LEGATO SYSTEMS INC
Form 10-K
February 28, 2003
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2002

¨ **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: 0-26130

LEGATO SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-3077394**
(State of incorporation)	**(I.R.S. Employer Identification No.)**

2350 West El Camino Real

Mountain View, California 94040

(Address of principal executive offices)

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(650) 210-7000

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Preferred Share Purchase Rights

Common Stock, $0.0001 par value

(Title of each class)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

The aggregate market value of the voting stock held by non-affiliates of the registrant on June 30, 2002, the last day of the registrant s second fiscal quarter, was approximately $380 million. Shares of Common Stock held by each officer and director have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No ¨

The number of shares outstanding of the registrant s common stock as of January 31, 2003 was 116,163,918.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive proxy statement (the Proxy Statement) relating to its annual meeting of stockholders to be held in 2003 are incorporated by reference into Part III of this Annual Report on Form 10-K. Except as expressly incorporated by reference, the registrant s Proxy Statement shall not be deemed to be part of this report.

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LEGATO SYSTEMS, INC.

FORM 10-K ANNUAL REPORT

FOR THE YEAR ENDED

DECEMBER 31, 2002

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PART I

ITEM 1. BUSINESS

The discussion in this report on Form 10-K 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 operations. In some cases, forward-looking statements can be identified by terminology such as may, will, should, would, expect, plan, anticipate, believe, estimate, predict, potential, continue or the negatives of these or other comparable terminology. 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, litigation, competition, product concentration, technological changes, reliance on enterprise license transactions, 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.

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 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 archive 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.

Gartner Group, an independent information technology research firm, estimates that customer demand will increase the size of the storage software market from $4.9 billion in 2002 to $8.6 billion in 2006, with a year-over-year growth rate ranging from 11% in 2003 to 17.8% in 2006.

OTG Software Acquisition

On May 14, 2002, we acquired OTG Software, Inc. (OTG). OTG 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.

What Customers Require for Information Management

Our customers are Global 2000 companies that typically use a combination of UNIX, Windows and Linux server systems to support their enterprise operations in large centralized data centers, regional data centers, and remotely located branch offices. Centralized and regional data centers manage data and applications that support the business-critical functions of a company, including financial records and reporting, customer support and service, human resources and sales and marketing activities. Branch offices are frequently connected to data centers by wide-area networks to exchange daily revenue reports and other types of business-critical data. Increasingly, businesses are also relying on Internet and Intranet capabilities to support communications and operations within a company, to support business-to-business operations among partners and to support e-commerce business directly with customers.

Within this complex environment, converging business trends are combining to put significant pressure on the information technology resources supporting the business. The challenges facing our customers are severe:

- Many Global 2000 businesses are doubling their data every year.
- Many Global 2000 businesses are becoming more and more global in their operations, which means that applications and data must be available all of the time.
- Businesses cannot find, hire or train enough skilled administrators to manage and protect all of the new storage devices, servers, network connections, data and applications that are required each year.
- Information technology managers are faced with decreasing capital budgets.
- Stronger enforcement of retention policy and demand for instant access to information from regulatory agencies are bringing renewed attention to current information technology policies at the corporate board and executive management level.

Expanding Data Growth. The rate of data growth is increasing due to the competitive requirements of running a global business. The need for more and quicker access to information is causing companies to deploy many new types of applications. New applications generate new data. Newer applications generally include media-rich formats, which mean that they are generating larger quantities of data than ever before.

Complex, Global Information Technology Environments. The need for new applications and data creates an increased demand for more server systems and greater capacity storage devices, all of which must be managed, interconnected with networks, and kept available. Moreover, business operations are becoming more and more global and taking advantage of Internet and Intranet technologies to support company communications, business-to-business operations, and e-commerce business. Global businesses require global information technology infrastructures, and these infrastructures need to be managed and available around the clock.

The Effect of Labor Shortage on Information Technology Organizations. Gartner Group, IDC and other independent information technology research firms report that a worldwide labor shortage continues to exist for people who are experienced and skilled in information technology disciplines. This includes the people required to manage and protect expanding data and application resources that are critical to delivering information to business users.

Tighter Budgets, Higher Service Levels. Information technology managers need to provide higher levels of service to their business operations, which necessitates implementing more complex information technology environments. But these managers must somehow manage the complex environments with the same resources that they have had in the past. In addition, information technology managers require reduced total cost of ownership, long term data retention, high performance, scalability, application integration and ease of management. These competing requirements are creating a demand for storage management software that enables customers to manage more data and applications with less effort and expense.

Increased Scrutiny of Corporate Retention Policies. Record retention is becoming more and more important to corporations. Enterprise applications like email, Customer Relationship Management (CRM) or Enterprise Resource Planning (ERP) generate large quantities of information and often burden the primary storage devices the information is stored on. Email applications alone are forecasted to consume up to 230 petabytes of storage in 2003 according to a Merrill Lynch and McKinsey & Company study published in 2001. In addition, the information that these enterprise applications generate must be readily accessible and

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available if requested by regulatory officials, like the Securities and Exchange Commission (SEC), NASD or external auditors. These scenarios are requiring information technology managers to find ways to provide integrated storage management solutions, and are part of the reason that the hierarchical storage management and archiving segment of the storage management market is growing at an 18.5% compounded annual growth rate, or CAGR, through 2006, according to Gartner Group. In addition, IDC forecasts that the worldwide Document and Content technologies market is growing at a 47.2% CAGR through 2005.

What Businesses Need from Storage Management Solutions

There are two fundamentals ways to look at what businesses require from their storage management software solutions; operational efficiency and business continuity.

Operational Efficiency. Information management storage resources require operational efficiency. Maximizing the investment businesses have made in their information technology infrastructure is paramount. To that end, information technology managers must be able to share key resources and automate operations in order to deliver on key operational metrics. Ease of operational management within the information technology infrastructure improves the return on investment within the information technology environment and serves to improve high service level requirements.

Business Continuity. Business continuity is the number one requirement in maintaining a competitive advantage in a global economy. Information technology management is responsible for decreasing the time to recover key data and applications in case of a failure, ensuring adequate redundancy of resources, data and applications, ensuring permanent availability of key informational resources, and maintaining access to key records over long periods of time. All these business needs are required to be met with minimal or no incremental operational costs.

Critical Requirements for Networked Storage Management

In a traditional deployment, a storage device, whether it is a disk or tape library, is connected directly to a single server system; this is called Direct Attached Storage, or DAS. DAS deployments accounted for nearly 68% of the disk storage market in 2001 as reported by Gartner Group. However, DAS is expected to retain only 8% of the disk storage market by 2004, and drop to only 30% of this market by 2006 according to Gartner Group. Gartner Group expects DAS to be replaced by various types of networked storage architectures including Storage Area Networks, or SANs, and Network Attached Storage, or NAS.

SANs provide a separate network on which all storage devices are located, for common access by all applications. These networks are usually connected by fibre-channel, which allows application servers and storage devices to be located at farther distances from each other than conventional network connections, and thus offers more flexibility to support wider parts of a business.

