

LEGATO SYSTEMS INC  
Form 10-Q  
May 14, 2003  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**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 March 31, 2003

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: 000-26130

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# LEGATO SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

**Delaware**  
(State incorporation)

**94-3077394**  
(I.R.S. Employer  
Identification No.)

**2350 West El Camino Real, Mountain View, CA 94040**

(Address of principal executive offices)

**Registrant's telephone number, including area code: (650) 210-7000**

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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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

**Yes**       **No**

The number of shares outstanding of the registrant's Common Stock as of April 29, 2003 was 116,303,683.

**Table of Contents**

**LEGATO SYSTEMS, INC**

**INDEX**

**PART I FINANCIAL INFORMATION**

	<b><u>Page No</u></b>
Item 1	
Financial Statements:	
<u>Condensed Consolidated Balance Sheets as of March 31, 2003 and December 31, 2002 (unaudited)</u>	3
<u>Condensed Consolidated Statements of Operations for the three months ended March 31, 2003 and 2002 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2003 and 2002 (unaudited)</u>	5
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	6
Item 2	13
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	
Item 3	26
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	
Item 4	26
<u>Controls and Procedures</u>	
<b>PART II OTHER INFORMATION</b>	
Item 1	27
<u>Legal Proceedings</u>	
Items 2 5	27
<u>Not applicable</u>	
Item 6	27
<u>Exhibits and Reports on Form 8-K</u>	
<u>Signatures</u>	28

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****LEGATO SYSTEMS, INC.****Consolidated Balance Sheets**

(in thousands, except per share data)

	March 31, 2003	December 31, 2002
	<i>(unaudited)</i>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 65,803	\$ 54,726
Short-term investments	9,402	15,318
Accounts receivable, net	43,140	51,501
Other current assets	8,823	7,487
	<u>127,168</u>	<u>129,032</u>
Total current assets	127,168	129,032
Property and equipment, net	41,141	43,906
Intangible assets, net	27,891	30,586
Goodwill	270,709	270,709
Other assets	5,209	5,483
	<u>\$ 472,118</u>	<u>\$ 479,716</u>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Line of credit	\$ 14,620	\$ 10,550
Accounts payable	11,688	12,294
Accrued liabilities	47,027	58,314
Deferred revenue	69,675	67,956
	<u>143,010</u>	<u>149,114</u>
Total current liabilities	143,010	149,114
Deferred revenue net of current portion	2,919	2,808
	<u>145,929</u>	<u>151,922</u>
Stockholders' equity:		
Common stock and capital in excess of par, \$0.0001 par value; 116,205 and 116,136 issued and outstanding, respectively	627,312	627,067
Deferred stock compensation	(332)	(416)
Accumulated other comprehensive income	1,253	582

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Accumulated deficit	(302,044)	(299,439)
Total stockholders' equity	326,189	327,794
	<u>\$ 472,118</u>	<u>\$ 479,716</u>

See accompanying notes to these condensed consolidated financial statements.

Table of Contents

## LEGATO SYSTEMS, INC.

## Condensed Consolidated Statements of Operations

(in thousands, except per share data)

	Three Months Ended	
	March 31,	
	2003	2002
	<i>(unaudited)</i>	
Revenue:		
License	\$ 34,388	\$ 28,750
Service and support	39,623	26,881
Total revenue	<u>74,011</u>	<u>55,631</u>
Cost of revenue:		
License	1,995	1,711
Service and support	11,587	10,595
Cost of revenue	<u>13,582</u>	<u>12,306</u>
Gross profit	<u>60,429</u>	<u>43,325</u>
Operating expenses:		
Sales and marketing	33,314	31,719
Research and development	18,510	14,520
General and administrative	8,154	7,069
Amortization of intangibles	2,695	1,432
Litigation settlement charge		67,000
Total operating expenses	<u>62,673</u>	<u>121,740</u>
Loss from operations	(2,244)	(78,415)
Interest and other income (expense), net	(361)	514
Loss before benefit from income taxes	(2,605)	(77,901)
Benefit from income taxes		(31,160)
Net loss	<u>\$ (2,605)</u>	<u>\$ (46,741)</u>
Net loss per share:		
Basic and diluted	<u>\$ (0.02)</u>	<u>\$ (0.52)</u>
Weighted average common shares outstanding	<u>116,173</u>	<u>90,312</u>

See accompanying notes to these condensed consolidated financial statements.

**Table of Contents****LEGATO SYSTEMS, INC.****Condensed Consolidated Statements of Cash Flows****(in thousands)**

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
	<i>(unaudited)</i>	
<b>Cash flows from operating activities:</b>		
Net loss	\$ (2,605)	\$ (46,741)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Deferred taxes		(30,084)
Depreciation and amortization	7,382	5,225
Provision for doubtful accounts and product returns	1,100	31
Amortization of deferred stock compensation	67	
Changes in assets and liabilities:		
Accounts receivable	7,261	5,626
Other assets	(1,062)	749
Accounts payable	(606)	(1,455)
Accrued liabilities	(11,182)	57,701
Deferred revenue	1,830	(1,058)
Net cash provided by (used in) operating activities	<u>2,185</u>	<u>(10,006)</u>
<b>Cash flows from investing activities:</b>		
Purchases of available-for-sale securities		(17,036)
Maturities and sales of available-for-sale securities	6,436	10,530
Acquisition of property and equipment	(2,027)	(6,345)
Net cash provided by (used in) investing activities	<u>4,409</u>	<u>(12,851)</u>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock	262	6,673
Borrowing against line of credit	14,620	
Payment against line of credit	(10,550)	
Net cash provided by financing activities	<u>4,332</u>	<u>6,673</u>
Effect of exchange rate changes on cash	<u>151</u>	
Net change in cash and cash equivalents	11,077	(16,184)
Cash and cash equivalents at beginning of period	54,726	63,281
Cash and cash equivalents at end of period	<u>\$ 65,803</u>	<u>\$ 47,097</u>



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See accompanying notes to these condensed consolidated financial statements.

**Table of Contents**

**LEGATO SYSTEMS, INC.**

**Notes to Condensed Consolidated Financial Statements**

**(unaudited)**

**1. Basis of Presentation and Significant Accounting Policies**

*Basis of Presentation.* The accompanying unaudited consolidated financial statements have been prepared by Legato Systems, Inc. (the Company or Legato ) in accordance with the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted in accordance with such rules and regulations. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position, results of operations and cash flows of the Company and its subsidiaries. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for any future interim period or for the year ending December 31, 2003, and the Company makes no representations related thereto. These financial statements should be read in conjunction with the annual audited consolidated financial statements and notes as of and for the year ended December 31, 2002, included in the Company's Form 10-K dated February 28, 2003.

The preparation of financial statements 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, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Certain prior year financial statement balances have been reclassified to conform to the current year presentation.

*Revenue Recognition.* Revenue is derived from primarily two sources: (i) license revenue, derived from the sale of software licenses to resellers and end users, including large-scale enterprises, and royalty revenue, derived from initial license fees and ongoing royalties from licenses of source code to OEMs; and (ii) service and support revenue, derived from providing software updates, technical support, training and consulting services to our customers.

License revenue is generally recognized when a signed contract or other persuasive evidence of an arrangement exists, the software has been shipped or electronically delivered, the license fee is fixed or determinable and collection of resulting receivables is reasonably assured. Estimated product returns are recorded upon recognition of revenue from customers having rights of return, including exchange rights for unsold products and product upgrades. For sales to international distributors, license revenue is generally recognized upon meeting the criteria above and identifying their customers. For sales to domestic distributors, license revenue is recognized upon sale by the distributor to its customer. License revenue from royalty payments is recognized upon receipt of royalty reports from OEMs related to their product sales. Revenue from subscription license agreements, which include software, rights to future products and maintenance, is recognized ratably over the term of the subscription period.

Service and support revenue consists primarily of revenue received for providing software updates, technical support for software products, on-site support, consulting and training. Revenue from updates and support is recognized ratably over the term of the agreements. Revenue

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allocated to training and consulting services, or derived from the separate sales of these services, is recognized as the related services are provided.

When contracts contain multiple obligations (e.g., products, updates, technical support and other services) wherein vendor specific objective evidence exists for all undelivered elements, we account for the delivered elements in accordance with the Residual Method prescribed by Statement of Position 98-9. Any revenue related to updates or technical support in these arrangements is recognized ratably over the term of the maintenance arrangement.

*Comprehensive Loss.* Comprehensive loss includes unrealized gains (losses) on investments and reflects the effect of foreign currency translation adjustments on the accounts of our foreign operations, the impacts of which are excluded from net loss and are included in stockholders' equity.

