STORAGE COMPUTER CORP
Form 10-Q
May 15, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2002

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____ .

COMMISSION FILE NUMBER 1-13616

STORAGE COMPUTER CORPORATION

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	02-0450593
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

11 RIVERSIDE DRIVE NASHUA, NH 03062

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE)

(603) 880-3005

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 [X] No [_]

Number of shares outstanding of the registrant's class of common stock, as of the latest practicable date.

CLASS	OUTSTANDING AT MAY 15, 2002
Common Stock.....	19,803,917

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

Storage Computer Corporation
Consolidated Balance Sheets

MARCH 31,

	2002
	(UNAUDITED)
ASSETS	
Current assets:	
Cash and cash equivalents	$3,496,193
Accounts receivable, net	1,357,602
Inventories	4,017,285
Due from officers and directors	127,934
Other current assets	692,714
Total current assets	9,691,728
Property and equipment, net	803,734
Goodwill, net	16,287,911
Other intangibles, net	3,718,834
Other assets	388,829
Total assets	$30,891,036
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$942,145
Accrued expenses	1,524,657
Deferred revenue	445,688
Current maturities of long-term debt	1,053,967
Total current liabilities	3,966,457
Long-term debt, less current maturities	258,279
Commitments and contingencies	
Redeemable convertible preferred stock	3,776,150
Stockholders' equity:	
Preferred stock	1,302,228
Common stock	19,200
Additional paid-in capital	76,147,054
Accumulated deficit	(54,578,332)
Total stockholders' equity	22,890,150
Total liabilities and stockholders' equity	$30,891,036

See Notes to Consolidated Financial Statements.

Storage Computer Corporation
Consolidated Statements of Operations (Unaudited)

	Three Mon
	MARCH 31, 2002
Revenues:	
Products and services	$766,003
License fees	--
Total revenues	$766,003
Costs and expenses:	
Cost of products and services	721,700
Cost of license fees, primarily legal fees	679,114
Research and development	1,019,669
Sales and marketing	1,016,726
General and administrative	801,529
Amortization of intangibles	240,072
Total costs and expenses	4,478,810
Operating loss	(3,712,807)
Other income (expense):	
Interest income (expense), net	(3,257)
Other income	50,859
Total	47,602
Loss before income taxes	(3,665,205)
Provision for income taxes	--
Net loss	(3,665,205)
Dividends on preferred stock including amortization of the beneficial conversion features	(257,044)
Net loss applicable to common stockholders	$(3,922,249)

Net loss applicable to common stockholders per basic and dilutive share	$(0.20)
Basic and dilutive shares	19,176,260

See Notes to Consolidated Financial Statements.

Storage Computer Corporation
Consolidated Statements of Cash Flows (Unaudited)

	Three Mo
	MARCH 31, 2002
Cash flows from operating activities:	
Net loss	$(3,665,205)
Reconciliation to operating cash flows:	
Depreciation and amortization of property and equipment	124,980
Amortization of goodwill	--
Amortization of other intangibles	240,072
Stock issued to 401(k) plan	18,786
Changes in operating assets and liabilities:	
Accounts receivable	286,764
Inventories	(276,315)
Due from officers and directors	1,000,000
Other current assets	106,816
Accounts payable and accrued expenses	49,355
Net cash used in operations	(2,114,747)
Cash flows from investing activities:	
Capital expenditures	(15,442)
Other assets	6,073
CyberStorage acquisition costs	--
Net cash provided by (used in) investing activities	(9,369)
Cash flows from financing activities:	
Reduction of long-term debt	(72,857)
Net proceeds from issuance of common stock for stock options	79,078

Net cash provided by (used in) financing activities	6,221
Effect of exchange rate changes on cash	(13,767)
Net decrease in cash and cash equivalents	(2,131,662)
Cash and cash equivalents-beginning of period	5,627,855
Cash and cash equivalents-end of period	$ 3,496,193

Supplemental cash flow information:

Cash payments of interest	$16,478
Preferred stock dividends paid in common stock	$47,556

See Notes to Consolidated Financial Statements.

