respectively, and $19.7 million and $8.0 million for the years ended December 31, 2016 and January 2, 2016, respectively. We also incurred net losses of $3.8 million, $7.2 million, $1.5 million and $2.9 million for the three and six months ended July 1, 2017 and July 2, 2016, respectively, and $11.2 million and $20.5 million for the fiscal years ended December 31, 2016 and January 2, 2016, respectively. We have historically financed our operations primarily through issuances of equity and debt securities and revenues generated from operations, including product revenues and NRE revenues from the JDLA. We have also funded our operations with a revolving line of credit and term loans under a bank credit facility, a funding arrangement for costs associated with our legal proceedings against SK hynix and, to a lesser extent, equipment leasing arrangements. See “Liquidity and Capital Resources” below for further information.

Recent Developments

Amendments to SVB Credit Agreement

On March 27, 2017 and April 12, 2017, we entered into amendments to our credit agreement (as amended, the “SVB Credit Agreement”) with Silicon Valley Bank (“SVB”). The amendments extend the maturity date of advances

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under the SVB Credit Agreement to April 1, 2018; modify our financial covenants under the SVB Credit Agreement to remove all prior financial standards and replace them with a liquidity ratio standard; remove or amend certain termination, anniversary and unused facility fees payable by us under the SVB Credit Agreement; and make certain other administrative changes.

Establishment of Funding Arrangement and Rights Agreement in connection with SK hynix Proceedings

In April and May of 2017, we established a funding arrangement and a rights agreement in connection with our strategy for our proceedings against SK hynix, each of which is described below.

TRGP Agreement

On May 3, 2017, we entered into an investment agreement (the "TRGP Agreement") with TR Global Funding V, LLC, an affiliate of TRGP Capital Management, LLC ("TRGP"), which generally provides that TRGP will directly fund the costs incurred by us or on our behalf in connection with our proceedings against SK hynix, including costs previously incurred since January 1, 2017 and costs to be incurred in the future. In exchange for such funding, we have agreed that, if we recover any proceeds in connection with the SK hynix proceedings, we will pay to TRGP the amount of its funding plus an escalating premium based on when any such proceeds are recovered, such that the premium will equal a specified low-to-mid double-digit percentage of the amount of TRGP's funding and such percentage will increase by a specified low double-digit amount each quarter after a specified date until any such proceeds are recovered. In addition, we have granted to TRGP a first priority security interest in the claims underlying the SK hynix proceedings and any proceeds we may receive in connection with these proceedings, and a second priority security interest in our patents that are the subject of these proceedings. We have established this funding arrangement in order to provide us with increased security that we will be able to vigorously pursue our claims against SK hynix through their final resolution.

Rights Agreement

On April 17, 2017, we adopted a short-term rights agreement to implement a standard "poison pill." In general terms, for so long as the rights issued under the rights agreement are outstanding, which is expected to be no longer than 12 months, the rights agreement prevents any person or group from acquiring a significant percentage of our outstanding capital stock or attempting a hostile takeover of our Company by significantly diluting the ownership percentage of such person or group. As a result, the rights agreement has a significant anti-takeover effect. Our board of directors approved the rights agreement as part of our strategy in connection with our proceedings against SK hynix, with the intent of disconnecting our market capitalization from the damages calculations and any settlement negotiations that may develop in connection with these proceedings.

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 Product Revenues

Net product revenues consist of resales of certain component products, including NAND flash, and 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 do not have long-term agreements with any of our customers. Instead, sales are made primarily pursuant to standard purchase orders. Purchase orders generally have no cancellation or rescheduling penalty provisions. We often ship products to our customers' international manufacturing sites. All of our sales to date, however, are denominated in U.S. dollars.

The component products we resell include products we purchase from Samsung and certain alternative suppliers for the purpose of resale, and excess component inventory we purchase for, but do not use in, our memory subsystems. We purchase certain products, including primarily NAND flash, from Samsung under the terms of our JDLA with Samsung in order to resell these products to end-customers that are not reached in Samsung's distribution model, including storage customers, appliance customers, system builders and cloud and datacenter customers. We have also sourced these products from alternative suppliers to the extent sufficient product is not available from Samsung to meet customer demand. In the three and six months ended July 1, 2017 and July 2, 2016, resales of these products represented 91% ,91%, 34% and 21% of our net product revenues, respectively, and we expect resales of these products may continue to increase over time. We also resell excess component inventory to distributors and other users of memory integrated circuits, but these sales have historically been, and we expect will continue to be, a relatively small percentage of our net product revenues.