NAS provides a central storage device that can be added to an existing network for common access by all applications. NAS devices have started to introduce support for fibre-channel networks in addition to conventional networks, which means that businesses have the ability to combine the use of SAN with NAS.

The key benefit of any networked data storage architecture is that it provides data consolidation and scalability. With the appropriate storage management software, consolidated storage can cost less to manage. As storage devices are added in either a SAN or NAS deployment, the storage management software must be able to scale to accommodate the expansion of the environment

By definition, consolidated storage also supports a wider segment of a customer s business operations, because more servers are connected to it. This means that SAN and NAS failures and performance problems have wider impacts on the business, since they affect more applications and more business users than a failure of

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a stand-alone DAS device. Therefore, deployment of SAN and NAS is further increasing the demand for storage management software.

Our Software Products

Our storage management solutions can help to address key challenges facing our customers by:

- Enabling information protection to occur without interrupting application service levels.
- Providing methods for restoring data and applications quickly, efficiently and with minimal risk to the business operation.
- Optimizing use of existing networks and storage devices such as tape libraries, slowing the rate at which new bandwidth and devices must be introduced and ensuring higher returns on investment of the new devices as they are added.
- Automating, or partially automating, management tasks for applications and data, reducing administration time and human error.

Our software solutions are fully backed by support services, consulting services and educational services.

Our software products are designed to help Global 2000 companies manage and safeguard their applications and data more efficiently and effectively in operating enterprise computing infrastructures, from the largest enterprise data center environments to the smallest branch offices and even mobile laptops. Because our products are designed to work with mixed deployments of market-leading server systems, applications, databases, networks, storage devices and architectures, our products also give our customers the maximum choice to create the storage network that they need to support their business while also being able to safeguard it. Our goal for our customers is to increase the overall recoverability and reliability of their complex computing infrastructures, while also reducing apparent complexity and cost to manage.

We, directly and through strategic partnerships and alliances, develop and deliver the software solutions and services that protect and make available the business-critical information that customers need to succeed in today s competitive environment.

To succeed in this mission, we combine solution components from three essential categories:

- Information Protection;
- Application Availability; and
- Content and Messaging.

Our solutions recognize the interdependence between data and applications. Customers need to ensure that data is protected, that applications are available and that both are efficiently and cohesively managed.

The Legato Approach

We provide integrated solutions and services that protect and manage information, assure the availability of applications and provide immediate access to business-critical information by:

- Ensuring continuous operation of data center and branch office environments;
- Increasing system administrators span of control for managing highly complex, heterogeneous deployments;
- Reducing management overhead;
- Increasing information protection that each system administrator can manage by:
  - Automating manual tasks and
  - Monitoring key data and applications states, and triggering recovery;

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Increasing system and data availability by:

Reducing downtime resulting from human error and

Reducing downtime resulting from system failure;

Improving information access to increase end-user productivity in order to:

Enable information sharing across multiple departments and

Automate business processes to streamline operations;

Maintaining data and online systems;

Optimizing operational efficiency to improve business competitiveness;

Ensuring a return on investment through standards-based flexibility when adding components; and

Providing worldwide customer support.

Information Protection

Centralize. Manage. Recover.

In data centers, departments and branch offices, the need for reliable, comprehensive, automated protection of information assets has never been more critical. Yet with vast, expanding storage volumes, 24-hours-by-7-days-a-week service level demands, new complexities of SAN and NAS storage architectures and relentless pressure to lower costs, data protection is an increasingly difficult challenge for today s global enterprise. To meet this challenge, we deliver the performance, flexibility and management consistency required to fully protect storage assets across heterogeneous environments, while reducing overhead and minimizing downtime.

The foundation of our suite of information protection solutions is LEGATO NetWorker. Operating across UNIX, Windows, NetWare, and Linux platforms, NetWorker utilizes a client/server architecture comprising of three distinct functions within a data zone Clients, Storage Nodes and Server to:

CENTRALIZE backup operations;

MANAGE the entire storage environment through media tracking, consolidation of storage and full utilization of libraries for maximum return on investment; and

RECOVER business-critical servers and restore data quickly.

Within the NetWorker suite of products are:

AutoChanger/Silo Modules that deliver advanced, automated media management and broad support for the industry s leading tape and optical autochangers. **NetWorker Modules** keep mission-critical applications online during backup operations and provide point-in-time, granular recovery to simplify and speed recovery operations.

LEGATO NetWorker Management Console (formerly known as GEMS Console) enables system administrators to manage and monitor multiple NetWorker Servers from anywhere on the web. **NetWorker Operations** can control backup operator functions across multiple NetWorker Servers, audit operator activity and generate comprehensive reports of NetWorker environments.

LEGATO NetWorker Recovery Manager performs bare-metal, boot-level recovery of critical servers quickly and restores data immediately without having to first rebuild the operating system.

LEGATO NetWorker Laptop provides complete, reliable, automated protection for data where it is most often at risk on laptops, desktops and at remote sites with minimum user effort and maximum speed and security.

DiskXtender Family for Data Migration, Archiving and Hierarchical Storage Management (HSM). DiskXtender products, which are new to LEGATO s Information Protection line as a result of the 2002 acquisition of OTG Software, unify storage management across the enterprise by creating a virtualized data pool that expands primary or secondary storage onto any number of additional media/devices while simplifying management of those resources. DiskXtender products work with Windows, Unix, Linux operating systems, and Oracle databases. We also offer departmental archiving solutions with our ArchiveXtender product.

LEGATO AlphaStor facilitates media tracking and consolidation of tape storage and allows tape devices and libraries to be fully utilized thereby providing maximum return on library investment.

Application Availability

Monitor. Remedy. Proceed.

When application servers become unavailable because of failures or system maintenance, the result is zero access to data. The same level of service protection required for data must also be expected for application servers. Otherwise, operational efficiency and business continuance is at risk.

The foundation of our application availability product group is **LEGATO Automated Availability Manager (AAM).** From the branch office to the data center, AAM automates availability of all applications and data. It will:

MONITOR the health and performance of applications;

REMEDY failures by providing alerts when resources begin to run out; and

PROCEED to re-provision and restart services when failures occur and automate process control and data management.

By monitoring the health and responsiveness of applications, AAM notifies the appropriate personnel when critical thresholds are exceeded, and restarts applications automatically when failures occur. It also automates application management to lower the cost of ownership associated with high-maintenance applications and management tasks.

AAM is an enterprise-level availability management tool that runs on Solaris, HP-UX, AIX, Linux, and Windows NT/200K. For purely Windows environments, such as small branch offices or small focused departments within Fortune 500 organizations, that need a simple 2-server/single-application availability solution, **LEGATO CoStandbyServer AAdvanced** monitors and automates the restart of critical applications.