**Table of Contents**

A summary of comprehensive loss is as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
Net loss	\$ (2,605)	\$ (46,741)
Unrealized gain (loss) on investments	91	(575)
Reclassification adjustment due to realized loss	429	
Foreign currency translation adjustments	151	
	<u>\$ (1,934)</u>	<u>\$ (47,316)</u>

*Computation of Net Income (Loss) Per Share.* Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average shares of common stock outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average shares of common stock and potential common shares outstanding during the period. Potential common shares outstanding consist of dilutive shares issuable upon the exercise of outstanding options to purchase common stock as computed using the treasury stock method. For periods in which Legato incurs a loss, potential common shares outstanding are excluded from the computation of diluted net loss per share as their effect is anti-dilutive.

Options to purchase 29.4 million shares and 20.1 million shares of common stock at a weighted average price of \$9.53 per share and \$12.14 per share were outstanding as of March 31, 2003 and 2002, respectively, but were not included in the computation of diluted net loss per share because their effect would be anti-dilutive.

*Stock-Based Compensation.* We account for stock-based employee compensation plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No significant stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net loss and net loss per share if we had applied the fair value recognition provisions of Statement of Financial Account Standard ( SFAS ) No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
Net loss as reported	\$ (2,605)	\$ (46,741)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards net of related tax effects	(9,591)	(12,648)
Net loss pro forma	<u>\$ (12,196)</u>	<u>\$ (59,389)</u>

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Basic and diluted net loss per share	as reported	\$ (0.02)	\$ (0.52)
		<u>          </u>	<u>          </u>
Basic and diluted net loss per share	pro forma	\$ (0.10)	\$ (0.66)
		<u>          </u>	<u>          </u>

**2. Restructuring Charges**

During 2002, we incurred a charge to our results of operations of \$11.7 million, related primarily to excess facilities located in Burlington, Ontario; Mountain View, California and Rockville, Maryland and to the closure of several smaller sales offices. Throughout 2002 and the first quarter of 2003, we actively pursued sub-tenants for the excess space; however, given the current excess capacity in these metropolitan areas, we had limited success in finding sub-tenants. As of March 31, 2003, accrued restructuring charges related primarily to future lease commitments, which will be paid through 2004, and to severance and benefits, which will be paid in 2003.

**Table of Contents**

The following table summarizes the restructuring activity for the first quarter of 2003 (in thousands):

	<b>Severance &amp; Benefits</b>	<b>Excess Facilities</b>	<b>Total</b>
	<u>          </u>	<u>          </u>	<u>          </u>
Balance, December 31, 2002	\$ 878	\$ 10,780	\$ 11,658
Cash payments	(814)	(1,129)	(1,943)
	<u>          </u>	<u>          </u>	<u>          </u>
Balance, March 31, 2003	\$ 64	\$ 9,651	\$ 9,715
	<u>          </u>	<u>          </u>	<u>          </u>

**3. Balance Sheet Components**

	<b>March 31, 2003</b>	<b>December 31, 2002</b>
	<u>          </u>	<u>          </u>
Accounts receivable:		
Trade accounts receivable	\$ 50,980	\$ 58,776
Allowances for doubtful accounts and product returns	(7,840)	(7,725)
	<u>          </u>	<u>          </u>
	\$ 43,140	\$ 51,501
	<u>          </u>	<u>          </u>
Property and equipment:		
Computer hardware	\$ 54,024	\$ 52,705
Computer software	27,684	27,212
Office equipment, furniture and fixtures	18,820	18,490
Leasehold improvements	14,558	14,757
	<u>          </u>	<u>          </u>
	115,086	113,164
Accumulated depreciation and amortization	(73,945)	(69,258)
	<u>          </u>	<u>          </u>
	\$ 41,141	\$ 43,906
	<u>          </u>	<u>          </u>
Accrued liabilities:		
Accrued compensation and benefits	\$ 14,751	\$ 18,369
Taxes payable	7,526	9,487
Restructuring	9,715	11,658
Other accrued liabilities	15,035	18,800
	<u>          </u>	<u>          </u>
	\$ 47,027	\$ 58,314
	<u>          </u>	<u>          </u>

**4. Legal Proceedings**

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On or about July 26, 2001, a class action lawsuit was filed in the Southern District of New York naming OTG, officers of OTG who signed the registration statement in connection with OTG's initial public offering, and the managing underwriters of the initial public offering as defendants. The complaint alleges that OTG's initial public offering registration statement and final prospectus contained material misrepresentations and/or omissions, related in part to additional, excessive and undisclosed commissions allegedly received by the underwriters from investors to whom the underwriters allegedly improperly allocated shares of the public offering. The complaint seeks relief in the form of damages and/or rescission of the plaintiff's purchase transaction. Since this initial complaint was filed, three other complaints making similar or identical allegations and seeking similar relief have been filed. All of the actions brought against OTG have been consolidated, and are being heard along with other similar actions brought against approximately 300 other issuers, issuers' officers and underwriters in the Southern District of New York. On July 19, 2002, the defendants filed a motion to dismiss the complaint. On February 19, 2003, the Court denied defendants motion with respect to the claims asserted against OTG. We intend to defend the action vigorously and believe that it is not possible at the current time to estimate the amount of a probable loss, if any, that might result from this matter.

On July 1, 2002, we received notice that an action captioned *Nickel v. Kay, et al.* had been filed in the Circuit Court for Montgomery County, Maryland. The action, brought by a former OTG employee, asserts claims that Richard Kay, OTG and Legato are liable under various legal theories for the alleged breach of Mr. Nickel's employment contract and breach of fiduciary duties allegedly owed to Mr. Nickel. The complaint alleges compensatory and punitive damages, to be proven at trial. In January 2003, the Court dismissed all claims against Legato. In March 2003, OTG settled with the plaintiff. The only remaining claims are asserted against Mr. Kay. The Company intends to work with Mr. Kay to vigorously oppose the remaining claims.

On or about November 20, 2002, we received an arbitration demand filed with the American Arbitration Association by Buro- und Datentechnik, an OTG European reseller, and BDT Products, one of its subsidiaries. The reseller alleges that OTG misrepresented information concerning the capabilities of certain OTG products, and

## Table of Contents

OTG's intentions with respect to development plans for those products. On that basis, the reseller asserts that it is entitled to damages of \$44 million, which consist primarily of alleged consequential damages in the form of lost profits. In response, on December 23, 2002, we filed a Statement of Defense and Counterclaim. We assert that the OTG products functioned as warranted, that consequential damages, including lost profits, are prohibited under the terms of the contract. Our counterclaim asserts that the reseller failed to perform its obligations to market and sell our products. We assert that if consequential damages are permitted, we seek such damages against the reseller in an unspecified amount. No estimate can be made of the possible loss or possible range of loss associated with the resolution of this contingency. Although insurance may be available to cover some portion of any potential liability, an adverse arbitration award could be materially adverse to our operating results.

On January 15, 2003, we received a notice of potential claim from the former shareholders of Intelliguard, Inc., a company purchased by Legato in April 1999. They alleged that the Company and certain of its former officers made certain misrepresentations, upon which they relied when they agreed to sell Intelliguard to the Company. After informal discussions between the parties in April 2003, the Intelliguard shareholders communicated their intention not to pursue their allegations any further.

In addition to the foregoing matters, we are parties to various other lawsuits and disputes regarding commercial and employment matters arising in the ordinary course of operations. We believe that the amounts in dispute in these other matters are insubstantial, and the effect of these matters, individually and in the aggregate, would not be material to our operating results.

## **5. Stock Option Program**

**Option Program Description.** Our stock option program is a broad-based, long-term retention program that is intended to attract and retain talented employees and align stockholder and employee interests. We consider our option program critical to our operation and productivity; essentially all of our employees participate. Of the options granted in 2002, eighty-eight percent went to employees other than the five most highly compensated officers. The program consists of one plan, which was approved by our shareholders, and is divided into three separate components:

Discretionary Option Grant Program, under which employees, non-employee Board members who are not serving on our Compensation Committee and consultants may, at the discretion of the Compensation Committee, be granted options to purchase shares of common stock;

Stock Issuance Program, under which such persons may, at the Compensation Committee's discretion, be issued shares of common stock directly, through the purchase of such shares or in consideration of the past performance of services; and

Automatic Option Grant Program, under which option grants will automatically be made at periodic intervals to eligible non-employee Board members.