With respect to sales of our memory subsystems, our original equipment manufacturer ("OEM") customers typically provide us with non-binding forecasts of future product demand over specific periods of time, but they generally place orders with us no more than two weeks in advance of the desired delivery date. Selling prices are typically negotiated monthly, based on competitive market conditions and the current price of key product components, including DRAM ICs and NAND flash. Sales of our memory subsystem products have declined in recent periods due in large part to the rapid decline in sales of our first-generation NVvault products following the loss of our former most significant NVvault customer, Dell, beginning in 2012, and the rate and degree of customer adoption of our next generation NVvault product extensions, which has been slower and smaller than expected to date. We expect these declines could continue in future periods unless and until our next-generation products gain significantly greater customer and market acceptance.

Engineering Services

Pursuant to the terms of our JDLA with Samsung, we provided certain engineering services for Samsung and received a NRE fee as compensation for these services. These fees from Samsung are the only such fees for engineering services that we have received to date, although we may in the future receive additional fees of this type, from Samsung or other customers, depending on the terms of the relationships we may develop.

Cost of Sales

Our cost of sales includes the cost of materials, labor and other manufacturing costs, depreciation and amortization of equipment expenses, inventory valuation provisions, stock-based compensation expenses, occupancy costs and other allocated fixed costs.

For resales of component products, our cost of sales also includes the cost of the products we purchase for resale from Samsung under the terms of the JDLA or from alternative suppliers on the terms we negotiate with these suppliers. As a result, our gross margin on the resale of component products, including Samsung products and excess component inventory, is significantly lower than our gross margin on sales of our own products. Accordingly, increased resales of component products as a percentage of our total product revenues have a significant negative impact on our gross margin. In addition, to the extent we are not able to procure sufficient component products for resale from Samsung under the terms of the JDLA to satisfy customer orders for these products, we would need to seek to procure these products from alternative suppliers, which may not be available on terms comparable to those we have negotiated with Samsung under the JDLA. As a result, any inability to source sufficient component products from Samsung could increase our cost of sales associated with resales of these products if we are forced to pay higher prices to obtain these products from other suppliers.

With respect to sales of our memory subsystem products, the DRAM ICs and NAND flash incorporated into these products constitute a significant portion of our cost of sales for the products, and thus our cost of sales will fluctuate based on the cost of DRAM ICs and NAND flash. We attempt to pass through these DRAM IC and NAND flash cost fluctuations to our memory subsystem 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 conditions in our key customer markets that are unrelated to the cost of DRAM ICs and NAND flash, which affects our gross margin. In addition, we have in the past experienced supply chain disruptions and shortages of DRAM and NAND flash required to create our HyperCloud, NVvault and Planar X VLP products, which can cause fluctuations in our net product revenues and gross profits associated with memory subsystem sales.

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Any significant decrease in demand for our products or the component products we resell 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 understate or overstate 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. Conversely, 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, NAND flash or other component products decrease, we may be required to lower the selling prices of our memory subsystems or component product resales to reflect the lower cost of these 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, NAND flash or other component products could have a material effect on the value of our inventories and our reported operating results.

Research and Development

Research and development expenses consist primarily of employee and independent contractor compensation and related costs, stock based compensation expenses, NRE fees, computer aided design software license costs, reference design development costs, depreciation or rental of evaluation equipment expenses, and occupancy and other allocated overhead costs. Also included in research and development expenses are the costs of materials 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.

Intellectual Property Legal Fees

Intellectual property legal fees consist of legal fees incurred for patent filings, protection and enforcement. Although we anticipate that intellectual property legal fees will generally increase over time as we continue to protect and seek to expand our patent portfolio, we expect that our intellectual property legal fees may decrease or increase at a slower rate in the near term due to the impact of the TRGP Agreement on our expense related to our proceedings against SK hynix. The legal expenses we incur that are paid by TRGP pursuant to the terms of the TRGP Agreement are excluded from our financial statements in each period in which the TRGP Agreement remains in effect. In the six months ended July 1, 2017, we excluded legal expenses of $6.0 million as a result of TRGP's payment of these expenses under the TRGP Agreement. Pursuant to the TRGP Agreement, any settlement or other cash proceeds we may recover in the future in connection with the SK hynix proceedings would be reduced by the aggregate amount of legal expenses we exclude as a result of TRGP's payment of these expenses under the TRGP Agreement, plus the premium amount due to TRGP under the terms of the TRGP Agreement at the time of any such recovery. As a result, we expect our intellectual property legal fees would be significantly higher in the period in which any such recovery occurs.