LEGATO RepliStor adds asynchronous data replication for Windows NT/2000, supporting as many servers as needed and as far apart as required, to replicate Windows data where and when it is needed. RepliStor is used for a variety of business purposes that include obtaining disaster recovery protection, consolidated data for off-line data backup, sharing data among departments and across sites, and for creating secondary copies of data for decision-support and other purposes.

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Content and Messaging

Capture. Organize. Access.

Our content and messaging solutions help maximize the value of business-critical information by enabling immediate access from user desktops or the web, facilitating use in daily applications and supporting compliance with regulations and corporate retention policies.

The foundation suites of this solution group are the **ApplicationXtender** Family and the **EmailXtender** Family. Like the DiskXtender Family, the ApplicationXtender Family and the EmailXtender Family are also a result of the 2002 acquisition of OTG Software. Both ApplicationXtender and EmailXtender work to:

- CAPTURE enterprise content from a wide range of sources;
- ORGANIZE this information to maximize its accessibility and usability; and
- ACCESS via desktop clients or web browsers, for both end-users and administrators.

The ApplicationXtender Family is a complete, fully integrated suite of enterprise content management solutions. ApplicationXtender works hand-in-hand with business applications, maximizing the value of information by providing more efficient means to capture, organize and provide intelligent access to mission-critical information. ApplicationXtender modules enable desktop and production level scanning, processing of text and printstream information, automated workflow and web access. Integration with third-party applications, such as Geographic Information Systems (GIS), CRM, ERP and Financials, helps combine documents with data to improve operational efficiency.

The EmailXtender Family provides automated archiving, granular search and retrieval, retention management and monitoring for electronic messaging. The EmailXtender Family is a comprehensive, policy-based system that automatically collects, organizes, retains and retrieves messages/attachments. By creating and managing a central repository of email and other messages, EmailXtender helps reduce the cost of email storage, boost end-user and administrator productivity and control risk by supporting compliance with government regulations and corporate governance policies. EmailXaminer is another product offered in this messaging suite for compliance with NASD regulations, with features such as supervisory review and documentation. As discussed below, EmailXtender and EmailXaminer are two products in the broader group of our Messaging Solutions.

LEGATO s NAS Solutions

Network Attached Storage (NAS) has emerged as a valuable means for accessing files quickly and enabling the sharing of data in a heterogeneous enterprise. Because NAS systems deliver a form of modular, on demand scalability and are relatively simple to install, they are an attractive means for coping with growing data volumes and rising service level requirements. As the volume of mission-critical data residing on

NAS steadily rises, the need for robust, enterprise-class protection becomes paramount.

We provide automated backup and recovery solutions that simplify and centralize protection of NAS across an enterprise and enable businesses to reduce management overhead, consolidate storage assets and leverage library investments. Our NAS solutions offer the flexibility and scalability required to fully protect Network Data Management Protocol (NDMP) compliant and non-NDMP compliant NAS systems in heterogeneous data center and branch office environments. Among our solutions capabilities for NAS are:

LEGATO co-developed **Network Data Management Protocol (NDMP)** with Network Appliance. Now an industry standard, NDMP is an optimum means to backup and restore critical data residing on NAS systems.

NetWorker in tandem with **NetWorker Client Connections** enables local, 3-way and remote (in native format), data protection for the most widely used NDMP compliant NAS systems, such as Network Appliance, EMC, Mirapoint, Procom and Auspex.

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- NetWorker delivers Dynamic Drive Sharing (DDS), enabling businesses to optimize their investments in storage through the sharing of tape libraries and drives between multiple NAS systems or storage nodes.

- Through Direct Access Restore (DAR), the NetWorker provides faster recovery of NAS data, facilitating the timely resumption of business operations.

- **NetWorker SnapImage Module** enables remote backup of NDMP-compliant NAS file servers natively versus NFS to Unix-attached libraries, providing improved storage consolidation, ease of management and greater library Return on Investment, or ROI.

Our DiskXtender also provides HSM capabilities to automatically migrate data to NAS devices helping to consolidate data, speed access and enable long-term management.

LEGATO s SAN Solutions

The evolution of Storage Area Networks (SANs) a high performance network dedicated to storage is changing the manner in which information technology organizations conduct data protection operations and provide application availability. Usually based upon fibre-channel, SANs enable storage consolidation and the sharing of storage resources, facilitate centralized management and High Availability, perform data transfer at higher speeds over greater distances and free the LAN from backup traffic.

We deliver maximum protection and availability of mission critical data through interoperable, scalable and standards based solutions for heterogeneous enterprise SANs. Among our solution capabilities for SANs are:

- **NetWorker** provides LAN-free data protection, library sharing and advanced storage management with platform, filesystem and database support.

- **Celestra Power** frees LAN and server resources from the impact of data protection operations, through live, serverless backup eliminating the need for a backup window.

- **SANXtender** works with DiskXtender to enable file level data migration and HSM within a SAN environment.

- **AlphaStor** delivers dynamic drive and library sharing between multiple NetWorker backup servers, enabling businesses to increase library ROI.

- **Automated Availability Manager** is a heterogeneous clustering solution available for enterprise environments that manages application and service-level availability within SAN deployments.

LEGATO s Email Solutions

Email has become one of the primary means of business communication. IDC estimates that the number of emails sent worldwide on a daily basis today, not including spam, is 15.5 billion and is expected to grow to 34.6 billion by 2006. Since email has become business critical, the availability and reliability of the application and the protection and retention of email data have become more important. As a result, administrators are facing huge challenges related to managing volumes of email data, maintaining availability of overloaded systems and ensuring that critical messages can be found quickly when they are needed.

Our email solutions provide automated archiving, granular search and retrieval, availability management and backup and recovery for major email systems including Microsoft Exchange and Lotus Notes/Domino. These solutions include:

EmailXtender provides automated archiving and granular search and retrieval, as well as supporting compliance with government regulations and corporate policies.

EmailXaminer enhances EmailXtender functionality by helping companies supervise email content to ensure compliance with government regulations and organizational policies.

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NetWorker Modules for Exchange and Lotus provide online backup and granular recovery of Exchange and Lotus systems, ensuring complete data protection while minimizing application downtime.

CoStandby Server AAdvanced leverages our patented synchronous mirroring technology to maximize the availability and reliability of Windows-based data and applications.

RepliStor supports critical Windows environments with real-time data replication in flexible configurations allowing the use of data for off-line backup protection and disaster recovery switch over.

Sales and Marketing

We market and sell our products and services through a variety of sales channels (or partners), including direct sales, value-added resellers, system integrators, distributors and original equipment manufacturers, or OEMs.

Our principal strategy is to work with market-leading storage vendors and reseller organizations as partners. We provide the technology, and our partners sell, deliver and support LEGATO-based solutions. This provides us with an effectively larger penetration in the market than we could achieve on our own. In addition, our customers obtain more effective solutions, because they are integrated with market-leading storage solutions, and supported and maintained in a coordinated fashion. In selecting a strategy that relies upon partners, we obtain competitive advantage for ourselves, for our partners and for our customers. We currently obtain 75% of our revenue from our channel partners and 25% of our revenue from our direct sales. This is in line with our long-term model.