The Compensation Committee of our Board has primary responsibility for administering the option program. All members of the Compensation Committee are independent directors, as defined in the applicable rules for issuers traded on The Nasdaq Stock Market. The Board has also appointed a Stock Option Committee, currently comprised of one employee-Board member, to have separate but concurrent authority under the program to make stock option grants to individuals who are not officers, vice presidents or Board members at the time of grant, up to a maximum of 30,000 shares per person. See the Report of the Compensation Committee on Executive Compensation appearing in our proxy statement dated April 30, 2003 for further information concerning the policies and procedures of the Company and the Compensation Committee regarding the use of stock options.

As of March 31, 2003, 41.0 million shares of common stock have been authorized for issuance under the 1995 Plan, of which 7.5 million were available for future grant. Options to purchase shares may be granted and shares may be issued directly under the 1995 Plan. Options must have



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an exercise price not less than 100% and 85% of fair market value of the common stock on the date of grant for incentive stock options and non-statutory stock options, respectively. The purchase price for shares issued directly may not be less than 85% of fair market value on the date of grant. Options generally vest over four years, whereby 25% of the shares become exercisable one year after the grant date and monthly thereafter over 36 months, and terminate ten years after their original grant date.

**Table of Contents**

A summary of option activity is as follows (in thousands, except per share amounts):

	Three Months Ended		Year Ended December 31,			
	March 31, 2003		2002		2001	
	Shares	Weighted Average Price	Shares	Weighted Average Price	Shares	Weighted Average Price
Outstanding at beginning of period	26,388	\$ 10.07	20,996	\$ 12.24	14,892	\$ 15.43
Options granted and assumed(1)	3,510	5.54	9,954	6.19	10,509	8.76
Options exercised	(69)	3.80	(1,087)	4.87	(1,421)	5.60
Options forfeited	(426)	11.28	(3,475)	13.67	(2,984)	19.26
Outstanding at the end of period	29,403	9.53	26,388	10.07	20,996	12.24

(1) During 2002, we assumed 3.4 million options in connection with our acquisition of OTG Software.

**Distribution and Dilutive Effect of Options.** We have a goal to keep the dilution related to our option program to an average of less than three percent annually. Accordingly, the shares reserved under this program automatically increase on the first trading day in each calendar year by the lesser of (i) the number of shares equal to 3% of the total number of shares of our common stock outstanding on December 31 of the immediately preceding calendar year or (ii) 3.0 million shares. As of January 1, 2003, 3.0 million shares were added to the shares available to grant, bringing the aggregate number of shares available for grant to 10.6 million. Because we had 7.6 million shares available at the beginning of the year, we could potentially grant more than 3% of the total number of shares of our common stock this year. The dilution percentage is calculated as the new option grants for the year, net of options forfeited by employees leaving the Company, divided by the total outstanding shares at the beginning of the year. Employee and executive option grants are as follows:

	Three Months Ended March 31, 2003	Year Ended December 31,	
		2002	2001
Net grants as a % of outstanding shares at beginning of period	2.7%	4.2%	8.4%
Grants to listed officers(2) as a percentage of total options granted		11.8	18.3
Grants to listed officers(2) as a percentage of outstanding shares		0.9	2.1
Cumulative options held by listed officers(2) as a percentage of total options outstanding at end of period	18.8	21.6	24.1

(2) See below for the listed officers; they are defined by the SEC for the proxy as the CEO and each of the four other most highly compensated executive officers.

During the first three months of 2003, we granted options to purchase 3.5 million shares of our stock to our employees, which was a net grant of options for 3.1 million shares after deducting 0.4 million shares for options forfeited. The net options granted after forfeitures represented 2.7% of our total outstanding shares of 116.1 million as of the beginning of the year. Options granted to the five most highly compensated officers as a percentage of the total options granted to all employees vary from year to year. During the first three months of 2003, no options were granted to executive officers, which is down compared to 2002 and 2001. The decrease in 2002 when compared to 2001 is a result of the fact that one

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executive officer was hired in 2001. In order to attract this executive officer, a significant initial stock grant was made. Subsequent grants are substantially less than the initial grant.

As of March 31, 2003, the In-the-Money and Out-of-the Money (3) option information is as follows (in thousands, except per share amounts):

**Table of Contents**

	Exercisable		Unexercisable		Total	
	Shares	Weighted Average Price	Shares	Weighted Average Price	Shares	Weighted Average Price
In-the-money	2,335	\$ 4.01	6,399	\$ 3.57	8,734	\$ 3.69
Out-of-the-money	11,009	14.71	9,659	8.94	20,669	12.01
	<u>13,344</u>	<u>12.84</u>	<u>16,058</u>	<u>6.80</u>	<u>29,403</u>	<u>9.53</u>

- (3) Out-of-the-money options are those options with an exercise price equal to or above the closing price of \$5.13 at the end of the quarter. Our stock price is volatile. The high, average and low closing stock price for the three months ended March 31, 2003 was \$6.59, \$5.67 and \$5.01, respectively.

**Executive Officer Options.** A Listed Officer is defined as the CEO and each of the four other most highly compensated executive officers. With the closing stock price of \$5.13 on March 31, 2003, the majority of the Listed Officers' options were under water or out-of-the-money. As of and for the three months ended March 31, 2003, options exercised and remaining holdings of the Listed Officers were as follows (in thousands):

	Shares Acquired on Exercise	Value Realized	Number of Securities Underlying Unexercised Options as of March 31, 2003		Values of Unexercised In-the-Money Options at March 31, 2003	
			Exercisable	Unexercisable	Exercisable	Unexercisable
David B. Wright		\$	1,682	1,418	\$ 83	\$ 724
David L. Beamer			256	445	19	324
Andrew J. Brown			469	491	19	324
James P. Chappell			309	196	10	205
Noah D. Mesel			71	192	7	199

**6. Recent Accounting Pronouncements**

In December 2002, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 148, Accounting for Stock Based Compensation Transition and Disclosure as Amendment to FAS 123. SFAS No. 148 provides two additional transition methods for entities that adopt the preferable method of accounting for stock based compensation. Further, the statement requires disclosure of comparable information for all companies regardless of whether, when or how an entity adopts the preferable, fair value based method of accounting. As we continue to disclose the fair value of stock option compensation only, SFAS No. 148 did not have any impact on our financial position or results of operations. The interim disclosures of SFAS No. 148 have been disclosed in Note 1.

In the first quarter of fiscal 2003, the Company adopted Financial Accounting Standards Board Interpretation No. 45 ( FIN 45 ), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 requires that a

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liability be recorded in the guarantor's balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosure about guarantees that an entity has issued, including a reconciliation of changes in the entity's product warranty liabilities. The initial recognition and measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. Our software license agreements typically provide for indemnification of customers for intellectual property infringement claims. To date, no such claims have been filed against us. We also warrant to customers that software products operate substantially in accordance with specifications. Historically, minimal costs have been incurred related to product warranties, and as such, no accruals for warranty costs have been made. The adoption of this standard did not have a material impact on our consolidated results of operations or financial position.

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a

**Table of Contents**

controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. We are evaluating the impact that the adoption of this standard will have on our consolidated financial statements.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. The standard replaces EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) and requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. The adoption of SFAS No. 146 did not impact our financial position or results of operations.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

The discussion in this report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. The statements contained in this Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements on our expectations, beliefs, intentions or strategies regarding the future, including without limitation, our financial outlook, successful introduction of new products and expansion of operation. All forward-looking statements included in this document are based on information available to us on the date hereof. We assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those indicated in such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, fluctuations in quarterly operating results, uncertainty in future operating results, competition, the current challenging information technology spending environment, litigation, product concentration, technological changes, reliance on enterprise license transactions, modifications in the application of accounting policies, reliance on indirect sales channels, changes in marketing strategies, dependence on international revenue, management of our growth and expansion, the ability to attract and retain qualified personnel, and other risks discussed in this item under the heading "Risk Factors" and the risks discussed in our other Securities and Exchange Commission filings.

**RESULTS OF OPERATIONS**

The following table sets forth, for the periods indicated, certain financial data as a percentage of total revenue:

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
	—	—
<b>Revenue:</b>		
License	46%	52%
Service and support	54	48
	—	—
Total revenue	100	100
	—	—
<b>Cost of revenue:</b>		
License	2	3
Service and support	16	19
	—	—
Total cost of revenue	18	22
	—	—
Gross profit	82	78
	—	—
<b>Operating expenses:</b>		
Sales and marketing	45	57
Research and development	25	26
General and administrative	11	13
Amortization of intangibles	4	3
Litigation settlement charges		120
	—	—

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Total operating expenses	85	219
	<u>          </u>	<u>          </u>
Loss from operations	(3)	(141)
Interest and other income, net	(1)	1
	<u>          </u>	<u>          </u>
Net loss before benefit from income taxes	(4)	(140)
Benefit from income taxes		(56)
	<u>          </u>	<u>          </u>
Net loss	(4)%	(84)%
	<u>          </u>	<u>          </u>

### Overview

We develop, market and support storage software products and services worldwide. Our solutions protect and manage information, assure the availability of applications and provide immediate access to business-critical information in distributed open systems environments. Our solutions provide enterprise level customers the business



## **Table of Contents**

continuity and operational efficiency to maintain a constant state of access to, and availability of, business-critical information. Our solutions recognize the interdependence between data and applications. Information management within an enterprise includes the protection, recovery and archiving of data, the management of performance and operation of applications, the optimization of storage devices and media including disk and tape, and the capture, organization and immediate access to content and messages. Our heterogeneous software products are mostly found in distributed, open systems which are generally understood to include UNIX, Windows NT, Windows 2000 and Linux server and storage computer systems.