Selling, General and Administrative

Selling, general and administrative expenses primarily consist of employee compensation and related costs, stock-based compensation expenses, independent sales representative commissions, professional service fees, 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.

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Provision for Income Taxes

The federal statutory tax rate was 34% for the six months ended July1, 2017 and July 2, 2016. Our effective tax rate differs from the statutory rate because we provide a full valuation allowance against net deferred tax assets, and accordingly we did not recognize an income tax benefit related to losses incurred for the six months ended July 1, 2017 and July 2, 2016.

Factors Affecting Our Performance and Business Risks and Uncertainties

Our performance, financial condition and prospects are affected by a number of factors and are exposed to a number of risks and uncertainties. See the discussion of certain major factors affecting our performance in the MD&A included in our 2016 Annual Report, and see the discussion of certain risks that we face under “Risk Factors” in Part II, Item 1A of this report.

Critical Accounting Policies and Use of Estimates

The preparation of our condensed consolidated financial statements included in this report in conformity with accounting principles generally accepted in the United States 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 revenues 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 belief 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 consolidated 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 included in this report: provisions for uncollectible receivables and sales returns; warranty liabilities; valuation of inventories; fair value of financial instruments; recoverability of long-lived assets; valuation of stock-based transactions; estimates for completion of NRE and other revenue milestones; and realization of deferred tax assets.

Our critical accounting policies and estimates are discussed in Note 2 to the condensed consolidated financial statements included in this report and the MD&A included in our 2016 Annual Report. For the six months ended July 1, 2017, there were no material changes to our critical accounting policies.

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Results of Operations

The following table presents each line item of our condensed consolidated statement of operations as a percentage of total net revenues for the three and six months ended July 1, 2017 compared to three and six months ended July 2, 2016:

	Three Months Ended				Six Months Ended			
	July 1, 2017		July 2, 2016		July 1, 2017		July 2, 2016	
Net product revenues	100	%	51	%	100	%	41	%
NRE revenues	-		49		-		59	
Total net revenues	100		100		100		100	
Cost of sales	94		47		94		38	
Gross profit	6		53		6		62	
Operating expenses:								
Research and development	13		26		14		30	
Intellectual property legal fees	8		15		7		16	
Selling, general and administrative	17		31		19		38	
Total operating expenses	38		72		40		85	
Operating loss	(33)		(20)		(33)		(23)	
Other expense, net:								
Interest expense, net	(1)		(2)		(1)		(2)	
Other income (expense), net	-		-		-		-	
Total other expense, net	(1)		(2)		(1)		(2)	
Loss before provision for income taxes	(34)		(22)		(35)		(25)	
Provision for income taxes	-		-		-		-	
Net loss	(34)	%	(22)	%	(35)	%	(25)	%

Net Product Revenues, NRE Revenues, Cost of Sales and Gross Profit

The following tables present net product revenues, NRE revenues, cost of sales and gross profit for the three and six months ended July 1, 2017 and July 2, 2016:

	Three Months Ended			
	July 1, 2017	July 2, 2016	Change	% Change

	(in thousands, except percentages)							
Net product revenues	$	11,404	$	3,500	$	7,904	226	%
NRE revenues		-		3,428		(3,428)	(100)	%
Total net revenues		11,404		6,928		4,476	65	%
Cost of sales		10,760		3,267		7,493	229	%
Gross profit	$	644	$	3,661	$	(3,017)	(82)	%
Gross margin		5.6%		52.8%		(47.2) %		

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	Six Months Ended				
	July 1, 2017	July 2, 2016	Change	% Change	
	(in thousands, except percentages)				
Net product revenues	$ 20,830	$ 4,671	$ 16,159	346	%
NRE revenues	-	6,857	(6,857)	(100)	%
Total net revenues	20,830	11,528	9,302	81	%
Cost of sales	19,506	4,416	15,090	342	%
Gross profit	$ 1,324	$ 7,112	$ (5,788)	(81)	%
Gross margin	6.4%	61.7%	(55.3) %		

Net Product Revenues

The increase in our net product revenues for the three months ended July 1, 2017 as compared to the three months ended July 2, 2016 resulted primarily from increases of $5.5 million in sales of NAND flash, primarily sourced from Samsung under our JDLA, and $2.2 million in sales of other small outline dual in-line memory module (“SODIMM”) and registered dual in-line memory module (“RDIMM”) products. The increase in our net product revenues for the six months ended July 1, 2017 as compared with the six months ended July 2, 2016 resulted primarily from increases of $11.4 million in sales of NAND flash, also primarily sourced from Samsung under our JDLA, and $4.8 million of other SODIMM and RDIMM sales. Our product revenues in all periods presented were impacted by fluctuating customer concentrations. Our two largest customers in the three and six months ended July 2, 2016, which respectively accounted for 47% and 11%, and 35% and 12% of our net product revenues in the respective periods, made significantly fewer purchases and together contributed less than 2.5% of our net product revenues in the six months ended July 1, 2017. Our largest customers in the three and six months ended July 1, 2017, one of which accounted for 16% of our net product revenues in the three month period and the other of which accounted for 11% of our net product revenues in the six month period, were each relatively new customers that made no purchases and contributed no net product revenues in the three or six months ended July 2, 2016.