Storage Computer Corporation
Notes to Consolidated Financial Statements
March 31, 2002

Note A - The Company and Basis of Presentation

Storage Computer Corporation ("Company", "we" and "us") and our subsidiaries are engaged in the development, manufacture, and sale of computer disk arrays and computer equipment worldwide. The consolidated financial statements include the accounts of the Company and those of our wholly-owned subsidiaries CyberStorage Systems Corporation, Storage Computer Europe GmbH, Vermont Research Products, Inc., Storage Computer UK, Ltd., and Storage Computer France SAS. All significant intercompany accounts and transactions have been eliminated in consolidation. We have a 20% investment in Storage Computer (Asia) Ltd. which is accounted for by the equity method.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the financial statements and related notes included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission, containing our financial statements for the fiscal year ended December 31, 2001. In management's opinion, the accompanying financial statements reflect all adjustments, all of which are of a normal, recurring nature, to fairly present our consolidated financial position, results of operations and cash flows. The results of operations for the three months ended March 31, 2002 are not necessarily indicative of the results to be expected for the full year.

Certain 2001 amounts have been reclassified to conform with the current period presentation. These reclassifications did not change previously reported total assets, liabilities, stockholder's equity or net loss.

Note B - Stockholders' Equity

A summary of changes in stockholders' equity in the quarter ended March 31, 2002 follows:

	Preferred Stock		Common Stock		
	Shares	Carrying Value	Shares	Par Value	Additional Paid-In Capital
Balance--December 31, 2001	2,500	$1,178,319	19,134,773	$19,135	$76,001,699
Exercise of stock options			43,500	43	79,035
Stock issued to 401(k) plan			2,935	3	18,783
Amortization of beneficial conversion feature of preferred stock		123,909			
Dividends on preferred stock			18,507	19	47,537
Net loss					
Balance-March 31, 2002	2,500	$1,302,228	19,199,715	$19,200	$76,147,054

Note C - Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board finalized FASB Statements No. 141, Business Combinations ("SFAS 141"), and No. 142, Goodwill and Other Intangible Assets ("SFAS 142"). SFAS 141 requires the use of the purchase method of accounting and prohibits the use of the pooling-of-interests method of accounting for business combinations initiated after June 30, 2001. SFAS 141 also requires that the Company recognize acquired intangible assets apart from goodwill if the acquired intangible assets meet certain criteria. SFAS 141 applies to all business combinations initiated after June 30, 2001 and for purchase business combinations completed on or after July 1, 2001. The FASB also requires, upon adoption of SFAS 142, that the Company reclassify the carrying amounts of intangible assets and goodwill based on the criteria in SFAS 141.

SFAS 142 requires, among other things, that companies no longer amortize goodwill, but instead test goodwill for impairment at least annually. In addition, SFAS 142 requires that the Company identify reporting units for the purposes of assessing potential future impairments of goodwill, reassess the useful lives of other existing recognized intangible assets, and ceases amortization of intangible assets with an indefinite useful life. An intangible asset with an indefinite useful life should be tested for impairment in accordance with the guidance in SFAS 142. SFAS 142 is required to be applied in fiscal years beginning after December 15, 2001 to all goodwill and other intangible assets recognized at that date, regardless of when those assets were initially recognized.

The Company's acquisition of CyberStorage Systems in 2000 was accounted for using the purchase method. All future business combinations will be accounted for under the purchase method, which may result in the recognition of goodwill and other intangible assets, some of which may subsequently be charged to operations, either by amortization or impairment charges. As of March 31, 2002, the net carrying amount of goodwill is $16,288,000 and other intangible assets is $3,719,000. Amortization expense during the three-month period ended March 31, 2002, which represents amortization of other intangible assets only, amounted to $240,072. Currently, the Company is assessing but has not yet

determined how the adoption of SFAS 141 and SFAS 142 will impact its financial position and results of operations. The Company will complete this assessment in the quarter ended June 30, 2002.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment of Long-Lived Assets," which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This statement supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of," and APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions for the Disposal of a Segment of a Business." SFAS No. 144 became effective for fiscal years beginning after December 15, 2001. The Company reviews the carrying values of its long-lived and identifiable intangible assets for possible impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be recoverable. Any long-lived assets held for disposal are reported at the lower of their carrying amounts or fair values less costs to sell. The Company has adopted SFAS No. 144 during the first quarter of 2002 and has determined that the adoption of SFAS No. 144 has had no impact on its financial position or results of operations for that period.

Note C - Subsequent Event

On May 3, 2002 the Company completed a $3,000,000 financing through a private placement of common stock to a group of four European and US based institutional investors. The Company sold 600,000 shares of common stock at $5.00 per share and issued 260,000 warrants to purchase common stock at $6.18 per share that are exercisable over a five-year period.