*OTG Software, Inc.* On May 14, 2002, we completed our acquisition of OTG Software, Inc. ( OTG ) for cash and stock at a value of \$382.5 million. OTG, based in Rockville, Maryland, provides data management and collaboration solutions that virtualize storage for any type of data, including files, messages and databases, while providing easy and transparent access. Today, we market the OTG Software products under the XtenderSolutions® brand. The results of the operations of OTG have been included in our Consolidated Statement of Operations since May 15, 2002. At the time of the acquisition, OTG had approximately 400 employees.

## **Results of Operations**

### **Revenue**

Total revenue increased \$18.4 million, or 33%, to \$74.0 million in the first quarter of 2003 from \$55.6 million for the first quarter of 2002. Revenue associated with products acquired from OTG accounted for \$12.3 million of the increase. In addition, in the first quarter of 2003, we saw the number of transactions greater than \$0.25 million increase to 22, of which we recognized \$8.9 million, from 17, of which we recognized \$2.9 million, in the first quarter of 2002.

**License revenue.** License revenue increased \$5.6 million, or 20%, to \$34.4 million in the first quarter of 2003 from \$28.8 million in the first quarter of 2002. The revenue contribution from the OTG acquisition accounted for \$6.6 million of increased license revenue in the first quarter of 2003.

We typically sell our products with the first year of update service included, creating a multiple element arrangement. As discussed in Note 1 to the accompanying condensed consolidated financial statements, we account for these arrangements using the Residual Method, which means a portion, or potentially all, of the product sale is allocated to our update service with license fee being the remainder, or residual. Our best evidence for the value of the update service is the fees our customers are willing to pay for the update subscription when it sold separately in the second year. Therefore, as our update renewal fees increase as a percentage of product list price, the greater proportion of initial product sale is allocated to our update subscription, thereby reducing the residual amount of license fee. Compared to the first quarter of 2002, we have experienced nominal change to our average selling price for update service renewals and, hence, no material impact to license revenue.

International license revenue increased \$1.8 million, or 13%, to \$15.1 million in the first quarter of 2003 from \$13.3 million in the first quarter of 2002. We experienced more sales activity in Asia in the first quarter of 2003 compared to the same period in 2002. Overall the split between domestic and international revenue remained relatively constant in the first quarter of 2003 at 56% and 44%, respectively.

**Service and Support Revenue.** Service and support revenue increased \$12.7 million, or 47%, to \$39.6 million in the first quarter of 2003 from \$26.9 million in the first quarter of 2002. The revenue contribution from the OTG acquisition accounted for \$5.8 million of service and support

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revenue in the first quarter of 2003. Without OTG, our service and support revenue would have increased by 26%. During 2002, a greater percentage of our initial product sales were allocated to update revenue as discussed above. Because update revenue is recognized over time, we realized the cumulative effect of this increased allocation in the first quarter of 2003 when compared to the first quarter of 2002.

## Table of Contents

### **Gross Profit**

Gross profit increased \$17.1 million, or 39%, to \$60.4 million, representing 82% of total revenue, in the first quarter of 2003 as compared to \$43.3 million, representing 78% of total revenue, in the first quarter of 2002. For the remainder of 2003, we expect gross profit to be relatively unchanged at 80-82% of revenue.

Gross profit from license revenue increased \$5.3 million, or 20%, to \$32.4 million, representing 94% of license revenue, in the first quarter of 2003 from \$27 million, representing 94% of license revenue, in the first quarter of 2002. The increase in absolute dollars, and as a percentage, relates to the overall increase of license revenue. Gross profit from license revenue consists of license revenue less the related costs of product media, documentation, third-party royalties and packaging.

Gross profit from service and support revenue increased \$11.8 million, or 72%, to \$28.0 million, representing 71% of service and support revenue, in the first quarter of 2003 from \$16.3 million, representing 61% of service and support revenue, in the first quarter of 2002. The increase in absolute dollars, and as a percentage, is primarily a result of the increase in support and update revenue partially offset by increases of salaries and benefits of \$0.6 million and subcontracting of external consultants of \$0.4 million. Service and support personnel increased to 321 in 2003 from 304 in 2002. Costs of service and support revenue consist primarily of personnel-related costs incurred in providing telephone support, consulting services, and training to customers, costs of providing software updates and costs of education and consulting materials.

### **Operating Expenses**

**Sales and marketing.** Sales and marketing expenses consist primarily of salaries and commissions for sales and marketing personnel and promotional and advertising expenses. Sales and marketing expenses increased \$1.6 million, or 5%, to \$33.3 million in the first quarter of 2003 from \$31.7 million in the first quarter of 2002. The increase in sales and marketing expenses was attributable primarily to increases in salaries of \$1.9 million, facilities of \$0.6 million and information technology costs of \$0.6 million partially offset by a decrease in commission expense of \$1.5 million. Sales and marketing personnel increased to 576 in 2003 from 508 in 2002. We believe that sales and marketing expenses will decrease as a percentage of revenue.

**Research and development.** Research and development expenses consist primarily of personnel-related costs. Research and development expenses increased \$4.0 million, or 27%, to \$18.5 million in the first quarter of 2003 from \$14.5 million in the first quarter of 2002. The increase in research and development expenses was primarily attributable to increases in salaries and benefits of \$2.6 million, facilities of \$0.8 million and information technology costs of \$0.4 million. The number of research and development personnel increased to 450 in 2003 from 341 in 2002. We expect research and development expenses to decrease as a percentage of revenue and in absolute dollars.

**General and administrative.** General and administrative expenses include personnel and other costs of our finance, human resources, facilities, information systems and other administrative departments. General and administrative expenses increased \$1.1 million, or 15%, to \$8.2 million in the first quarter of 2003 from \$7.1 million in the first quarter of 2002. The increase in general and administrative expenses was primarily attributable to increases in salaries and benefits of \$0.8 million, legal fees of \$0.4 million and facilities of \$0.3 million. General and administrative personnel increased to 216 in 2003 from 200 in 2002. We believe that general and administrative expenses will decrease in absolute dollars.

**Amortization of intangibles.** Amortization of intangibles increased \$1.3 million to \$2.7 million in the first quarter of 2003 from \$1.4 million in the first quarter of 2002. The increase is a result of our purchase of certain identifiable intangible assets via the OTG Software acquisition in May 2002, which we are amortizing over five years. We expect to amortize the identifiable intangibles of \$8.1 for the remainder of 2003, \$7.9 million in 2004, \$5.0 million in 2005 and 2006 and \$1.9 million in 2007.

**Litigation Settlement Charges.** In April 2002, we settled the class action and derivative lawsuits filed in 2000 in the United States District Court for the Northern District of California and in San Mateo County Superior Court,

## Table of Contents

respectively. The settlements in the federal and state litigation called for Legato to pay a total of \$87.7 million, which includes attorneys' fees, in May 2002. Approximately \$21 million of the settlement amount was reimbursed by our corporate insurance. The settlement was recorded as a \$67 million charge to the results of operations for the quarter ended March 31, 2002.

**Interest and other income (expense), net.** Interest and other income (expense), net, primarily represents interest income from funds available for investment. Interest and other income (expense), net, was an expense of \$0.4 million in the first quarter of 2003 as compared to income of \$0.5 million in the first quarter of 2002. The decrease represents a reduction of interest income due to lower cash investment yields and overall decrease in investment balances. In addition, we realized a \$0.4 million loss from the sale of an investment in the first quarter of 2003.

**Benefit from income taxes.** During the third quarter of 2002, we established a full valuation allowance against our deferred tax assets, because we determined that it is more likely than not that all deferred tax assets will not be realized in the foreseeable future. The net operating loss and R&D credit carryovers that make up the vast majority of our deferred tax assets do not begin to expire until 2019, possibly allowing sufficient time to be utilized. Going forward, we will assess the continued need for the valuation allowance. After we have demonstrated profitability for a period of time and begin utilizing a portion of the deferred tax assets, we may reverse the valuation allowance, likely resulting in a benefit to the Consolidated Statement of Operations in some future period. At this time, we cannot reasonably estimate when this reversal might occur, if at all.