NRE Revenues

The decrease in NRE revenues for the three and six months ended July 1, 2017 as compared to the three and six months ended July 2, 2016 resulted from the recognition of revenues from the NRE fee for engineering services performed under our JDLA with Samsung in the 2016 period due to our completion of the engineering services required under the initial phase of the agreement in 2016.

Cost of Sales, Gross Profit and Gross Margin

The increase in our cost of sales for the three and six months ended July 1, 2017 as compared to the three and six months ended July 2, 2016 resulted primarily from increased costs associated with our increased product revenues. The decrease in our gross margin in the three and six months ended July 1, 2017 as compared to the three and six months ended July 2, 2016 resulted primarily from the decrease of NRE revenues from the JDLA, partially offset by increased product revenues. Our gross margin is also impacted by the mix of products that we sell, as resales of NAND flash and other components, including resales of Samsung products, result in significantly lower gross margins than sales of our memory subsystems and other specialty DIMM products. Because our resales of these component products accounted for the vast majority of our product revenues in the 2017 periods, our gross margin was negatively impacted in these periods by this product mix.

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Research and Development

The following tables present research and development expenses for the three and six months ended July 1, 2017 and July 2, 2016:

	Three Months Ended				
	July 1, 2017	July 2, 2016	Change	% Change	
	(in thousands, except percentages)				
Research and development	$ 1,487	$ 1,831	$ (344)	(19)	%

	Six Months Ended				
	July 1, 2017	July 2, 2016	Change	% Change	
	(in thousands, except percentages)				
Research and development	$ 2,983	$ 3,477	$ (494)	(14)	%

The decrease in research and development expenses in the three months ended July 1, 2017 as compared to the three months ended July 2, 2016 of $0.3 million resulted primarily from decreases of (i) $0.2 million in headcount, overhead and travel expenses and (ii) $0.1 million in product research expenses.

The decrease in research and development expenses in the six months ended July 1, 2017 as compared to the six months ended July 2, 2016 of $0.5 million resulted primarily from decreases of (i) $0.3 million in headcount, overhead and travel expenses (ii) $0.05 million in product research expenses and (iii) $0.1 million in professional and outside service fees.

Intellectual Property Legal Fees

The following tables present intellectual property legal fees for the three and six months ended July 1, 2017 and July 2, 2016:

	Three Months Ended				
	July 1, 2017	July 2, 2016	Change	% Change	
	(in thousands, except percentages)				
Intellectual property legal fees	$ 915	$ 1,023	$ (108)	(11)	%

	Six Months Ended				
	July 1, 2017	July 2, 2016	Change	% Change	
	(in thousands, except percentages)				
Intellectual property legal fees	$ 1,381	$ 1,846	$ (465)	(25)	%

The decrease in intellectual property legal fees for the three and six months ended July 1, 2017 as compared to the three and six months ended July 2, 2016 resulted primarily from a decrease between periods in legal fees incurred for certain trade secret litigation and our establishment of the TRGP Agreement to finance the legal fees and costs incurred in the 2017 period in connection with our legal proceedings against SK hynix.

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Selling, General and Administrative

The following tables present selling, general and administrative expenses for the three and six months ended July 1, 2017 and July 2, 2016:

	Three Months Ended			
	July 1, 2017	July 2, 2016	Change	% Change
	(in thousands, except percentages)			
Selling, general and administrative	$ 1,951	$ 2,159	$ (208)	(10) %

	Six Months Ended			
	July 1, 2017	July 2, 2016	Change	% Change
	(in thousands, except percentages)			
Selling, general and administrative	$ 3,865	$ 4,424	$ (559)	(13) %

The decrease in selling, general and administrative expenses for the three months ended July 1, 2017 as compared to the three months ended July, 2016 resulted primarily from decreases of $0.3 million in sales and marketing headcount costs and related overhead and travel expenses and $0.05 million in advertising and product evaluation costs, partially offset by a $0.1 million increase in fees for outside services.