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

CAUTIONARY STATEMENT

Forward-looking Statements

THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1996 CONTAINS CERTAIN SAFE HARBORS REGARDING FORWARD-LOOKING STATEMENTS. FROM TIME TO TIME, INFORMATION PROVIDED BY US OR STATEMENTS MADE BY OUR DIRECTORS, OFFICERS OR EMPLOYEES MAY CONTAIN "FORWARD-LOOKING" INFORMATION SUBJECT TO NUMEROUS RISKS AND UNCERTAINTIES. ANY STATEMENTS MADE HEREIN THAT ARE NOT STATEMENTS OF HISTORICAL FACT ARE FORWARD-LOOKING STATEMENTS INCLUDING, BUT NOT LIMITED TO, STATEMENTS CONCERNING THE CHARACTERISTICS AND GROWTH OF OUR MARKETS AND CUSTOMERS, OUR OBJECTIVES AND PLANS FOR FUTURE OPERATIONS AND PRODUCTS AND OUR EXPECTED LIQUIDITY AND CAPITAL RESOURCES. SUCH FORWARD-LOOKING STATEMENTS ARE BASED ON A NUMBER OF ASSUMPTIONS AND INVOLVE A NUMBER OF RISKS AND UNCERTAINTIES, AND, ACCORDINGLY, ACTUAL RESULTS COULD DIFFER MATERIALLY. FACTORS THAT MAY CAUSE SUCH DIFFERENCES INCLUDE, BUT ARE NOT LIMITED TO: THE CONTINUED AND FUTURE ACCEPTANCE OF OUR PRODUCTS; THE RATE OF GROWTH IN THE INDUSTRIES OF OUR PRODUCTS; THE PRESENCE OF COMPETITORS WITH GREATER TECHNICAL, MARKETING AND FINANCIAL RESOURCES; OUR ABILITY TO PROMPTLY AND EFFECTIVELY RESPOND TO TECHNOLOGICAL CHANGE TO MEET EVOLVING CUSTOMER NEEDS; RISKS ASSOCIATED WITH SALES IN FOREIGN COUNTRIES; AND OUR ABILITY TO SUCCESSFULLY EXPAND OUR OPERATIONS.

INTRODUCTION

This discussion summarizes the significant accounting policies, accounting estimates and other significant factors affecting the liquidity, capital

resources and result of all operations for the periods ended March 31, 2002 and 2001. The discussion should be read in connection with the Consolidated Financial Statements and other financial information included in our 2001 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

We prepare our financial statements in conformity with accounting principles generally accepted in the United States of America. These accounting principles require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements. Our management is also required to make certain judgments that affect the reported amounts of revenues and expenses during the reporting period. We periodically evaluate our estimates including those relating to the allowance for doubtful accounts; inventory reserves for lower of cost or market adjustments, excess quantities and discontinued products; estimated lives and impairment of tangible and intangible long-life assets; restructuring costs; litigation and other contingencies. We base our estimates on historical experience and various other assumptions that we believe to be reasonable based on the specific circumstances, the results of which form the basis for making judgments about the carrying value of certain assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates.

We believe the following critical accounting policies impact the most significant judgments and estimates used in the preparation of our consolidated financial statements:

Revenue Recognition

We recognize revenue from product sales at the time of shipment. Revenue from services is recognized over the contract period or as services are provided. Revenue from license fees is recognized over the contract period or when received for fully-paid license agreements. These revenue accounting policies do not require significant estimates by management.

Impairment of Goodwill and Intangible Assets

Goodwill and other intangible assets that resulted from our acquisition of CyberStorage Systems in 2000 which was accounted for as a purchase, are recorded at amortized cost. We periodically review the carrying amounts of these intangible assets for indications of impairment based on the integration of the acquired technology into our product lines and market conditions for the sale of these products. If indications of impairment are present, we assess the value of the intangible assets. During 2001 and continuing into the first quarter of 2002, considerable turmoil existed in storage technology markets and the impact of overall economic conditions on introduction of our new products, signaled an indication of the potential for impairment. On the other hand, the events of September 11th created a strong focus on business continuance practices and information storage and redundancy. We have analyzed the positioning of our existing and new product technologies in our market place and concluded that there was no impairment in the value of our various intangible assets. Future events could cause us to conclude that impairment indicators exist and that intangible assets associated with acquired businesses are impaired.