As we continue to provide a full valuation allowance, we have not received any benefit from our continued operating losses. Accordingly, the effective tax rate for the first quarter of 2003 was 0% as compared to 40% for the first quarter of 2002.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our cash, cash equivalents and investments totaled \$75.2 million as of March 31, 2003 as compared to \$70.0 million as of December 31, 2002; and our short-term liquidity (cash plus investments plus accounts receivable less line of credit less accounts payable less accrued liabilities) improved during the quarter to \$45.0 million at March 31, 2003 from \$40.4 million at December 31, 2002. Cash equivalents are highly liquid investments with original maturities of ninety days or less as of the date of purchase. Investments are debt instruments with original maturities greater than three months.

Net cash provided by operating activities was \$2.1 million in the quarter of 2003 and consisted primarily of depreciation and amortization of \$7.4 million, partially offset by the net loss of \$2.6 million and a net change in assets and liabilities of \$3.9 million. Net cash used by operating activities was \$10.0 million in the first quarter of 2002 and consisted primarily of the net loss of \$46.7 million and deferred taxes of \$30.1 million, partially offset by the net change in assets and liabilities of \$62.5 million and depreciation and amortization of \$5.2 million.

Net cash provided by investing activities was \$4.5 million in the first quarter of 2003, which resulted primarily from the net maturities of marketable securities and sales of investment of \$6.4 million, partially offset by the purchases of property and equipment of \$1.9 million. Net cash used by investing activities was \$12.9 million in the first quarter of 2002, which resulted primarily from the net purchases of marketable securities of \$6.5 million and purchases of property and equipment of \$6.3 million. The investments in property and equipment in the first quarter of 2002 were primarily for the completion of our core systems implementation that occurred in January 2002.

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Net cash provided by financing activities was \$4.3 million in the first quarter of 2003, which resulted from the net increase in line of credit of \$4.1 million and the sale of our common stock of \$0.3 million. Net cash provided by financing activities was \$6.7 million in the first quarter of 2002, which resulted from the proceeds received from the issuance of our common stock from stock option exercises and our employee stock purchase plan.

As of March 31, 2003, the only significant contractual obligations or commercial commitments consisted of our facility lease commitments and line of credit. (See Note 5 to the Notes to the Consolidated Financial Statements in our Annual Report

## **Table of Contents**

on Form 10-K for further details.) We do not have any other off-balance sheet arrangement that could significantly reduce our liquidity.

Based on our current operating plan and limited capital spending, we believe our current cash and investment balances and cash flow from the sale of stock will be sufficient to meet our working capital and capital expenditure requirements for at least the next twelve months.

## **RISK FACTORS**

*The following risk factors and other information included in this report on Form 10-Q should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem less significant also may impair our business operations. If any of the following risks actually occur, our business, operating results and financial condition could be materially and negatively affected.*

*Our quarterly operating results are volatile and are subject to macro- and microeconomic factors beyond our control.*

Our quarterly operating results have varied in the past and may vary in the future. Our quarterly operating results may vary depending on a number of factors, many of which are outside of our control, including:

- Lengthy sales cycles, particularly with enterprise license transactions;
- The dollar value of orders and the timing of when orders are received;
- Intense competition;
- Market acceptance of our new products, applications and product enhancements of our competitors;
- Price changes by us or our competitors;
- The on-going just-in-time spending practices by our customers' information technology departments;
- Our ability to develop, introduce and market new products, applications and product enhancements;
- Our ability to control, and where appropriate reduce, costs;
- Quality control of products sold;
- Delay in the recognition of revenue from enterprise license and application service provider transactions;
- Success in expanding sales and marketing programs;
- Technological changes in our customers' environments;
- The impairment of goodwill or intangibles;
- The mix of sales among our channels;
- Deferrals of customer orders in anticipation of new products, applications or product enhancements;
- Market readiness of our products for distributed computing environments;
- Changes in our strategy or that of our competitors;
- Customer budget cycles and changes in these budget cycles;
- Foreign currency and exchange rates;
- Acquisition costs or other non-recurring charges in connection with the acquisition of companies, products or technologies;
- Loss of our information technology infrastructure for a significant period of time;
- Personnel changes; and

General economic factors.

***Our future operating results are uncertain due to changing customer demand, the unpredictability of future orders and weakness in the market for storage software.***

Our historical results of operations are not necessarily indicative of our results for any future period. Expectations, forecasts and projections by others or us are by nature forward-looking statements, and it is likely that future results will vary. Forward-looking statements that were reasonable at the time made may ultimately prove to be incorrect or false. It is our general policy and practice not to update our forward-looking statements. Some investors in our securities inevitably will experience gains while others will experience losses, depending on the



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**Table of Contents**

prices at which they purchase and sell securities. Prospective and existing investors are strongly urged to carefully consider the various cautionary statements and risks set forth in this report.

We cannot predict our future revenue with any significant degree of certainty for several reasons including:

Our sales cycles vary substantially from customer to customer, in large part because we depend upon large enterprise license transactions with corporate customers. Larger sales transactions may include extended payment terms, escalating discounts, acceptance provisions or other terms that would preclude immediate revenue recognition of some or all of the license component; Revenue in any quarter is substantially dependent on orders booked and shipped in that quarter since we operate with virtually no order backlog;

We do not recognize revenue on sales to domestic distributors until the products are sold through to end-users;

The storage management market is rapidly evolving;

The on-going sluggish economy affects our end-user customers' businesses; accordingly, those customers tend to purchase information technology on a just-in-time basis;

OEM license and royalty revenue are difficult to forecast. Our royalty revenue is dependent upon product license sales by OEMs of their products that incorporate our software. Accordingly, this royalty revenue is subject to OEMs' product cycles and the general health of their businesses; these trends are also difficult for us to predict. Fluctuations in licensing activity from quarter to quarter further impact royalty revenue, because initial license fees generally are non-recurring and generally are recognized upon the signing of a license agreement;

The timing of recognition of revenue for each of the different elements of enterprise license and other large transactions (which principally consist of license, maintenance and professional services elements) can significantly affect revenue within a quarter; and Our expense levels are relatively fixed and are based, in part, on our expectations of our future revenue. Consequently, if revenue levels fall below our expectations, our net losses will increase because only a small portion of our expenses varies with our revenue.

We believe that period-to-period comparisons of our results of operations may not be meaningful and should not be relied upon as indications of future performance. Our operating results could be below the expectations of public market analysts and investors in some future quarter or quarters. Our failure to meet such expectations would likely cause the market price of our common stock to decline.

***We have recorded losses and may continue to record losses.***

We have cumulative losses, we continue to record losses, and we may incur additional losses in the future. We lost \$2.6 million for the three months ended March 31, 2003 and \$228.8 million for the year ended December 31, 2002. Our accumulated deficit was \$302.0 million as of March 31, 2003. While we achieved our second quarter of positive cash flows from operations and continued to increase deferred revenue to \$72.6 million in the first quarter of 2003, there can be no assurance that such results will result in profitability or whether these trends will continue. If we cannot achieve and sustain operating profitability or positive cash flow from operations, we may not be able to meet our working capital requirements. This would have a material adverse effect on our business financial condition and results of operations.

***We are currently subject to litigation.***

On or about July 26, 2001, a class action lawsuit was filed in the Southern District of New York naming OTG, officers of OTG who signed the registration statement in connection with OTG's initial public offering, and the managing underwriters of the initial public offering as defendants. The complaint alleges that OTG's initial public offering registration statement and final prospectus contained material misrepresentations and/or omissions, related in part to additional, excessive and undisclosed commissions allegedly received by the underwriters from investors to whom

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the underwriters allegedly improperly allocated shares of the public offering. The complaint seeks relief in the form of damages and/or rescission of the plaintiff's purchase transaction. Since this initial complaint was filed, three other complaints making similar or identical allegations and seeking similar relief have been filed. All of the actions

## **Table of Contents**

brought against OTG have been consolidated, and are being heard along with other similar actions brought against approximately 300 other issuers, officers and underwriters in the Southern District of New York. On July 19, 2002, the defendants filed a motion to dismiss the complaint. On February 19, 2003, the Court denied defendants motion with respect to the claims asserted against OTG. We intend to defend the action vigorously and believe that it is not possible at the current time to estimate the amount of a probable loss, if any, that might result from this matter.