The decrease in selling, general and administrative expenses for the six months ended July 1, 2017 as compared to the three months ended July, 2016 resulted primarily from decreases of $0.7 million in sales and marketing headcount costs and related overhead and travel expenses and $0.1 million in advertising and product evaluation costs, partially offset by a $0.2 million increase in fees for outside services.

Other Expense, Net

The following tables present other expense, net for the three and six months ended July 1, 2017 and July 2, 2016:

Three Months Ended

	July 1, 2017	July 2, 2016	Change	% Change	
	(in thousands, except percentages)				
Interest expense, net	$ (138)	$ (132)	$ 6	5	%
Other expense, net	-	(10)	(10)	(100)	%
Total other expense, net	$ (138)	$ (142)	$ (4)	(3)	%

	Six Months Ended				
	July 1, 2017	July 2, 2016	Change	% Change	
	(in thousands, except percentages)				
Interest expense, net	$ (286)	$ (269)	$ 17	6	%
Other income (expense), net	2	(2)	(4)	(200)	%
Total other expense, net	$ (284)	$ (271)	$ 13	5	%

Interest expense, net, for the three and six months ended July 1, 2017 and 2016 consisted primarily of interest payments under the SVIC Note and the SVB Credit Agreement, and the increase between periods resulted primarily from increased borrowings under the SVB Credit Agreement in the first quarter of 2017.

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The increase in other income (expense), net, was not significant between periods.

Provision for Income Taxes

The following tables present the provision for income taxes for the three and six months ended July 1, 2017 and July 2, 2016:

	Three Months Ended			
	July 1, 2017	July 2, 2016	Change	% Change
	(in thousands, except percentages)			
Provision for income taxes	$ -	$ -	$ -	- %

	Six Months Ended			
	July 1, 2017	July 2, 2016	Change	% Change
	(in thousands, except percentages)			
Provision for income taxes	$ -	$ 1	$ (1)	(100) %

The federal statutory rate was 34% for the three and six months ended July 1, 2017 and July 2, 2016. In all periods presented, we continued to provide a full valuation allowance against our net deferred tax assets, which consist primarily of net operating loss carryforwards. In these periods, our effective tax rate differed from the statutory rate primarily due to the valuation allowance on newly generated loss carryforwards.

Liquidity and Capital Resources

Liquidity generally refers to the ability to generate adequate amounts of cash to meet our cash needs. We require cash to fund our operating expenses and working capital requirements, to make required payments of principal and interest under our outstanding debt instruments and, to a lesser extent, to fund capital expenditures.

Working Capital and Cash and Cash Equivalents

The following table presents working capital and cash and cash equivalents as of July 1, 2017 and December 31, 2016:

	July 1, 2017	December 31, 2016
	(in thousands)	
Working capital	$ 7,001	$ 13,043
Cash and cash equivalents(1)	$ 4,496	$ 9,476

(1) Included in working capital.

Our working capital decreased for the six months ended July 1, 2017, primarily as a result of a $5.0 million decrease in cash and cash equivalents attributable to our use of cash to fund our operations, including a $1.7 million increase in inventory costs to support the increase in our product revenues and a $2.6 million increase in our accounts payable, and a $0.7 million increase in our borrowings under the SVB Credit Agreement to fund the purchase of additional inventory and to otherwise fund our operations.

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Cash Flows

The following table summarizes our cash flows for the six months ended July 1, 2017 and July 2, 2016:

	Six Months Ended	
	July 1, 2017	July 2, 2016
	(in thousands)	
Net cash provided by (used in):		
Operating activities	$ (5,510)	$ (8,517)
Investing activities	(53)	(274)
Financing activities	583	(90)
Net change in cash and cash equivalents	$ (4,980)	$ (8,881)

Operating Activities

Net cash used in operating activities for the six months ended July 1, 2017 was primarily the result of a net loss of $7.2 million, partially offset by (i) $1.0 million of net non-cash operating expenses, which primarily consisted of stock-based compensation, depreciation and amortization, interest accrued on convertible debt and amortization of debt discounts, and (ii) $0.6 million of net cash provided by operating activities due to changes in operating assets and liabilities, which were primarily from a $2.6 million increase in accounts payable partially offset by a $1.7 million increase in inventory and a $0.3 million decrease in accrued payroll and related liabilities. The increase in accounts payable between periods was primarily due to increased purchases of inventory. The increase in inventories between periods was primarily due to our purchase of additional inventory to support the increase in our product revenues. The decrease in accrued payroll and related liabilities between periods was primarily due to reduction in the number of employees.