Beginning in 2002, the method for assessing potential impairments of intangibles will change based on new accounting rules issued by the Financial Accounting Standards Board (FASB). The Company has not yet determined how the pronouncements will affect its future financial position and results of operations. The Company will complete its assessment of the impact of the new pronouncement in the quarter ended June 30, 2002. The new accounting rules have resulted in the elimination of the non-cash charge to our operations for

amortization of goodwill in the quarter ended March 31 2002.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific risks identified in our portfolio of receivables. If the financial condition of our customers deteriorates resulting in an impairment of their ability to make payments, or if payments from customers are significantly delayed, additional allowances might be required.

Restructuring Costs

During 2000, we recorded significant restructuring accruals in connection with the integration of our acquisition of CyberStorage Systems into our existing business. These accruals included estimated costs to settle certain contractual obligations, personnel related costs for benefit programs and redundancy, and charges related to excess inventory quantities and parts for discontinued products. The majority of our estimates were based on reasonably determinable facts and circumstances and our actual costs incurred were consistent with our estimates. During 2001 additional reserves were provided for inventories related to discontinued products.

Intellectual Property Rights, Contingencies and Litigation

We have a substantial portfolio of patents, claims and other intellectual property rights. Costs and expenses in connection with the development of and the enforcement of our rights are expensed when incurred. Certain contingent fees for legal services are due upon the receipt of license fees over contract periods or upon receipt of payment for paid-up license arrangements. We currently are in legal proceedings in connection with the enforcement of our intellectual property rights the results of which cannot be predicted. Our failure to successfully enforce our patent rights could have a material adverse effect on our business, operating results and financial condition.

In the normal course of our business, we are subject to various other proceedings, lawsuits and claims relating to product, technology, labor and other matters as further described in Part II, Item 1. Legal Proceedings. We are required to assess the likelihood of any adverse outcomes and the potential range of probable losses in these matters. The amount of loss accrual, if any, is determined after careful analysis of each matter, and is subject to adjustment if warranted by new developments or revised strategies. We believe that none of the existing matters will result in a material adverse effect on our business, operating results and financial condition.

LIQUIDITY AND CAPITAL RESOURCES

Our future success depends on maintaining adequate liquidity and working capital to meet our operational requirements. On May 3, 2002 we completed a $3,000,000 financing through a private placement of common stock to a group of four European and US based institutional investors. The Company sold 600,000 shares of common stock at $5.00 per share and issued 260,000 warrants to purchase common stock at $6.18 per share that are exercisable over a five-year period. However, given the continued volatility in the securities markets and, in particular, the securities of technology companies, we cannot assure you that continuing investors' investments will be available to us or that we will receive additional equity financing. Our failure to maintain adequate liquidity and working capital could have a material adverse impact on us.

We continue to incur operating losses in 2002. While development and introduction of our new products continues and our marketing and sales activities have increased, we have implemented cost reductions programs where

possible, primarily in employee headcount and the use of independent software contractors. Management believes that available working capital coupled with the ability for raising additional equity financing will support the Company's operating plan. We continue to evaluate opportunities for raising additional financing and believe that such will be available on reasonable terms to the Company.

CASH FLOW

Operations used $2,115,000 of cash during the first quarter of 2002 compared to $2,622,000 in the first three months of 2001.

The use of cash by operations in the first three months of 2002 resulted from the net loss for the quarter which was offset in part by net cash from changes in operating assets and liabilities, non cash charges related to depreciation and amortization and the repayment of an advance by one of our officers. The use of cash by operations in the first three months of 2001 resulted from the net loss for the quarter and net cash from changes in operating assets and liabilities, which were partially offset in part by non cash charges relating to depreciation and amortization.

Investing activities used $9,000 of cash in the first three months of 2002 primarily for the purchase of capital items offset in part by change in other assets. Investing activities generated positive cash flow of $94,000 in the first three months of 2001 from other assets partially offset by capital expenditures.

Financing activities provided $6,000 of cash in the first three months of 2002 from the proceeds of employee stock option exercises offset by scheduled payments of long-term debt. Financing activities used $59,000 of cash in the first three months of 2001 relating to scheduled payment of long-term debt partially offset by the proceeds of employee stock option exercises.

BORROWING ARRANGEMENTS

We currently have no outstanding bank loans, lines of credit, or credit facilities.

WORKING CAPITAL

Our working capital at March 31, 2002 was $5,725,000 compared with $9,126,000 at December 31, 2001. In management's opinion, our current working capital position, the availability of additional equity financing and a reduction of cash flow used by operations will be sufficient to accommodate working capital requirements through the fiscal year ending December 31, 2002.