On July 1, 2002, we received notice that an action captioned *Nickel v. Kay, et al.* had been filed in the Circuit Court for Montgomery County, Maryland. The action, brought by a former OTG employee, asserts claims that Richard Kay, OTG and Legato are liable under various legal theories for the alleged breach of Mr. Nickel's employment contract and breach of fiduciary duties allegedly owed to Mr. Nickel. The complaint alleges compensatory and punitive damages, to be proven at trial. In early January 2003, the Court dismissed all claims against Legato. In March 2003, OTG settled with the plaintiff. The only remaining claims are asserted against Mr. Kay. The Company intends to work with Mr. Kay to vigorously oppose the remaining claims.

On or about November 20, 2002, we received an arbitration demand filed with the American Arbitration Association by Buro- und Datentechnik, an OTG European reseller, and BDT Products, one of its subsidiaries. The reseller alleges that OTG misrepresented information concerning the capabilities of certain OTG products, and OTG's intentions with respect to development plans for those products. On that basis, the reseller asserts that it is entitled to damages of \$44 million, which consist primarily of alleged consequential damages in the form of lost profits. In response, on December 23, 2002, we filed a Statement of Defense and Counterclaim. We assert that the OTG products functioned as warranted, that consequential damages, including lost profits, are prohibited under the terms of the contract. Our counterclaim asserts that the reseller failed to perform its obligations to market and sell our products. We assert that if consequential damages are permitted, we seek such damages against the reseller in an unspecified amount. Although insurance may be available to cover some portion of any potential liability, an adverse arbitration award could be materially adverse to our operating results.

On January 15, 2003, we received a notice of potential claim from the former shareholders of Intelliguard, Inc., a company purchased by Legato in April 1999. They alleged that the Company and certain of its former officers made certain misrepresentations, upon which they relied when they agreed to sell Intelliguard to the Company. After informal discussions between the parties in early April 2003, the Intelliguard shareholders communicated their intention not to pursue their allegations any further.

In addition to the foregoing matters, we are parties to various other lawsuits and disputes regarding commercial and employment matters arising in the ordinary course of operations. We believe that the amounts in dispute in these other matters are insubstantial, and the effect of these matters, individually and in the aggregate, would not be material to our operating results.

***Our competitors include several very large technology companies that have greater cash resources and larger sales and marketing than ours.***

We operate in the enterprise storage management market, which is intensely competitive, highly fragmented and characterized by rapidly changing technology and evolving standards. Competitors vary in size and in the scope and breadth of the products and services offered. Our competitors include, but are not limited to, Commvault, Computer Associates, EMC, Fujitsu-Siemens, Hewlett Packard, Hitachi, IBM, Sun Microsystems and Veritas. We expect to encounter new competitors as we enter new markets. In addition, many of our existing competitors are broadening their platform coverage. We also expect increased competition from systems and network management companies, especially those that have historically focused on the mainframe market and are broadening their focus to include the client/server computer market. In addition, since there are relatively low barriers to entry in the software market, we expect additional competition from other established and emerging companies. We also expect that competition will increase as a result of future software industry consolidations. Increased competition could harm us by causing, among other things, price reductions, reduced gross margins and loss of market share.

Many of our current and potential competitors have longer operating histories and have substantially greater financial, technical, sales, marketing and other resources, as well as greater name recognition and a larger customer base than we have. As a result, certain current and potential competitors can respond more quickly to new or

## **Table of Contents**

emerging technologies and changes in customer requirements. They can also devote greater resources to the development, promotion, sale and support of their products. In addition, current and potential competitors may establish cooperative relationships among themselves or with third parties. If so, new competitors or alliances among competitors may emerge and rapidly acquire significant market share. In addition, network operating system vendors could introduce new or upgraded operating systems or environments that include functionality offered by our products. If so, our products could be rendered obsolete and unmarketable. For all the foregoing reasons, we may not be able to compete successfully, which would seriously harm our business, operating results and financial condition.

*We depend on our NetWorker product line, which comprises a large majority of our sales and is subject to significant competition.*

We currently derive, and expect to continue to derive, a substantial majority of our revenue from our NetWorker software products and related services. A decline in the price of, or demand for, NetWorker, or failure to build and sustain broad market acceptance of NetWorker, would seriously harm our business, operating results and financial condition. We cannot reasonably predict NetWorker's remaining life for several reasons, including:

The effect of new products, applications or product enhancements;  
Technological changes in the network storage management environment in which NetWorker operates; and  
Future competition.

*Our business significantly depends on the acceptance of open system environments such as UNIX, Microsoft Windows and Linux operating systems to run computer networks, and a decrease in their rates of acceptance could cause our revenues to decline.*

For the foreseeable future, we expect a substantial majority of our revenues to continue to come from sales of our Microsoft Windows-based data storage software products. As a result, we depend on the growing use of Windows-based operating systems for computer networks. If the deployment of Windows-based operating systems does not increase as we anticipate, or if it decreases, our revenues could decline. In addition, if users do not accept future Windows-based operating systems, or if there is a wide acceptance of other existing or new operating systems, including Microsoft products, our business would suffer.

Future Windows-based operating systems may not gain market acceptance. In addition, users of previous versions of Windows-based operating systems may decide to migrate to another operating system. We have expended significant resources on the development of Windows-compatible versions of our product suite and our future success depends upon sales of this product suite. If users of Windows-based networks do not widely adopt and purchase our products, our revenue and business would suffer.

We expect the percentage of our revenues attributable to UNIX- and Linux-based products to increase over time. We have expended significant resources developing and acquiring technology to make UNIX- and Linux compatible versions of our products. If users of UNIX and Linux networks do not widely adopt and purchase our products our revenue and business would suffer.

*Although we continue to introduce new products, we must respond to technological changes and competition with new product offerings.*

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The markets for our products are characterized by rapid technological change, changing customer needs, frequent new software product introductions and evolving industry standards. The introduction of products embodying new technologies and the emergence of new industry standards could render our existing products obsolete and unmarketable. In particular, our content management and messaging management offerings compete in markets where new standards continue to be introduced and to evolve. To be successful, we need to develop and introduce new software products on a timely basis that keep pace with technological developments and emerging industry standards and address the increasingly sophisticated needs of our customers. In addition, we need to continue to integrate into our product lines the technologies of products we acquired through the acquisition of OTG

## **Table of Contents**

Software completed in May 2002. We may fail to develop and market new products that respond to technological changes or evolving industry standards, experience difficulties that could delay or prevent the successful development, introduction and marketing of these new products or fail to develop new products that adequately meet the requirements of the marketplace or achieve market acceptance. If so, our business, operating results and financial condition would be seriously harmed.

We have introduced several new products during 2002, including OpenVMS, zSeries for NetWorker and NetWorker Operations, and currently plan to introduce and market several more potential new products and major revisions to existing products in the next twelve months. Some of our competitors currently offer products analogous to certain of these products. Such potential new releases are subject to significant technical risks. We may fail to introduce such releases on a timely basis or at all. In the past, we have experienced delays in the commencement of commercial shipments of some of our new products. Such delays caused customer frustrations and delay of, or loss of, revenue. If potential new products are delayed or do not achieve market acceptance, our business, operating results and financial condition would be seriously harmed. In the past, we have also experienced delays in purchases of our products by customers anticipating our launch of new products. Our business, operating results and financial condition would be seriously harmed if customers defer material orders in anticipation of new product introductions.

*Our products are inherently complex; they may contain undetected errors, as has occurred in the past.*

Software products as complex as those we offer are likely to contain errors or failures that are initially undetected when the product is first introduced or as new versions are released. We have in the past discovered software errors in certain of our new products after their introduction. As a result of those errors, we experienced delays or lost revenue during the period required to correct these shipments, despite testing by us and by our current and potential customers. In addition, customers have in the past brought to our attention bugs in our software created by the customers' unique operating environments. Although we have been able to fix such software bugs in the past, we may not always be able to do so. These types of circumstances may result in the loss of, or delay in, market acceptance of our products or increase the need for additional customer support personnel, which could seriously harm our business, operating results and financial condition.

*Defects in our products would harm our business.*

Our products are used to manage data critical to organizations. As a result, the licensing and support of products we offer entail the risk of product liability claims. Although we generally include provisions in our license agreements that are intended to limit our liability, and routinely purchase errors and omissions insurance to mitigate our risk exposure, a successful product liability claim brought against us could seriously harm our business, operating results and financial condition.