Net cash used in operating activities for the six months ended July 2, 2016 was primarily the result of a net loss of $2.9 million and $6.6 million in net cash used in operating activities due to changes in operating assets and liabilities, which were primarily from changes in deferred revenue, inventories, accounts receivable, prepaid expenses and other assets and accounts payable, partially offset by $1.0 million in net non-cash operating expenses, which primarily consisted of depreciation and amortization, amortization of debt discounts and stock-based compensation.

Investing Activities

Net cash used in investing activities for six months ended July 1, 2017 and July 2, 2016 was the result of our purchases of property and equipment during the periods.

Financing Activities

Net cash provided by financing activities for the six months ended July 1, 2017 was primarily the result of $0.7 million in net borrowings under the SVB Credit Agreement and $0.2 million in net proceeds from the exercise of equity awards, partially offset by $0.2 million in payments of outstanding debt. Net cash used in financing activities for the six months ended July 2, 2016 was primarily the result of $0.2 million in payments of outstanding debt, partially offset by $0.05 million in net proceeds from the exercise of equity awards.

Capital Resources

Our sources of cash have historically consisted of proceeds from issuances of equity and debt securities and revenues generated from operations, including product revenues and NRE revenues from our JDLA with Samsung. We have also funded our operations with a revolving line of credit and term loans under a bank credit facility, a funding arrangement for costs associated with our legal proceedings against SK hynix and, to a lesser extent, equipment leasing arrangements.

SVB Credit Agreement

On October 31, 2009, we entered into the SVB Credit Agreement, which provides that we may borrow up to the lesser of (i) 80% of eligible accounts receivable, or (ii) $5.0 million, subject to certain adjustments as set forth in the SVB Credit Agreement. The SVB Credit Agreement expires April 1, 2018.

As of July 1, 2017, we had outstanding borrowings under the SVB Credit Agreement of $1.3 million. We made no borrowings under the SVB Credit Agreement in the six months ended July 2, 2016. As of July 1, 2017 and December 31, 2016, we had borrowing availability under the SVB Credit Agreement of $0.3 million and $0.8 million, respectively.

SVIC Note and SVIC Warrant

On November 18, 2015, we issued to SVIC the SVIC Note and the SVIC Warrant. The SVIC Note has an original principal amount of $15.0 million, accrues interest at a rate of 2.0% per year, is due and payable in full on December 31, 2021, and is convertible into shares of our common stock at a conversion price of $1.25 per share, subject to certain adjustments, on the maturity date of the SVIC Note. The SVIC Warrant grants SVIC a right to purchase up to 2,000,000 shares of our common stock at an exercise price of $0.30 per share, subject to certain adjustments, is only exercisable in the event we exercise our right to redeem the SVIC Note prior to its maturity date, and expires on December 31, 2025. Proceeds from the SVIC Note were used to repay a former loan from a different lender.

2016 Offering

On September 23, 2016, we completed a registered firm commitment underwritten public offering (the “2016 Offering”), pursuant to which we sold 9,200,000 shares of our common stock at a price to the public of $1.25 per share. The net proceeds to us from the 2016 Offering were $10.3 million, after deducting underwriting discounts and commissions and offering expenses paid by us.

TRGP Agreement

On May 3, 2017, we entered into the TRGP Agreement, which generally provides that TRGP will directly fund the costs incurred by us or on our behalf in connection with our legal proceedings against SK hynix, including costs previously incurred since January 1, 2017 and costs to be incurred in the future. In the six months ended July 1, 2017, TRGP directly paid $6.0 million of legal expenses we incurred in connection with the SK hynix proceedings.

Equipment Leasing Arrangements

We have in the past utilized equipment leasing arrangements to finance certain capital expenditures. Although equipment leases did not contribute material cash during the periods covered by this report, they continue to be a financing alternative that we may pursue in the future.

Sufficiency of Cash Balances and Potential Sources of Additional Capital

We believe our existing cash balance, together with cash provided by our operations and borrowing availability under the SVB Credit Agreement, and taking into account cash expected to be used in our operations and the funding to be received under the TRGP Agreement, will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our capital requirements will depend on many factors, including, among others: the acceptance of, and demand for, our products and the component products we resell to customers directly; our levels of net product revenues and any other revenues we may receive, including NRE, license, royalty or other fees; the extent and timing of any investments in developing, marketing and launching new or enhanced products or technologies; the costs of developing, improving and maintaining our internal design, testing and manufacturing processes; the costs associated with defending and enforcing our intellectual property rights; and the nature and timing of acquisitions and other strategic transactions in which we participate, if any.