RESULTS OF OPERATIONS

Our operating results have fluctuated in the past and may in the future fluctuate significantly, depending upon a variety of factors. After the acquisition of CyberStorage Systems Corporation in September of 2000, we commenced a corporate-wide restructuring, including the expansion of our North America sales territories to seven regions; the initiation of the plan to re-establish our re-seller sales channel; consolidation of our European sales, marketing and service organizations; implemented strategic marketing initiatives and programs for product development and repositioning. We believe these actions and the introduction of our new products in 2002 will provide the revenue growth that will enable us to return to profitability. Currently, we are experiencing

an extended cycle for receipt of new orders due to the introduction of our new sales management and staff persons, the marketing and training cycles related to the new sales staff and the introduction of our new products as well as the current economic climate for the storage sector.

Additional factors that may contribute to variability of operating results include: trends in national and world-wide economic growth or recession; the pricing and mix of products offered by us; changes in pricing of our products and services due to competitive pressures; our ability to obtain sufficient supplies of sole or limited source components; the ability to manage future growth and expansion; the continual development of new products; the ability to successfully identify, target, acquire and integrate suitable acquisitions.

REVENUE

Revenues from products and services for the three-month periods ended March 31, 2002 and 2001 were $766,000 and $2,059,400, respectively. Revenues from products and services in 2001 consists primarily of our legacy RAID products. In 2002 revenues from products and services are from our new product lines of CyerFiber that was introduced in late 2001 and CyberNAS that was introduced in the first quarter of 2002. Revenue for domestic and international products and services were approximately 75% and 25% of total revenues of products and services during both periods.

There were no revenues from license fees in the three-month periods ended March 31, 2002 and 2001.

COST OF PRODUCTS AND SERVICES

Product and service costs for the three month periods ended March 31, 2002 and 2001 were $721,700 and $1,362,600, respectively, or 94% and 66% of revenue from products and services. The increase in the cost percentage between 2001 and 2002 of approximately 28% was a direct result of decreased sales, while factory overheads and technical service costs remained relatively consistent with the same period in the prior year.

COST OF LICENSE FEES

Costs associated with the enforcement of our patent and other intellectual property rights for the periods ended March 31, 2002 and 2001 amounted to $679,100 and $41,400, respectively. These costs relate to legal and consulting fees and expenses incurred associated with the enforcement of our patent and other intellectual property rights which began to increase during the second quarter of 2001.

RESEARCH AND DEVELOPMENT

Research and development expenses for the three month periods ended March 31, 2002 and 2001 were $1,019,700 and $1,225,800, respectively. The $206,100 decrease in expenditures between the three month periods was due to the decrease in the utilization of independent software engineers and other subcontractors for short term assignments.

SELLING AND MARKETING EXPENSES

Selling and marketing expenses for the three month periods ended March 31, 2002 and 2001 were $1,016,700 and $657,900, respectively. The increase in expenses between the three month periods ended March 31, 2002 and the comparable period

of 2001 of $358,800, was principally due to the increased head count in corporate marketing and staffing of the field sales organizations.

GENERAL AND ADMINSTRATIVE EXPENSES

General and administrative expenses for the three month periods ended March 31, 2002 and 2001 were $801,500 and $699,800, respectively. The increase in general and administrative expenses between the three month periods ended March 31, 2001 and 2002 of $101,700 resulted primarily from an increase in the allowance for doubtful accounts and increased legal fees relating to equity financing and other corporate matters.

OTHER INCOME (EXPENSE)

Interest income (expense), net was $(3,257) and $111,078 for the three month periods ended March 31, 2002 and March 31, 2001, respectively. The reduction in interest income is directly related to reduced cash balances when compared to the same period last year. Interest expense has remained relatively constant during both periods.

Other income relates primarily to translation adjustments which decreased in the current period due to reduced changes in translation rates.

FACTORS THAT MAY AFFECT FUTURE RESULTS

OUR STOCK PRICE IS VOLATILE

Our stock price, like that of other technology companies, is subject to significant volatility because of factors such as:

- the announcement of new products, services or technological innovations by us or our competitors
- quarterly variations in our operating results
- changes in revenue or earnings estimates by the investment community
- speculation in the press or investment community
- failure to meet earning expectations

In addition, our stock price may be affected by general market conditions and domestic and international economic factors unrelated to our performance. Further, until recently, our common stock was thinly traded. Because of these factors, recent trends should not be considered reliable indicators of future stock prices or financial results.