We provide sales and pre-sales technical support to business partners and end-user customers worldwide from our corporate offices and from regional offices in the following metropolitan areas:

Amsterdam	Los Angeles	Stockholm
Atlanta	Madrid	Sydney
Beijing	Miami	Taipei
Boston	New York	Tokyo
Brussels	Oslo	Toronto
Chicago	Paris	Vienna
Cincinnati	San Francisco	Warsaw
Dallas	San Jose	Washington, D.C.
Denver	Seoul	Zurich
London	Singapore	

Direct Sales. Our direct sales force works on large enterprise-wide projects to ensure close relationships with our largest corporate clients. Customers participating in our enterprise sales program have an assigned salesperson and an executive contact, participate in our technical exchange program and work closely with us to develop large projects for installations over a period of time. An enterprise sales representative coordinates business partner activities across the customer s enterprise and closely monitors customer business initiatives and satisfaction.

Resellers and Distributors. We have deployed a regional sales force dedicated to working with our partners to increase their effectiveness in supporting our mutual customers.

Enterprise Solution Partners. Our North America Enterprise Solution Partners program enables third-party integrators specializing in storage management and open systems network solutions to provide customers with complete solutions. These complete solutions include systems and storage hardware, complementary software and our software. The reseller is responsible for managing the sales and installation process in each customer situation. In large, complex storage environments, our support personnel work with the reseller to provide technical support. This approach enables us to achieve broader market coverage, while maintaining close contact with customers in order to obtain input on product direction and to monitor customer satisfaction.

Distributor Program. To further expand coverage in the marketplace, we license our products to large regional and national distributors who distribute the products to resellers with expertise in storage management and the integration of network solutions for end-users. We provide support to these network solutions resellers. We currently have relationships with various major distributors, including Gates/Arrow, Ingram Micro, Nissho Electronics and Tech Data.

Our international revenue was $110.9 million in 2002, $121.7 million in 2001 and $75.7 million in 2000, representing 42% of total revenue in 2002, 50% of total revenue in 2001 and 33% of total revenue in 2000. The majority of our international sales during these periods were made in Europe. We believe that international markets present an attractive growth opportunity, and we have expanded the scope of our international operations. We have engaged, and will continue to engage, international resellers and distributors in targeted countries. In order to facilitate penetration in certain markets, we are working in conjunction with certain international distributors to localize certain products to certain targeted languages.

OEMs and Strategic Alliances. Our OEM and strategic alliances program generates royalty and reseller revenue. Under this program, we can license our software products, in source or object code form, to leading computer system and software suppliers from which we typically receive an initial license fee and ongoing royalty revenue. The OEM partner is then generally responsible for porting our software to its unique operating system environment, testing it, licensing it through the OEM partner s direct sales force and distribution channels and providing the primary customer support after installation. LEGATO can also support reseller sales, joint sales initiatives and co-support and co-marketing agreements.

The customer can benefit from these alliances, because they can acquire our family of storage management products as part of a complete system solution from a single vendor, with simplified implementation of the entire set of technology and with a single point of contact for customer support or coordinated support.

Our principal strategic alliance and OEM relationships include: Dell, EMC, Fujitsu, Fujitsu-Siemens Computers, Hewlett-Packard, IBM, Microsoft, Network Appliance, Oracle, StorageTek and Sun Microsystems.

Highlights of Our Strategic Alliances Activities

The following highlights reflect selected partner activities:

EMC. We support EMC s initiative of providing business continuance, content addressed storage and information protection solutions. As part of EMC s major partnership with Dell, we also support Dell-focused solutions. We do this by offering jointly tested and certified solutions that add value to EMC s software and hardware products. Through the EMC Developers, NAS and Centera partnership programs, the two companies work closely together to develop tightly integrated information management solutions. These solutions are enabled by open architectures and work in environments with UNIX, Linux and Windows operating systems, where customers can manage gigabytes of data from one server, or petabytes of data from many servers in DAS, NAS or SAN environments.

For example, we offer:

- Enterprise email archiving through LEGATO DiskXtender, EmailXtender and EmailXaminer products in combination with EMC Centera and CLARiiON systems.

LEGATO Automated Availability Manager for EMC SRDF, which adds value to EMC s solution for data replication on Symmetrix.

Information protection with NetWorker modules for EMC hardware.

Fujitsu. We are participating in Fujitsu s PRIMECLUSTER initiative of offering cost-effective servers with maximum power, availability and scalability. We accomplish this through an OEM relationship under which our NetWorker and SmartMedia products are integrated as components of Fujitsu s offerings. This solution targets the Japanese market.

Fujitsu-Siemens Computers (FSC). We are participating in FSC s initiative of offering customers solutions for data protection and high availability. Our joint activities with FSC include an OEM relationship under which FSC incorporates our NetWorker product within its products. FSC can also develop their own value-added modules to compliment NetWorker.

Hewlett-Packard (HP). We are participating in HP s initiative of delivering complete information management solutions to its customers. HP is engaged with us in the following joint activities:

HP resells our products.

HP provides first-level support for our products.

HP offers HP Care Paqs for services to install our products.

HP customers need the ability to migrate their OpenVMS environment into a fibre-attached SAN and want to centrally manage backups in their mixed environments. To help HP meet customer demands, LEGATO delivers a solution that provides for OpenVMS data stored in heterogeneous DAS environments and fibre-channel SANs with library sharing and tape drive sharing.

LEGATO NetWorker (Single Server Edition) is the only backup/recovery product that ships with Tru64 operating system.

IBM. We are participating in IBM s initiative to offer TotalStorage solution bundles and to offer Linux solutions. We accomplish this by:

Providing a bundle version of NetWorker for IBM Informix.

Providing a version of NetWorker that IBM bundles with its NAS devices, LTO tape libraries and DB2.

Offering NetWorker modules for key IBM middleware solutions on Linux, including Notes, DB2 and Informix.

A reseller agreement with IBM Global Services to sell LEGATO NetWorker, Xtender and AAM Solutions.

Providing DX2000 support with IBM Tivoli Storage Manager.

Working with IBM on z, x, and pSeries to support IBM in their investment of porting Linux to all of their platforms.

Microsoft. We protect and ensure availability of business critical information and applications on the Windows platform. Microsoft and LEGATO are working together as partners delivering Windows products, solutions and services to protect and manage customer information, assuring the availability of applications and providing immediate access to business-critical information. We accomplish this by:

Certifying our products for use with Microsoft Windows Server Operating Systems.

Maintaining an on site presence with Microsoft s development and solutions groups.

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Being a founding sponsor of the Microsoft Partner Solutions Center, working together with Microsoft and other partners, including HP and EMC, to design, integrate and document solutions that solve business problems in the enterprise.

Being a Managed Microsoft Gold Certified Partner in over 14 locations world wide.

Network Appliance. We are participating in Network Appliance s initiative to provide global solutions for information management. We accomplish this by:

Expanding our customers options for media and device management within a NAS or SAN networked storage configuration.