*We rely on enterprise license transactions, which vary greatly in number of licenses, types of services, total price and other material terms; thus revenue from such transactions is difficult to predict.*

We have developed strategies to pursue larger enterprise license transactions with corporate customers. However, we may not continue to successfully market our products through larger enterprise license transactions. Such failure would seriously harm our business, operating results and financial condition. In addition, many of the large organizations that we target as customers have lowered their rate of spending on enterprise software. Our operating results are sensitive to the timing of such orders. Such orders are difficult to manage and predict because:

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The sales cycle is typically lengthy, generally lasting three to nine months, and varies substantially from transaction to transaction;  
Enterprise license transactions often include multiple elements such as product licenses and service and support;  
Recognition of revenue from enterprise license transactions may vary from transaction to transaction;  
These transactions typically involve significant technical evaluation and commitment of capital and other resources;  
A large number of our direct-license customers are located outside the United States, where the sales cycle can be lengthier than transactions negotiated within the United States;



## **Table of Contents**

Our customers are being more deliberate about information technology spending decisions due to the current state of the overall economy; and

Customers' internal procedures frequently cause delays in orders. Such internal procedures include approval of large capital expenditures, implementation of new technologies within their networks and testing new technologies that affect key operations.

Due to the large size of enterprise transactions, if orders forecasted for a specific transaction for a particular quarter are not realized in that quarter, our operating results for that quarter may be seriously harmed.

*We rely on indirect sales channels such as distributors, systems integrators and value-added resellers; it is very difficult for us to predict their quarterly or annual sales of Legato products.*

We rely, and will continue to rely, significantly on our distributors, systems integrators and value-added resellers, or collectively, resellers, for the marketing and distribution of our products. Our agreements with resellers are generally not exclusive and in many cases may be terminated by either party without cause. Many of our resellers carry product lines that are competitive with ours. These resellers may not give a high priority to the marketing of our products. Rather, they may give a higher priority to other products, including the products of competitors, or may not continue to carry our products. Events or occurrences of this nature could seriously harm our business, operating results and financial condition. In addition, we may not be able to retain any of our current resellers or successfully recruit new resellers. Any such changes in our distribution channels could seriously harm our business, operating results and financial condition.

Our strategy is also to increase the proportion of our customers licensed through OEMs. We may fail to achieve this strategy. We are currently investing, and will continue to invest, resources to develop this channel. Such investments, if not successful, could seriously harm our operating margins. We depend on our OEMs' abilities to develop new products, applications and product enhancements on a timely and cost-effective basis that will meet changing customer needs and respond to emerging industry standards and other technological changes. Our OEMs may not effectively meet these technological challenges. These OEMs are not within our control, may incorporate the technologies of other companies in addition to, or to the exclusion of, our technologies, and are not obligated to purchase products from us. Our OEMs may not continue to carry our products. The inability to recruit, or the loss of, important OEMs could seriously harm our business, operating results and financial condition.

*Our original equipment manufacturers could choose to compete with us or with each other, which could harm our business.*

Our original equipment manufacturers, value-added resellers and distributors could, and in some cases already do, choose to develop their own data storage management products and incorporate those products into their systems or product offerings in lieu of our products. In addition, the original equipment manufacturers that we do business with may compete with one another. To the extent that one of our original equipment manufacturer customers views the products we have developed for another original equipment manufacturer as competitive, it may decide to stop doing business with us, which could harm our business.

*Overlapping sales efforts may lead to inefficiencies and may adversely affect our relationships with those who sell our products.*

Our original equipment manufacturers, value-added resellers, distributors and direct sales force might target the same sales opportunities, which could lead to an inefficient allocation of sales resources. This would result in us marketing similar products to the same end-users. These overlapping sales efforts could also adversely affect our relationships with our original equipment manufacturers, value-added resellers,

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distributors and other sales channels and result in them being less willing to market our products aggressively, and could compromise margins on products we sell directly.

*We depend on revenue from outside the United States, where sales cycles are longer, there are currency risks and there exist a number of local factors that could negatively affect sales.*

## **Table of Contents**

Our continued growth and profitability will require further expansion of our international operations. To expand international operations successfully, we must establish additional foreign operations, hire additional personnel and recruit additional international resellers. This will require significant management attention and financial resources and could seriously harm our operating margins. If we fail to further expand our international operations in a timely manner, our business, operating results and financial condition could be seriously harmed. In addition, we may fail to maintain or increase international market demand for our products. Most of our international sales are currently denominated in U.S. dollars. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and, therefore, potentially less competitive in those markets. In some markets, localization of our products and license documents is essential to achieve or increase market penetration. We may incur substantial costs and experience delays in localizing our products and license language. We also may fail to generate significant revenue from localized products.

Additional risks inherent in our international business activities generally include:

- Significant reliance on our distributors and other resellers who do not offer our products exclusively;
- A shift in the strength of foreign currencies, principally the Euro, relative to the U.S. Dollar
- Unexpected changes in regulatory requirements;
- Tariffs and other trade barriers;
- Lack of acceptance of localized products, if any, in foreign countries;
- Longer negotiation and accounts receivable payment cycles;
- Difficulties in managing international operations;
- Potentially adverse tax consequences, including restrictions on the repatriation of earnings;
- The burdens of complying with a wide variety of multiple local, country and regional laws; and
- The risks related to the current weakness in some regions, including, without limitation, Europe and Asia.

The occurrence of such factors could seriously harm our international sales and, consequently, our business, operating results and financial condition.

***We depend on growth in the enterprise data storage market, and currently we cannot accurately predict sales trends in that market.***

The overwhelming majority of our business is in the enterprise data storage market. The enterprise data storage management market remains maturing and dynamic. Our future financial performance will depend in large part on continued growth in the number of organizations adopting company-wide storage and management solutions for their client/server computing environments. The market for enterprise storage management may not continue to grow at historic rates, or at all. If this market fails to grow, or grows more slowly than we currently anticipate, and we are unable to capture market share from our competitors, our business, operating results and financial condition would be seriously harmed.

***We are affected by general economic and market conditions.***

Segments of the computer industry experience from time to time significant economic downturns characterized by decreased product demand, product overcapacity, price erosion, work slowdowns and layoffs. Our operations may experience substantial fluctuations from period-to-period as a consequence of such industry trends, general economic conditions affecting the timing of orders from major customers and other factors

affecting capital spending. The occurrence of such factors could seriously harm our business, operating results or financial condition.

*Our revenue recognition could be impacted by the unauthorized, and potentially improper, actions of our personnel.*

The recognition of our revenue depends on, among other things, the terms negotiated in our contracts with our customers. Our personnel may act outside of their authority and negotiate additional terms without our knowledge. We have implemented policies to prevent and discourage such conduct, but there can be no assurance that such policies will be followed. For instance, in the event that our sales personnel have negotiated terms that do not appear in the contract and of which we are unaware, whether the additional terms are written or verbal, we could be

## **Table of Contents**

prevented from recognizing revenue in accordance with our plans. Furthermore, depending on when we learn of unauthorized actions and the size of transactions involved, we may have to restate revenue for a previously reported period, which would seriously harm our business, operating results and financial condition.

*We rely on our sales personnel, who may be difficult to retain, thereby disrupting our business.*

In the past, we have experienced significant voluntary resignations in our sales force, including some of our senior level sales employees, and may experience such turnover again. Our future success depends on our continuing ability to attract and retain highly qualified sales personnel. Competition for such personnel remains intense, and we may fail to retain our sales personnel or attract, assimilate or retain other highly qualified sales personnel in the future. Any further disruption to our sales force could seriously harm our business, operating results and financial condition.

*We rely on our key personnel for the successful execution of our business strategy.*

Our future performance depends on the continued service of our key technical, sales and senior management personnel. Most of our technical and sales personnel are not bound by employment agreements. The loss of the services of one or more of our key employees could seriously harm our business, operating results and financial condition.

Our future success also depends on our continuing ability to attract and retain highly qualified technical, sales and managerial personnel. Despite recent weakness in the economy, competition for such highly qualified personnel remains intense, and we may fail to retain our key technical, sales and managerial employees or attract, assimilate or retain other highly qualified technical, sales and managerial personnel in the future.

*If we make unprofitable acquisitions or are unable to successfully integrate any acquisition, our business would suffer.*

We have in the past, and may in the future, acquire businesses, products or technologies that we believe compliment or expand our existing business. In furtherance of this strategy, we acquired OTG Software, Inc, a data storage software company based in Rockville, Maryland, in May 2002. Our ability to achieve favorable results in 2003 and beyond will be dependent in part upon our ability to continue to successfully integrate the people, products and business lines of our acquisitions. In addition, we will need to work with our acquired companies' customers and business partners to expand relationships based upon the broader range of products and services available from us. In some instances, we may need to discontinue relationships with business partners whose interests are no longer aligned with ours. We must accomplish the synergies we identified during the acquisition process. Failure to execute on any of these elements of the integration process could seriously harm our business, operating results or financial condition.