OUR BUSINESS MAY SUFFER IF WE CANNOT PROTECT OUR INTELLECTUAL PROPERTY

We generally rely upon patent, copyright, trademark and trade secret laws and contract rights in the United States and in other countries to establish and maintain our proprietary rights in our technology and products. However, we cannot assure you that any of our proprietary rights will not be challenged, invalidated or circumvented. In addition, the laws of certain countries do not

protect our proprietary rights to the same extent, as do the laws of the United States. Therefore, we cannot assure you that we will be able to adequately protect our proprietary technology against unauthorized third-party copying or use, which could adversely affect our competitive position. Further, we cannot assure you we will be able to obtain licenses to any technology that it may require to conduct our business or that, if obtainable, such technology can be licensed at a reasonable cost.

INTELLECTUAL PROPERTY RIGHTS

We are aggressively pursuing the enforcement of our intellectual property rights after an extensive patent review conducted in 1999. In 2000, we retained a major law firm to enforce these rights against infringing parties, the number of which management believes to be extensive. In 2001, we began bringing legal actions against companies whose products we believed infringed on our intellectual property rights and patent portfolio. We intend to vigorously pursue these actions. Despite ours and our legal representatives' efforts, there can be no assurance or predictability as to any amount of recovery or the length of time it will take us to recover any royalties or license fees which may be recoverable. Despite our efforts to protect our intellectual property rights, unauthorized use may still occur, particularly in foreign countries.

DEVELOPMENT OF NEW PRODUCTS AND SOLUTIONS

We must make continuous investment in research and development to maintain our ongoing effort to continually improve our products and provide innovative solutions to our customers. The development of software products is a difficult and costly process and subject to many other products' requirements. Our inability to timely deliver new products in the past has had an adverse effect on our operating and financial results. There can be no assurance that we will be able to effectively develop new products in the future.

COMPETITION

We compete with many established companies in the computer storage and server industries and certain of these companies have substantially greater financial, marketing and technological resources, larger distribution capabilities, earlier access to customers and more opportunity to address customers' various information technology requirements than we do. Our business may be adversely affected by the announcement or introduction of new products by our competitors, including hardware, software and services, price reductions of our competitors' equipment or services and the implementation of effective marketing strategies by our competitors.

Competitive pricing pressures exist in the computer storage and server markets and have had and may in the future have an adverse effect on our revenues and earnings. There also has been and may continue to be a willingness on the part of certain competitors to reduce prices in order to preserve or gain market share, which we cannot foresee. We currently believe that pricing pressures are likely to continue. The relative and varying rates of product price and component cost declines could have an adverse effect on our earnings.

RAPID TECHNOLOGICAL CHANGES

The computer industry is changing both dramatically and rapidly. The development of "open systems computing", the introduction of the Internet, new fibre technologies (SAN) and the increasing storage density in disk drive technologies, have caused an increase in new product development and shorter time to bring the new products to market. While we believe that our Virtual Storage Architecture, StorageSuite and CyberBORG products are advanced when compared to competitive products, and complement many other products utilized in total customer solutions, we cannot assure you that this will continue in the

future. The failure to remain consistently ahead of competitive technologies would have a negative impact on our operating results and financial condition.

BUSINESS ALLIANCES

Many companies are forming business alliances with their competitors, to be able to provide totally integrated storage solutions to their customers. One result of these alliances is to effectively preclude competitive products from being offered to their customers. Many of the relationships are exclusive and our failure to develop similar relationships will effectively reduce the number of qualified sales opportunities we will have for our products in the future. We believe that we address this issue by our return to the reseller channel sales model and having the integrator/solution providers/value added-resellers perform the solution selling required. Our failure to open these sales channels will have a negative effect on our operating results and financial condition.

OPERATIONS

Our products operate near the limits of electronic and physical performance, and are designed and manufactured with relatively small tolerances. If flaws in design, production, assembly or testing were to occur by us or our suppliers, we could experience a rate of failure in our products that would result in substantial repair or replacement costs and potential damage to our reputation. Continued improvement in manufacturing capabilities and control of material and manufacturing quality and costs are critical factors in our future growth. We frequently revise and update manufacturing and test processes to address engineering and component changes to our products and evaluate the reallocation of manufacturing resources among our facilities. We cannot assure that our efforts to monitor, develop and implement appropriate test and manufacturing processes for our products will be sufficient to permit us to avoid a rate of failure in our products that results in substantial delays in shipment, significant repair or replacement costs and potential damage to our reputation, any of which could have a material adverse effect on our business, results of operations or financial condition.