Deploying our solutions for Network Appliance s NearStore R100 to provide automatic policy based data migration, archive, rapid recovery and backup, that include LEGATO DiskXtender, LEGATO RepliStor for disk-to-disk data replication and LEGATO NetWorker.

Providing certified solutions to critical customer business concerns including:

Storage Consolidation with NetWorker and XtenderSolutions;

Data Center Operations with AlphaStor, NetWorker Operations and NetWorker Management Console;

Business Continuance with EmailXtender, NetWorker, RepliStor, LAAM and PowerSnap for NetApp; and

Distributed Enterprise Management with DiskXtender, NetWorker Operations, NetWorker Management Console and NetWorker Laptop.

Oracle. We provide information protection solutions for Oracle. We accomplish this through:

Continuing to provide a single server version of LEGATO NetWorker to Oracle, which Oracle ships to its customers with every Oracle database that it delivers.

Providing support for Oracle9i. NetWorker upgrades for LEGATO Single Server Version that ships with every Oracle9i database in the form of LEGATO Solution Suites (Modules) for Oracle are also made available.

LEGATO NetWorker is the first backup application to protect Oracle9i RAC in a Linux environment.

LEGATO s solutions can backup the Oracle9i Real Application Cluster (RAC) running on the Red Hat Advanced Server 2.1 of Linux.

StorageTek. StorageTek is an authorized reseller of LEGATO products. Our content and messaging products are a part of a long standing OEM agreement, which also encompasses our DiskXtender products. StorageTek participates in our self-certify program, validating LEGATO solutions in the StorageTek Customer Technology Center. The following examples show support of this relationship:

LEGATO NetWorker is certified with all StorageTek tape libraries and tape drives to simplify, centralize and automate backup and recovery across UNIX, Windows and Linux in DAS, NAS and SAN environments.

LEGATO AlphaStor is qualified with StorageTek tape libraries, tape drives and the SN6000 to provide enterprise-class media management as well as library and drive sharing for open systems data centers.

StorageTek s ASM for Windows is based on our DiskXtender automated data migration software.

StorageTek s new Email Xcelerator Suite of solutions leverages additional archiving, indexing and monitoring with Exchange and Notes environments.

Sun Microsystems. Sun and LEGATO have a long standing relationship in providing complete storage solutions. The cross platform nature of our offerings can accelerate time to market on Sun s open storage

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strategy, allowing Sun to address the heterogeneous data management opportunities and further penetrate data centers with their products. We accomplish this by:

Being included as part of Sun s Integrateable Stack through Sun Solstice Backup, an OEM version of LEGATO NetWorker, which can reduce total cost of ownership through its scalability and open architecture.

Selling Complementary Offerings to Solstice Backup such as NetWorker Console, NetWorker Administration, NetWorker Availability, NetWorker Modules, Email Xtender, AAM & AlphaStor through a reference sales model.

Employing a sales model that motivates teaming with Sun field sales.

Certifying LEGATO DiskXtender, Automated Availability Manager and NetWorker to run in the Sun Operating Environment.

Being the referenced backup and recovery solution for the Sun One Messaging solution.

Being identified as one of Sun s four key strategic partners (the list also includes: Hitachi Data Systems, StorageTek and QLogic).

Being the first storage management company to join the Sun VIP Program (Vendor Integration Program) for ease of customer support issue resolution.

Concentration of Customers

No single customer accounted for more than 10% of our total revenue for 2002, 2001 or 2000.

Corporate Marketing

We support our multi-tiered distribution efforts with marketing programs designed to increase our brand awareness in key markets, differentiate our products and to generate end-user demand. Marketing programs include channel marketing, product marketing, as well as programs specifically targeted to the North American, European and other intercontinental markets. We participate in industry forums, events and trade shows and advertise in key trade publications and on the Internet. We work directly with industry analysts to update them on our products. Leads are qualified by our inside sales staff and provided to our channel partners. Additionally, resellers and distributors are provided with promotional and educational materials and can qualify for market development funding for specific promotional activities tailored for their solutions and geography.

Service and Support

LEGATO Global Services is focused on delivering consulting services, technical support services and product education services that enable customers to protect, keep available and provide access to their business-critical information while maximizing their investment in enterprise storage solutions.

Technical Support Services. Our technical support is an integral component of the company s overall goal of delivering the software and services that protect and manage customer information, assure the availability of our applications and provide immediate access to the content that is business-critical. By providing excellent customer service and support, we have experienced higher customer satisfaction rates and long-term loyalty that potentially translates into future revenue. We view technical support and software update subscription service as key components to ensure customers maximize their return on investment.

We offer multiple levels of reactive and proactive technical support for our direct customers, plus a software update subscription service to protect the customer s long-term investment in a Legato solution. We view software update subscriptions and technical support as a critical success factor in avoiding unnecessary downtime in a customer s environment by proactively providing customers with our software updates. Customers can

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purchase technical support and software update subscription service directly from us, or from any authorized LEGATO Global Partner reseller. These services are based upon the level of technical support selected by the customer and currently have a list price of 18% to 24% of product license list prices.

LEGATO Technical Support portfolio focuses on providing reactive support and proactive, business critical support. We have two levels of reactive support, which are available during normal business hours or can be upgraded to provide reactive 24 by 7 support coverage. Our highest level of support, Premier Support, is focused on providing a proactive, world-class support service for global businesses that depend on around-the-clock availability of their data and applications. This program includes a broad range of features with a focus on avoiding problems before they arise to maximize uptime of the customers enterprise solution.

Our support organization consists of an experienced staff of technical support engineers providing telephone and electronic support via email from our offices in California, Maryland, Canada and Germany. Our sales, consulting and technical support organizations work closely together to ensure high levels of overall customer satisfaction.

We are focused on continually improving the standards by which we are measured and keeping them in tune with the needs of our customers. In recent years, our installed base of customers has significantly increased, as have the number of customers purchasing software maintenance contracts. As a result of increased staffing and operational improvements, we have successfully maintained a very high level of customer satisfaction. Continued investments in people, technology and operational infrastructure are intended to further improve customer satisfaction through decreased time to resolution, easier access to relevant knowledge and efficiencies in our operational workflows.

Education Services. LEGATO Education Services offers technical training on our products to end-users, resellers and partners. Courses cover theory, installation, operations, configuration and trouble-shooting for information protection, information availability and information management products. Courses are offered by LEGATO Authorized Training Partners (ATPs) in North America, Europe and Asia as well as at customer and reseller sites. LEGATO ATP instructors are required to be certified in our products (where certification is available) and also must have teaching experience with the product. All LEGATO ATPs use LEGATO-authored training materials. Course fees are charged separately from our software products.