We cannot ensure that any acquisitions or acquired businesses, products or technologies associated therewith will generate sufficient revenue to offset the associated costs of the acquisitions or will not result in other adverse effects. Moreover, from time to time, we may enter into negotiations for the acquisition of businesses, products or technologies but be unable or unwilling to consummate the acquisitions under consideration. This could cause significant diversion of managerial attention and out of pocket expenses to us. We could also be exposed to litigation as a result of an acquisition, including claims that we failed to negotiate in good faith, misappropriated confidential information or other claims.

*Our investment in goodwill and intangibles resulting from our acquisitions could become impaired.*

As of March 31, 2003, we had goodwill of \$270.7 million and acquired intangibles of \$27.9 million on our Consolidated Balance Sheet. To the extent we do not generate sufficient cash flows to recover the net amount of the goodwill and intangibles recorded, the goodwill and intangibles could be subsequently written-off. In such event, our results of operations in any given period could be negatively impacted, and the market price of our stock could decline. We expect to amortize identifiable intangibles of \$8.1 million in the remainder of 2003, \$7.9 million in 2004, \$5.0 million in 2005 and 2006 and \$1.9 million in 2007.

## **Table of Contents**

***Protection of our intellectual property is limited by the nature of the applicable law, and any misuse of our intellectual property by third parties could negatively affect our revenue and potentially result in litigation.***

Our success depends significantly upon proprietary technology. To protect our proprietary rights, we rely on a combination of patents, copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions. We seek to protect our software, documentation and other written materials under patent, trade secret and copyright laws, which afford only limited protection. Despite this limited protection, any issued patent may not provide us with any competitive advantages or may be challenged by third parties or the patents of others may seriously impede our ability to do business. We may also develop proprietary products or technologies that cannot be protected by patent law.

Despite our efforts to protect our proprietary rights, we are aware that unauthorized parties have attempted to transfer licenses to third parties, use our software without proper licenses, copy aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use and transfer of our products is difficult, and software piracy can be expected to be a persistent problem. In licensing our products, other than in enterprise license transactions, we rely on shrink wrap licenses that are not signed by licensees. Such licenses may be unenforceable, in whole or in part, under the laws of certain jurisdictions. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States. Our means of protecting our proprietary rights may not be adequate. Our competitors may independently develop similar technology, duplicate our products or design around patents issued to us or other intellectual property rights of ours.

From time to time, we have received claims that we are infringing on third parties' intellectual property rights. In the future, we may be subject to claims of infringement by third parties with respect to current or future products, trademarks or other proprietary rights. We expect that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require us to enter into royalty or licensing agreements with third parties. If such royalty or licensing agreements are not available on terms acceptable to us, our business, operating results and financial condition could be seriously harmed.

***Our trading price is volatile generally due to fluctuations in our business, in our industry and the stock market.***

The trading of our common stock historically has been highly volatile, and we expect that the price of our common stock will continue to fluctuate significantly in the future. An investment in our common stock is subject to a variety of significant risks, including, but not limited to the following:

- Quarterly fluctuations in financial results or results of other software companies;
- Changes in our revenue growth rates or our competitors' growth rates;
- Announcements that our revenue or income are below analysts' expectations;
- Changes in analysts' estimates of our performance or industry performance;
- Announcements of new products by our competitors or by us;
- Announcements of disappointing financial results from our competitors, strategic allies or major end users;
- Developments with respect to our patents, copyrights or proprietary rights or those of our competitors;
- Sales of large blocks of our common stock;

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Acquisitions or dispositions of our common stock by corporate officers or members of the Board of Directors;  
Unsubstantiated rumors in the marketplace regarding products and business plans;  
Conditions in the financial markets in general;  
Litigation; and  
General business conditions and trends in the distributed computing environment and software industry.

In addition, the stock market may experience extreme price and volume fluctuations, which may affect the market price for the securities of technology companies without regard to their operating performance or any of the factors listed above. These broad market fluctuations may seriously harm the market price of our common stock.



**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Interest Rate Risk.** Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. While we are exposed with respect to interest rate fluctuations in many countries, our interest income is most sensitive to fluctuations in the general level of U.S. interest rates. In this regard, changes in the U.S. interest rates affect the interest earned on our cash, cash equivalents and investments. We invest in high quality credit issuers and, by policy, limit the amount of our credit exposure to any one issuer. As stated in our policy, our first priority is to reduce the risk of principal loss. Consequently, we seek to preserve our invested funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in only high quality credit securities that we believe to be low risk and by positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer or guarantor. The portfolio includes only marketable securities with active secondary or resale markets to ensure portfolio liquidity.

The table below presents the carrying value and related weighted average interest rates for our investments in marketable securities as of March 31, 2003 (dollars in millions).

	<u>Carrying Value</u>	<u>Interest Rate</u>
Investments fixed rate	\$ 9.4	4.6%
Cash equivalents:		
Variable rate	24.0	0.9
	<u>\$ 33.4</u>	<u>1.9</u>

**Foreign Currency Risk.** As a global concern, we face exposure to adverse movements in foreign currency exchange rates. This exposure may change over time as business practices evolve and could seriously harm our financial results. Substantially all of our international sales are currently denominated in U.S. dollars and Euros. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore, reduce the demand for our products. Reduced demand for our products could seriously harm our financial results. Currently, we do not hedge against any foreign currencies and, as a result, could incur unanticipated gains or losses.

**ITEM 4. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-14(c) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act), within 90 days of the filing date of this report. Based on their evaluation, our principal executive officer and principal financial officer concluded that Legato's disclosure controls and procedures are effective. There have been no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

**Table of Contents**

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

Information concerning legal proceedings is incorporated herein by reference to Note 4 of the condensed consolidated financial statements in Part I of this Form 10-Q.

**ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS**

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

**ITEM 5. OTHER INFORMATION**

Not applicable.

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.**

(a) Exhibits:

10.1

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	Retention Bonus Agreement between Legato and David B. Wright dated January 20, 2003.
10.2	Retention Bonus Agreement between Legato and David L. Beamer dated January 20, 2003.
10.3	Retention Bonus Agreement between Legato and James P. Chappell dated January 20, 2003.
10.4	Form of Retention Bonus Letter Agreement Addendum between Legato and each of David B. Wright, David L. Beamer and James P. Chappell dated January 23, 2003.
10.5	Retention Bonus Agreement between Legato and Andrew J. Brown dated January 20, 2003.
10.6	Employment Agreement between Legato and Noah D. Mesel dated September 13, 2002.
10.7	Amendment to Employment Agreement between Legato and Noah D. Mesel dated September 13, 2002.
10.8	Transition Bonus Agreement between Legato and Noah D. Mesel dated January 20, 2003.
10.9	Employment Agreement between Legato and Cory J. Sindelar dated September 13, 2002.
10.10	Amendment to Employment Agreement between Legato and Cory J. Sindelar dated September 13, 2002.
10.11	Transition Bonus Agreement between Legato and Cory J. Sindelar dated January 20, 2003.
99.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K: None.

Table of Contents

**SIGNATURES**

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES EXCHANGE ACT OF 1934, THE REGISTRANT HAS DULY CAUSED THIS REPORT TO BE SIGNED ON ITS BEHALF BY THE UNDERSIGNED THEREUNTO DULY AUTHORIZED.

LEGATO SYSTEMS, INC.

By: /s/ Andrew J. Brown

Andrew J. Brown

Executive Vice President, Finance and  
Chief Financial Officer

By: /s/ Cory J. Sindelar

Cory J. Sindelar

Vice President, Corporate Controllers and  
Principal Accounting Officer

Date: May 14, 2003

**Table of Contents**

**CHIEF EXECUTIVE OFFICER CERTIFICATION**

I, David B. Wright, certify that:

1. I have reviewed this report on Form 10-Q of Legato Systems, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this quarterly report fairly present in all material respects the financial condition, results of operations, and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13c-14 and 15d-4) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize, and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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/s/ David B.  
Wright

By: \_\_\_\_\_  
David B. Wright  
Chairman and Chief  
Executive Officer

May 14, 2003

**Table of Contents**

**CHIEF FINANCIAL OFFICER CERTIFICATION**

I, Andrew J. Brown, certify that:

1. I have reviewed this report on Form 10-Q of Legato Systems, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this quarterly report fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13c-14 and 15d-4) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize, and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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/s/ Andrew J.  
Brown

By: \_\_\_\_\_  
Andrew J. Brown

Executive Vice  
President and

Chief Financial  
Officer

May 14, 2003