Additionally, most companies in the high technology arena are under pressure to be able to acquire and retain the services of talented individuals. At present, there is a shortage in the number of qualified employees who are available, creating a lucrative job market for qualified and talented high tech employees. We have had a decline in revenue in each of the three previous years and comparable reduction in our work force. While we believe that we have the required core personnel to effectively manage and grow, we cannot assure you that key employees will not leave the company in the future. The failure to maintain key employees could adversely affect our future operating and financial results.

LIQUIDITY AND WORKING CAPITAL

Our future success depends on maintaining adequate liquidity and working capital to meet our operational requirements. Given the continued volatility in the securities markets and, in particular, the securities of technology companies, we cannot assure you that continuing investors' investments will be available to us and that we will receive additional equity financing. Our failure to maintain adequate liquidity and working capital could have a material adverse impact on us.

FAILURE OF SUPPLIERS TO PROVIDE QUALITY PRODUCTS

We purchase several sophisticated components and products from one or a limited number of qualified suppliers. These components and products include disk drives, high density memory components and power supplies. We have experienced delivery delays from time to time because of high industry demand or the inability of some vendors to consistently meet our quality and delivery requirements. If any of our suppliers were to fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders and have significantly decreased quarterly revenues and earnings, which would have a material adverse effect on our business, results of operations or financial condition. Additionally, we periodically transition our product line to incorporate new technologies. The importance of transitioning our customers smoothly to new technologies, along with our historically uneven pattern of quarterly sales, intensifies the risk that a supplier who fails to meet its delivery or quality requirements will have an adverse impact on our revenues and earnings.

CHANGES IN LAWS, REGULATIONS OR OTHER CONDITIONS THAT COULD ADVERSELY IMPAIR OUR CONDITION

Our business, results of operations and financial condition could be adversely affected if any laws, regulations or standards, both foreign and domestic, relating to us or our products were newly implemented or changed.

LITIGATION THAT WE MAY BECOME INVOLVED IN MAY ADVERSELY AFFECT US

In the ordinary course of business, we may become involved in litigation, administrative proceedings and governmental proceedings. Such matters can be time-consuming, divert management's attention and resources and cause us to incur significant expenses. Furthermore, we cannot assure you that the results of any of these actions will not have a material adverse effect on our business, results of operations or financial condition.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We have the market risk inherent in financial instruments that relate primarily to fluctuations in the prime rate of interest to be charged under the terms of several promissory notes due from and to certain of our executive officers and directors.

Our foreign subsidiaries' obligations to us are denominated in U.S. dollars. There is a potential for a foreign currency gain or loss based upon fluctuations between the U.S. dollar and its subsidiaries' functional currencies, currently the British pound and Eurodollars. This exposure is limited to the period between the time of accrual of such liability to us in our subsidiaries' functional currency and the time of their payment to us in U.S. dollars.

Other than the inter-company balances noted above, we do not believe we have material unhedged monetary assets, liabilities or commitments that are denominated in a currency other than the operations' functional currencies. We expect such exposure to continue until our foreign subsidiaries reach a more mature level of operation. We currently have no plans to utilize any derivative products to hedge our foreign currency risk.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

In December 2001, Marketlink Technologies, LLC filed a civil action against us in the Circuit Court for Oakland County, Michigan, alleging that we owed them a $156,000 termination payment under the terms of a manufacturers representative agreement that we terminated for cause in April 2001 because of Marketlink's inability to sell our products and perform the services required by the agreement. In January 2002, we filed counterclaims against Marketlink in this matter, including Marketlink's breach of contract. We believe the claims of Marketlink are without merit and deny all allegations. Further, we intend to vigorously defend this action. We are unable to predict and outcome but we do not believe that our involvement in final settlement of or litigation costs defending this claim will have a material effect on our business, operating results or financial condition.

In March 2001, we filed an action against XIOTech Corporation ("XIOTECH") and its parent company, Seagate Technology, Inc. ("SEAGATE INC"), in the United States District Court for the Northern District of Texas claiming that its products infringe one of our patents. In December, 2001, we settled all matters in controversy that were pending in that action against XIOTECH, SEAGATE INC., and a related company, Seagate Technology LLC ("SEAGATE LLC"). Specifically, such matters included the alleged infringement of one of our patents, namely our U.S. Patent No. 5,893,919, by XIOTECH. The settlement between XIOTECH and us includes a one-time $2,500,000 royalty payment to us by XIOTECH for a fully paid up, royalty-free, worldwide, perpetual, license covering the `919 Patent, with no right to sublicense, and a royalty free cross license agreement between XIOTECH and us for all of our respective patents. Additionally, we entered into a cross license with SEAGATE LLC providing a royalty-free, worldwide, perpetual, cross license, with no right to sublicense, between SEAGATE LLC and us for all of our patents and for all of SEAGATE LLC's storage system patents. All cross license agreements entered into include all patents of Storage Computer Corporation and XIOTECH, and all storage system patents of SEAGATE LLC, including current and later acquired patents, domestic as well as foreign. Further, the parties agreed to dismiss all claims against each other and entered into certain mutual releases covering the subject matter, from any other action that may be brought as a result of these issues. Additionally, SEAGATE LLC has agreed to withdraw its oppositions in the European Patent Office to our `287 and `494 patents.