Consulting Services. LEGATO Consulting Services are focused on providing customers with the specialized expertise required to meet their information access, availability and protection challenges across the enterprise. In all of our work, we take an objective approach firmly centered on customer needs. And while we focus heavily on technology, we promote proper alignment of technology, processes and an effective operational model as critical to long-term success. Our consultants are available and specialized to work closely with customers to assist in efficiently designing, building or optimizing complex storage, content or messaging environments; implement SAN solutions or develop a comprehensive strategy to focus on maximizing the return on investment in a LEGATO solution. We offer a wide range of tailored consulting services targeted at solving our clients complex storage, content and messaging issues. Some of these services include performance assessments, architecture and design and installation, configuration, deployment and management of storage devices. We also offer a number of consulting packages that provide customers with more specific topics, such as storage consolidation, backup/recovery optimization, workflow business process analysis, messaging and storage migration services, along with messaging analysis and storage network health checks. Fees for consulting services are charged separately from our software products.

Research and Development

Our investment in research and development was $69.2 million in 2002, $64.3 million in 2001 and $59.6 million in 2000. We anticipate that we will continue to commit substantial resources to research and development in the future. To date, our development efforts have not resulted in any capitalized software

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development costs. In addition, we receive the benefits of additional testing and product enhancements from each source code OEM s development group. Our future success will depend upon our ability to develop and introduce new software products, including new releases, applications and enhancements, in a timely basis that keep pace with technological developments and emerging industry standards and address the increasingly sophisticated needs of our customers. In particular, our strategy is to continue to leverage the NetWorker architecture to enhance the functionality of the product through new releases, applications and product enhancements and integrate our other technologies into solutions to meet the ongoing storage management requirements of our customers. We cannot guarantee that we will be successful in developing and marketing new products that respond to technological change or evolving industry standards, that we will not experience difficulties that could delay or prevent the successful development, introduction and marketing of these new products or that our new products will adequately meet the requirements of the marketplace and achieve market acceptance. If we were unable, for technological or other reasons, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, our business, operating results and financial condition would be seriously harmed.

Our significant research and development centers are located in:

Bellevue, Washington;

Burlington, Ontario, Canada;

Dublin, California;

Marlborough, Massachusetts;

Palo Alto, California; and

Rockville, Maryland.

Competition

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. Certain storage companies with whom we have OEM and strategic alliance relationships also compete with us on various product and/or operating system platforms. Furthermore, our OEM and strategic alliance partners, whom do not currently compete with us, could decide to compete with us by offering their own storage management solutions that exclude our software. Our competitors include, but are not limited to, Commvault, Computer Associates, EMC, Fujitsu-Siemens, Hewlett-Packard, Hitachi, IBM, Sun Microsystems and Veritas.

Some potential customers may elect to develop their own capabilities internally that may be similar to our software products, and decide not to purchase storage management software from any outside vendor. Many competitors and partners have significantly more financial and technical resources than we do, and may cause us to lose sales and may limit the growth of our revenue and business.

Key Technology Differentiators

We are a technology leader in the networked storage management software market through our commitment to open, standards-based software development. Our customers have come to depend on the following key characteristics that commonly define all of our solutions:

Scalability;

Serviceability;

Interoperability;

Performance; and

Management.

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Scalability. Our solution architecture is designed to enable scalable growth within an enterprise computing environment, from the smallest single-server implementation, to a remote branch office, to the largest data center environment. For our customers, this means that they can scale their infrastructure up or down as their business requires, and continue to protect their information and applications with a continuity that ensures no gaps in protection and with no retraining. This also preserves our customers investment in their existing storage infrastructure, by supporting flexible options for sharing storage across larger and larger deployments of application servers.

Our solutions can be configured or expanded as required, to support our customers dynamically changing environments. Our solutions architecture is modular, allowing customers to add clients, servers, storage nodes and support for added networked storage without requiring redesign or redeployment of their storage management software. An existing server can be quickly upgraded with more powerful capabilities for information protection, application availability, or both, in some cases just by changing a license key.

Serviceability. Our solutions enable serviceability by providing tracing features built into our software that can be turned on when errors occur and can assist technical support teams in diagnosing and fixing problems. We also do this by providing commands that can be used to obtain information about the status of software components, again to assist technical support teams in diagnosing and fixing problems.

Our solutions are also built to enable easy upgrades and migration to newer versions and to support previous configuration data for the same product whenever possible. This means that customers moving from one version of our products to another have minimal disruption to their business operation. We also provide defined and tested migration procedures when required.

Interoperability. Our solutions are designed to support and protect market-leading open system servers, applications, databases, networks and storage devices to preserve our customers ability to select the combination of technologies that best support their business.

We support the following operating systems:

- Linux;
- NetWare;
- UNIX systems (AIX, HP-UX, Sun Solaris, Dynix/ptx, Irix and Tru64);
- Windows NT; and
- Windows 2000.

We provide Modules for NetWorker and AAM, for managing and protecting the following applications and databases:

DB2;

Informix;

Lotus Notes;

Microsoft Exchange;

Microsoft SQL;

Oracle;

SAP R/3; and

Sybase.

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Performance. Enterprise organizations continue to deal with expanding data volumes and increasing service levels for applications. These trends are in conflict with the need to control costs and preserve manageability. Moreover, what continues to drive expanding data volumes is the need to deploy strategic applications to keep organizations competitive in the market. To enable this type of growth to continue, businesses need options for eliminating the impact of backup on their application performance, for continuing to reduce the time-to-recovery and for proactively maintaining and optimizing the service levels that their applications layer delivers to support their business.

We provide market-leading capabilities for optimized backup performance, including options for backing up clients in parallel, multi-streamed, and LAN-free configurations to free up business networks, and even in serverless configurations to ensure application performance. These options enable backup to occur during business operations, while minimizing impact to those operations. Similarly, we provide solutions that continually reduce time-to-recovery by utilizing best-in-class technology, such as using disks for backup and integrating our products with market-leading snapshot technology.

Our AAM family of solutions is designed to monitor and proactively manage applications to ensure the highest service levels that can be achieved by the computing infrastructure and to avoid downtime caused by failures. AAM solutions are also tuned for fast recovery restart of application components and interdependent resources, including IP addresses, application services and connections to data.

Management. Our solutions provide centralized capabilities for managing heterogeneous infrastructures at local and remote distances. This creates a single point-of-control management interface across the most critical applications and data that support the business. In this way, we allow our customers to utilize their highly-skilled system administration staff to best advantage since they can manage and protect information and applications across all parts of their wide-scale infrastructure. Moreover, we provide separate consoles for operators and administrators to enable less expensive staff to take over less critical and complicated tasks, and reduce the overall cost of storage management for our customers. We also enable multiple points-of-operation within a customer s environment to ensure maximum division of workload.

To enable maximum flexibility and to lower training requirements, we also provide cross-platform manageability: our solutions provide a single management console that can be run on the platform of customer choice, whether it is Windows, UNIX or Linux, and can be used to operate information and application protection and recovery across all other platforms within the customer s environment.

Our solutions also deliver capabilities to automate repetitive tasks, freeing up expensive system administrator time that can be applied to other activities. This is achieved by designing our solutions to enable easy automation, by supporting standard event reporting, including SNMP event trapping to enable integration with leading systems management solutions and by providing our own solution for automating these capabilities. SNMP stands for Simple Network Management Protocol, and is the commonly accepted standard used in the industry for software event reporting and tracking.