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Although we expect to be able to rely in the near term on our existing cash balance, cash provided by our operations, payments under the TRGP Agreement and borrowing availability under the SVB Credit Agreement, our estimates of our operating revenues and expenses and working capital requirements could be incorrect, and we may use our cash resources faster than we anticipate. Further, some or all of our ongoing or planned investments may not be successful and could result in further losses. Until we can generate sufficient revenues to finance our cash requirements from our operations, which we may never do, we may need to increase our liquidity and capital resources by one or more measures, which may include, among others, reducing operating expenses, restructuring our balance sheet by negotiating with creditors and vendors, entering into strategic partnerships or alliances, raising additional financing through the issuance of debt, equity or convertible securities or pursuing alternative sources of capital, such as through asset or technology sales or licenses or other alternative financing arrangements. Further, even if our near-term liquidity expectations prove correct, we may still seek to raise capital through one or more of these financing alternatives. However, we may not be able to obtain capital when needed or desired, on terms acceptable to us or at all.

Inadequate working capital would have a material adverse effect on our business and operations and could cause us to fail to execute our business plan, fail to take advantage of future opportunities or fail to respond to competitive pressures or customer requirements. A lack of sufficient funding may also require us to significantly modify our business model and/or reduce or cease our operations, which could include implementing cost-cutting measures or delaying, scaling back or eliminating some or all of our ongoing and planned investments in corporate infrastructure, research and development projects, business development initiatives and sales and marketing activities, among other activities. Modification of our business model and operations could result in an impairment of assets, the effects of which cannot be determined. Furthermore, if we continue to issue equity or convertible debt securities to raise additional funds, our existing stockholders may experience significant dilution, and the new equity or debt securities may have rights, preferences and privileges that are superior to those of our existing stockholders. If we incur additional debt, it may increase our leverage relative to our earnings or to our equity capitalization or have other material consequences. If we pursue asset or technology sales or licenses or other alternative financing arrangements to obtain additional capital, our operational capacity may be limited and any revenue streams or business plans that are dependent on the sold or licensed assets may be reduced or eliminated. Moreover, we may incur substantial costs in pursuing any future capital-raising transactions, including investment banking, legal and accounting fees, printing and distribution expenses and other similar costs, which would reduce the benefit of the capital received from the transaction.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditure or capital resources that is material to investors.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management carried out an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this report. Based upon this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of July 1, 2017. Our disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission (“SEC”)and (ii) is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosures.

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Changes in Internal Control over Financial Reporting

During our fiscal quarter ended July 1, 2017, there were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Controls

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and any design may not succeed in achieving its stated goals under all potential conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

In addition, projections of any evaluation of effectiveness to future periods are subject to risks that controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with the controls.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The information under “Litigation and Patent Reexaminations” in Note 7 to the condensed consolidated financial statements included in Part I, Item 1 of this report is incorporated herein by reference.

Item 1A. Risk Factors

Investing in our common stock involves a high degree of risk. Before making any investment decision with respect to our securities, you should carefully consider each of the following risk factors and the other information in this report. Each of these risk factors, either alone or together, could adversely affect our business, operating results, financial condition, ability to access capital resources and future growth prospects, as well as the value of an investment in our common stock. As a result, you could lose some or all of any investment you have made or may make in our common stock. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this report, including our condensed consolidated financial statements and the related notes. The risks described below are not the only ones we face. Additional risks of which we are not presently aware or that we currently believe are immaterial may also impair our business operations and financial position.

Risks Related to Our Business

We have historically incurred losses and may continue to incur losses.

Since the inception of our business in 2000, we have only experienced one fiscal year (2006) with profitable results. In order to regain profitability, or to achieve and sustain positive cash flows from operations, we must reduce operating expenses and/or increase our revenues and gross margins. Although we have in the past engaged in a series of cost reduction actions, such expense reductions alone may not make us profitable or allow us to sustain profitability if it is achieved and eliminating or reducing strategic initiatives could limit our opportunities and prospects. Our ability to achieve profitability will depend on increased revenue growth from, among other things, monetization of our intellectual property, increased demand for our memory subsystems and other product offerings and our ability to expand into new and emerging markets. We may not be successful in any of these pursuits and we may never achieve profitability or sustain profitability if achieved.

We may not have sufficient working capital to fund our planned operations and, as a result, we may need to raise additional capital in the future, which may not be available when needed, on acceptable terms or at all.