During March 2001 we filed legal actions against Hitatchi Data Systems Limited in the United Kingdom for infringement of two of the European patents in our intellectual property portfolio. The trial date is set for June 17, 2002.

In October 2001 we filed a patent infringement action in the United States District Court for the Northern District of Texas, against Veritas Software Corporation and Veritas Software Global Corporation, alleging that certain Veritas Software Corporation storage products infringe Storage Computer's intellectual property patent number U.S. 5,893,919 entitled "Apparatus and Method for Storing Data with Selectable Data Protection Using Mirroring and Selectable Parity Inhibition." In February 2002, we filed an additional patent infringement action in the United States District Court of the Northern District of Texas, against Veritas Software Corporation and Veritas Software Global Corporation alleging that certain Veritas Software Corporation storage products infringe Storage Computer's intellectual property, specifically U.S. 5,257,367 entitled "Data Storage system with Asynchronous Host Operating System Communication Link". These actions were referred to a court appointed mediator with a mediation date in late April 2002 and such mediation has been continued to a mutually agreeable time and place, sometime in the third quarter of 2002. In March 2002, we filed a third patent infringement action against Veritas Software Corporation and Veritas Software Global Corporation alleging certain Veritas Software Corporation storage products infringe Storage Computer's

intellectual property patent number U.S. 6,098,128 entitled "Universal Storage Management System." The Storage Computer claim is for injunctive relief, damages and legal costs arising from the alleged infringement.

The outcome in the Hitachi and Veritas unresolved patent proceedings cannot possibly be predicted, but we intend to vigorously pursue the enforcement of our intellectual property rights and our claims in these actions and against other manufacturers whose products we believe infringe on our patents and intellectual property rights. Our failure to successfully enforce our patent rights could have a material adverse effect on our business, operating results and financial condition.

We are involved from time to time in various other minor legal actions in the ordinary course of our business, which we believe do not have a material adverse effect on our business, operating results or financial condition.

Item 2. Changes in Securities and Use of Proceeds.

During the quarter ended March 31, 2002 there were no changes in equity securities.

Item 3. Defaults Upon Senior Securities.

There has not been any material default in the payment of principal, interest, or any other material default not cured within 30 days with respect to any of our indebtedness during the three month period ended March 31, 2002.

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

There were no matters submitted to a vote of security holders during the three month period ended March 31, 2002.

Item 5. Other Information.

None

Item 6. Exhibits and Reports on Form 8-K.

A Exhibits

Number	Description
3.1	Certificate of Incorporation of Storage Computer Corporation dated August 23, 1991.
3.2	Certificate of Amendment of Certificate of Incorporation of Storage Computer Corporation dated February 24, 1995.
3.3	Certificate of Amendment of Certificate of Incorporation of Storage Computer Corporation dated August 15, 2001.
4.1	Registration Rights Agreement dated as of May 2, 2002 by and among Storage Computer Corporation and the purchasers named therein.
4.2	Form of warrant to purchase a total of 260,000 shares of common stock issued May 3, 2002 to the warrant holders named therein.
10.1	Securities Purchase Agreement dated as of May 2, 2002 by and among Storage Computer Corporation and the purchasers named therein.
99.1	Press release issued by Storage Computer Corporation on May 7, 2002.

B Reports On Form 8-K

In our Report on Form 8-K filed on January 16, 2002 we reported a press release providing estimates of our revenues and earnings for the fourth quarter and the year ended December 31, 2001.

In our Report on Form 8-K filed on March 26, 2002 we reported a press release giving notice and information as to the filing of an additional patent infringement action against Veritas Software Corporation.

SIGNATURE

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

STORAGE COMPUTER CORPORATION

Registrant

/s/ PETER N. HOOD

Peter N. Hood
Chief Financial Officer

Date: May 15, 2002