Employees

As of December 31, 2002, we had 1,577 employees. Of the total, 583 were in sales and marketing, 450 in research and development, 322 in service and support and 222 in general and administration. Of our 1,577 employees, 1,299 were located in the United States and Canada, 223 were located in Europe and 55 were located in the rest of the world. None of our employees are represented by a labor union, and we believe our relationship with our employees is good.

Available Information

Legato s Internet site is http://www.legato.com. We make available free of charge, on or through our Internet site, our annual, quarterly and current reports and any amendments to those reports filed or furnished

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pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Information contained on Legato s web site is not part of this report.

The public may read and copy any materials the Company files with the SEC at the SEC s Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC. The SEC s Internet site is http://www.sec.gov.

RISK FACTORS

The following risk factors and other information included in this report on Form 10-K 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 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 $228.8 million for the year ended December 31, 2002 and had an accumulated deficit of $299.4 million as of December 31, 2002. While we achieved positive cash flow from operations of $13.2 million and increased deferred revenue to $70.8 million in the fourth quarter of 2002, 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 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. 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. The case is in its preliminary stages, and an investigation of the facts is not complete. We intend to defend this action vigorously; however the outcome is uncertain at this time. Although insurance may be available to cover some portion of any potential liability, an adverse judgment could be materially adverse to our operating results.

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. The reseller alleges that OTG misrepresented information concerning the capabilities of certain OTG products during 2001, and OTG s intentions with respect to development plans for those products. On that basis, the reseller asserts that it is entitled to compensatory damages. 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 allege 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. No formal legal action has been commenced, and the parties intend to pursue informal discussions in an effort to determine whether the former Intelliguard shareholders will proceed with their claims. We believe the Company has numerous meritorious defenses to any action brought by the Intelliguard shareholders, and if

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any action is brought, we intend to defend the action vigorously. At this time, we believe that it is not possible to estimate the amount of a probable loss, if any, that might result from this matter.

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 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 rapid technological changes and competition with new product offerings.

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 integrate into our product lines the technologies of products we acquired through the acquisition of OTG Software completed in May 2002, and to develop the technologies we acquired from Software Clearing House, Inc. in July 2001. 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.

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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:

- 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;

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.

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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, 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.

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

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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 have recently experienced significant economic downturns characterized by decreased product demand, product overcapacity, price erosion, work slowdowns and layoffs. These downturns appear to coincide with the widely-reported weakness in the overall economy. 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.

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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 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. Also, we acquired Software Clearing House, Inc., a software developer, reseller and consulting organization based in Cincinnati, Ohio, in July 2001. 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

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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 December 31, 2002, we had goodwill of $270.7 million and acquired intangibles of $30.6 million on our Consolidated Balance Sheet. With our adoption of Statement of Financial Accounting Standard (SFAS) No. 142, Goodwill and Other Intangible Assets in the first quarter of 2002, we stopped amortizing goodwill. We expect to amortize identifiable intangibles of $10.8 million in 2003, $7.9 million in 2004 and $5.0 million in 2005. 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.

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 in 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;
- 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.

ITEM 2. PROPERTIES

Our principal headquarters is located in approximately 105,000 square feet of space in Mountain View, California. This facility is leased through December 2009. Our principal research and development facility is located in approximately 96,000 square feet of space in Palo Alto, California. This facility is leased through August 2006. Our principal technical support facility is located in approximately 98,000 square feet of space in Burlington, Ontario. This facility is leased through September 2010. Through our acquisition of OTG, we have approximately 94,000 square feet of space in Rockville, Maryland, which will be used primarily as a research and development facility. This facility is leased through May 2011. We also currently lease other domestic offices throughout the United States, as well as international offices throughout the world.

ITEM 3. LEGAL PROCEEDINGS

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. 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. The case is in its preliminary stages, and an investigation of the facts is not complete. We intend to defend this action vigorously; however the outcome is uncertain at this time. Although insurance may be available to cover some portion of any potential liability, an adverse judgment could be materially adverse to our operating results.

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. The reseller alleges that OTG misrepresented information concerning the capabilities of certain OTG products during 2001, and OTG s intentions with respect to development plans for those products. On that basis, the reseller asserts that it is entitled to compensatory damages. 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 allege 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. No formal legal action has been commenced, and the parties intend to pursue informal discussions in an effort to determine whether the former Intelliguard shareholders will proceed with their claims. We believe the Company has numerous meritorious defenses to any action brought by the Intelliguard shareholders, and if any action is brought, we intend to defend the action vigorously. At this time, we believe that it is not possible to estimate the amount of a probable loss, if any, that might result from this matter.

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.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF STOCKHOLDERS

We did not submit any matters to a vote of stockholders during the fourth quarter of the fiscal year ended December 31, 2002.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

Our common stock is traded on the Nasdaq National Market under the symbol LGTO. As of January 31, 2003, there were 515 record holders of our common stock. We have never declared or paid a cash dividend on our common stock and do not intend to pay cash dividends on our common stock in the foreseeable future. The following table sets forth the high and low closing sales prices of our common stock for each quarter in the two-year period ended December 31, 2002.

	2002		2001	
	High	Low	High	Low
First Quarter	$ 17.43	$ 8.70	$ 18.38	$ 6.94
Second Quarter	$ 8.89	$ 3.44	$ 17.99	$ 8.00
Third Quarter	$ 4.00	$ 1.88	$ 16.01	$ 4.76
Fourth Quarter	$ 6.20	$ 2.53	$ 15.05	$ 5.01

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

Five-Year Summary

	December 31,				
	2002	2001	2000	1999	1998(3)
	(in thousands, except per share amounts)				
Revenue	$ 261,894	$ 242,601	$ 231,395	$ 228,567	$ 167,907
Gross profit	207,581	188,168	183,784	195,789	142,657
Income (loss) from operations	(153,639)	(124,713)	(51,413)	2,991	27,815
Net income (loss) (1)	(228,763)	(81,495)	(35,249)	2,704	19,869
Basic net income (loss) per share (2)	(2.16)	(0.92)	(0.41)	0.03	0.26
Diluted net income (loss) per share (2)	(2.16)	(0.92)	(0.41)	0.03	0.24
Cash, cash equivalents and investments	70,044	145,695	165,145	169,928	125,972
Total assets	479,716	355,261	414,864	422,894	207,224

(1) Net loss for the year ended December 31, 2002 includes a provision for a valuation allowance against net deferred tax assets of $124.3 million, a litigation settlement charge of $67.0 million, restructuring charges of $11.7 million and in-process research and development of $32.2 million. Net loss for the year ended December 31, 2001 includes restructuring charges of $9.4 million and impairment of intangible of $48.9 million.

(2) See Note 2 of Notes to Consolidated Financial Statements.