We believe that, taking into account our planned activities and our sources of capital, we have sufficient cash resources to satisfy our capital needs for at least the next 12 months. However, our estimates of our operating revenues and expenses and working capital requirements could be incorrect, and we may use our cash resources faster than we anticipate. Further, some or all of our ongoing or planned investments may not be successful and could result in further losses.

Our capital requirements will depend on many factors, including, among others:

· the acceptance of, and demand for, our products and the component products we resell to customers directly;

· our success, and that of our strategic partners, in developing and selling products derived from our technology;

· the extent and timing of any investments in developing, marketing and launching new or enhanced products or technologies;

· the costs of developing, improving and maintaining our internal design, testing and manufacturing processes;

· the costs associated with defending and enforcing our intellectual property rights;

· our results of operations, including our levels of net product revenues and any other revenues we may receive, including non-recurring engineering (“NRE”), license, royalty or other fees;

· the amount and timing of vendor payments and the collection of receivables, among other factors affecting our working capital;

· our receipt of cash proceeds from the exercise of outstanding stock options or warrants to acquire our common stock;

· the nature and timing of acquisitions and other strategic transactions in which we participate, if any; and

· the costs associated with the continued operation, and any future growth, of our business.

We expect to rely in the near term on cash provided by our operations, funds raised pursuant to recent issuances of debt and equity securities, such as our November 2015 issuance of convertible debt to an affiliate of Samsung Venture Investment Co., Samsung Venture Investment Co. ("SVIC"), and our September 2016 public offering of common stock, our new funding arrangement with TR Global Funding V, LLC, an affiliate of TRGP Capital Management, LLC ("TRGP"), for costs associated with certain of our legal proceedings, and borrowing availability under our credit facility with Silicon Valley Bank ("SVB"). However, our estimates of our operating revenues and expenses and working capital requirements could be incorrect, and we may use our cash resources faster than we anticipate. Further, some or all of our ongoing or planned investments may not be successful and could result in further losses. Until we can generate sufficient revenues to finance our cash requirements from our operations, which we may never do, we may need to increase our liquidity and capital resources by one or more measures, which may include, among others, reducing operating expenses, restructuring our balance sheet by negotiating with creditors and vendors, entering into strategic partnerships or

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alliances, raising additional financing through the issuance of debt, equity or convertible securities or pursuing alternative sources of capital, such as through asset or technology sales or licenses or other alternative financing arrangements. Further, even if our near-term liquidity expectations prove correct, we may still seek to raise capital through one or more of these financing alternatives. However, we may not be able to obtain capital when needed or desired, on terms acceptable to us or at all.

Inadequate working capital would have a material adverse effect on our business and operations and could cause us to fail to execute our business plan, fail to take advantage of future opportunities or fail to respond to competitive pressures or customer requirements. A lack of sufficient funding may also require us to significantly modify our business model and/or reduce or cease our operations, which could include implementing cost-cutting measures or delaying, scaling back or eliminating some or all of our ongoing and planned investments in corporate infrastructure, research and development projects, business development initiatives and sales and marketing activities, among other activities. Modification of our business model and operations could result in an impairment of assets, the effects of which cannot be determined. Furthermore, if we continue to issue equity or convertible debt securities to raise additional funds, our existing stockholders may experience significant dilution, and the new equity or debt securities may have rights, preferences and privileges that are superior to those of our existing stockholders. If we incur additional debt, it may increase our leverage relative to our earnings or to our equity capitalization or have other material consequences. If we pursue asset or technology sales or licenses or other alternative financing arrangements to obtain additional capital, our operational capacity may be limited and any revenue streams or business plans that are dependent on the sold or licensed assets may be reduced or eliminated. Moreover, we may incur substantial costs in pursuing any future capital-raising transactions, including investment banking, legal and accounting fees, printing and distribution expenses and other similar costs, which would reduce the benefit of the capital received from the transaction.

We have incurred a material amount of indebtedness to fund our operations, the terms of which have required us to pledge substantially all of our assets as security. Our level of indebtedness and the terms of such indebtedness could adversely affect our operations and liquidity.

We have incurred debt under our convertible note issued to SVIC, our credit facility with SVB, and our new funding arrangement with TRGP. In connection with these debt and other arrangements, we have granted security interests to SVIC, SVB and TRGP in our various assets, such that all of our tangible and intangible assets, including our complete patent portfolio, are subject to one or more outstanding liens held by one or more of these parties. The SVIC and SVB debt instruments and the TRGP investment agreement contain customary representations, warranties and indemnification provisions, as well as affirmative and negative covenants that, among other things, restrict our ability to:

· incur additional indebtedness or guarantees;

· incur liens;

· make investments, loans and acquisitions;