(3) Selected financial data for the year-ended December 31, 1998 was derived by combining Legato s selected financial data for the year ended December 31, 1998 with FullTime s financial data for the twelve-months ended December 31, 1998.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The discussion in this report on Form 10-K 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. In some cases, forward-looking statements can be identified by terminology such as may, will, should, would, expect, plan, anticipate, believe, estimate, predict, potential, continue or the negatives of these or other comparable terminology. 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, litigation, competition, product concentration, technological changes, reliance on enterprise license transactions, 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.

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 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 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. OTG provides us with complementary channels, markets and technology, which will enable us to expand our opportunities by offering robust storage, content and email management solutions. We believe the combined company will have the scale, scope and worldwide channel access to leverage OTG s strengths in data access and business applications such as email. Today, we market the OTG Software products under the XtenderSolutions® brand.

The OTG acquisition was accounted for under SFAS No. 141, Business Combinations, and certain specified provisions of SFAS No. 142, Goodwill and Other Intangible Assets. The results of the operations of OTG were included in our Consolidated Statement of Operations since May 15, 2002. OTG had approximately 400 employees at the time of the acquisition. Refer to Note 6 of our Consolidated Financial Statements.

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Critical Accounting Policies

In preparing our financial statements, we must make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses during the reporting period. The areas that require significant judgment are as follows:

Revenue recognition and allowances for doubtful accounts and product returns. An assessment of our customers ability to pay is one of the considerations that affect revenue recognition. In some cases, we sell to undercapitalized resellers in emerging markets. As such, we defer revenue recognition until cash is received, the reseller has established a history of making timely payments or the reseller s financial condition has improved. Furthermore, once we have recognized revenue, we must evaluate our accounts receivable at each period end for amounts that we believe are no longer collectible. This evaluation is largely done based on comments received from the customer and/or our sales personnel, a review of financial condition via credit agencies and our historical experience with the customer. The unexpected filing of a bankruptcy petition by a customer or reseller may impact our evaluation of accounts receivable in any given period. However, this risk is mitigated by the fact that our accounts receivable is dispersed among a large number of customers. As of December 31, 2002, no customer accounted for more than 10% of our accounts receivable. For each reporting period, we must also estimate the amount of product that will be returned for reasons, which include, among others, wrong product ordered, duplicate orders and excessive quantities. Our estimates are computed using our historical return experience. Product returns over the past several years have not deviated significantly from our historical experience.

Accounting for income taxes. As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our actual current tax exposure together with assessing the temporary differences resulting from differing treatment of items, such as deferred revenue or deductibility of certain intangible assets, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income. To the extent we believe the recovery is not likely, we must establish a valuation allowance as we did in the third quarter of 2002. Going forward, we will assess the continued need for the valuation allowance. After we have determined that we will be able to begin utilizing a significant portion of the deferred tax assets, we may reverse the valuation allowance, resulting in a benefit to the statement of operations in some future period.

Valuation of long-lived and intangible assets and goodwill. We assess the impairment of long-lived assets, identifiable intangibles and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important that could trigger an impairment review include the following:

- Significant underperformance relative to historical or projected future operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
- Significant negative industry or economic trends; or
- Significant decline in our market capitalization relative to net book value for a sustained period.

When we determine that the carrying value may not be recovered based upon the existence of one or more of the above indicators, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model.

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Results of Operations

Revenue. 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. Provisions for estimated warranty costs and anticipated retroactive price adjustments are recorded at the time products are shipped. For sales to international distributors, license revenue is generally recognized upon meeting the above criteria 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 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.

				% Change	
	2002	2001	2000	02/01	01/00
		(in millions)			
License	$ 132.5	$ 147.5	$ 145.6	(10)%	1%
Service and support	129.4	95.1	85.8	36	11
Total revenue	$ 261.9	$ 242.6	$ 231.4		

Sources of Revenue as a Percent of Total Revenue.

	2002	2001	2000
License	51%	61%	63%
Service and support	49	39	37

We sell our products with the first year of update service included, creating a multiple element arrangement. As discussed above, 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. In 2002, license revenue decreased $15.0 million when compared to 2001. The decrease was primarily as a result of an increase in the average selling price of our update subscription service. We also saw a decrease in the amount of license revenue derived from our OEM channel. These decreases were partially offset by the revenue contribution from OTG since May 2002.

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While license revenue increased in 2001 over the previous year, license revenue decreased as a percentage of total revenue in 2001, when compared to 2000, primarily as a result of the economic recession and the reduced spending by customers. In prior years, our customers were willing to forecast expected demand for the next couple of years and purchase that quantity of licenses upfront in exchange for a greater discount. In 2001, our customers were more conservative with their estimates or were unwilling to make these large purchases.

Service and support revenue increased $34.3 million in 2002, when compared to 2001, as a result of increased renewal rates and increased average selling price. As discussed above, the increase in average selling price resulted in incremental license revenue being allocated to our update subscription service. Service and support revenue increased for 2001, when compared to 2000, as a result of our improvement in the number of customers renewing their support contracts to over 90% and the increased rates we charge for such services. Our increase in staffing for software support helped to increase new sales and renewals of our software support contracts. Even though overall service and support revenue increased in 2001, our revenue from consulting and educational services decreased by $5.2 million. The decrease in consulting services revenue was due to productivity issues caused by the re-organization of our field sales force, which typically sells consulting engagements. The decrease in educational services revenue was a result of our outsourcing of this function to Global Knowledge Networks, Inc., an international information technology education integrator, in the second quarter of 2001. We expect that service and support revenue will increase in absolute dollars in 2003, but at a growth rate less than 2002.

Revenue by Geography.

				% Change	
	2002	**2001**	**2000**	**02/01**	**01/00**
		(in millions)			
Domestic	$ 151.0	$ 120.9	$ 155.7	25%	(22)%
International	110.9	121.7	75.7	(9)	61
Total revenue	$ 261.9	$ 242.6	$ 231.4		

Revenue by Geography as a Percent of Total Revenue.

	2002	**2001**	**2000**
Domestic	58%	50%	67%
International	42	50	33

Domestic revenue increased $30.1 million in 2002, when compared to 2001, primarily due to increased productivity of the U.S. sales team and the revenue contribution from our OTG acquisition. Historically, OTG had international revenue of 15% or less. International revenue decreased $10.8 million as we saw significant weakness in the Asia Pacific region only modestly offset by an increase in Europe.

Domestic revenue decreased for 2001, when compared to 2000, primarily due to the economic recession in the United States. Revenue from our OEM partners decreased significantly as their businesses suffered in the poor economic climate; and our customers in the United States reduced their information technology spending in order to better align their expenses with their deflated revenue trends. Further, a large part of our sales force in the United States was new to Legato, and they had not reached the level of productivity of which we believe they are capable. International revenue increased primarily as a result of the continued market acceptance of our products overseas.

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Cost of Revenue.

	2002	2001	2000	% Change 02/01	% Change 01/00
	(in millions)				
License	$ 9.5	$ 5.5	$ 6.0	73%	(8)%
Service and support	44.8	48.9	41.6		