

---

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

---

**FORM 10-Q**

---

(Mark One)

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

**For the quarterly period ended June 30, 2010**

or

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

**Commission File Number: 0-26824**

**TEGAL CORPORATION**

*(Exact Name of Registrant as Specified in Its Charter)*

**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*

**68-0370244**  
*(I.R.S. Employer Identification No.)*

**2201 South McDowell Blvd.  
Petaluma, California 94954**  
*(Address of Principal Executive Offices)*

**Telephone Number (707) 763-5600**  
*(Registrant's Telephone Number, Including Area Code)*

---

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

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

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

As of August 12, 2010 there were 8,439,095 of the Registrant's common stock outstanding.

---

---

TEGAL CORPORATION AND SUBSIDIARIES

INDEX

	<u>Page</u>
<b>PART I. FINANCIAL INFORMATION</b>	
Item 1. Condensed Consolidated Financial Statements (Unaudited)	
Condensed Consolidated Balance Sheets as of June 30, 2010 and March 31, 2010	3
Condensed Consolidated Statements of Operations for the three months ended June 30, 2010 and June 30, 2009	4
Condensed Consolidated Statements of Cash Flows for the three months ended June 30, 2010 and June 30, 2009	5
Notes to Condensed Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	15
Item 3. Quantitative and Qualitative Disclosures About Market Risk	22
Item 4. Controls and Procedures	22
<b>PART II. OTHER INFORMATION</b>	
Item 1A. Risk Factors	23
Item 6. Exhibits	24
Signatures	25

PART I — FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

TEGAL CORPORATION AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (Unaudited)  
 (In thousands, except share data)

	<u>June 30,</u> <u>2010</u>	<u>March 31,</u> <u>2010</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 6,205	\$ 7,298
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$264 and \$324 at June 30, 2010 and March 31, 2010, respectively.	1,361	3,116
Notes receivable	1,268	1,347
Inventories, net	1,309	1,221
Prepaid expenses and other current assets	601	1,243
Total current assets	<u>10,744</u>	<u>14,225</u>
Property and equipment, net	270	308
Intangible assets, net	1,174	1,230
Other assets	503	540
Total assets	<u>\$ 12,691</u>	<u>\$ 16,303</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 840	\$ 1,520
Accrued product warranty	275	374
Common stock warrant liability	162	363
Deferred revenue	-	242
Accrued expenses and other current liabilities	1,690	1,867
Total current liabilities	<u>2,967</u>	<u>4,366</u>
Commitments and contingencies (Item 2)		
Stockholders' equity:		
Preferred stock; \$0.01 par value; 5,000,000 shares authorized; none issued and outstanding	-	-
Common stock; \$0.01 par value; 50,000,000 shares authorized; 8,439,095 and 8,438,115 shares issued and outstanding at June 30, 2010 and March 31, 2010, respectively.	84	84
Additional paid-in capital	128,399	128,290
Accumulated other comprehensive loss	(3)	(149)
Accumulated deficit	(118,756)	(116,288)
Total stockholders' equity	<u>9,724</u>	<u>11,937</u>
Total liabilities and stockholders' equity	<u>\$ 12,691</u>	<u>\$ 16,303</u>

See accompanying notes to condensed consolidated financial statements.

**TEGAL CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)  
(In thousands, except per share data)

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2010</b>	<b>2009</b>
Revenue	\$ 319	\$ 1,083
Cost of revenue	550	990
Gross (loss)/profit	<u>(231)</u>	<u>93</u>
Operating expenses:		
Research and development expenses	1,023	1,241
Sales and marketing expenses	158	704
General and administrative expenses	<u>1,150</u>	<u>1,160</u>
Total operating expenses	<u>2,331</u>	<u>3,105</u>
Operating loss	<u>(2,562)</u>	<u>(3,012)</u>
Other income, net	96	354
Loss before income tax benefit	<u>(2,466)</u>	<u>(2,658)</u>
Income tax expense (benefit)	2	(51)
Net loss	<u>\$ (2,468)</u>	<u>\$ (2,607)</u>
Net loss per share:		
Basic	\$ (0.29)	\$ (0.31)
Diluted	\$ (0.29)	\$ (0.31)
Weighted average shares used in per share computation:		
Basic	8,438	8,413
Diluted	8,438	8,413

See accompanying notes to condensed consolidated financial statements.

**TEGAL CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)  
(In thousands)

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>Cash flows from operating activities:</b>		
Net Loss	\$ (2,468)	\$ (2,607)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>		
Stock compensation expense	107	192
Stock issued under stock purchase plan	1	4
Fair value adjustment of common stock warrants	(201)	(112)
Provision for doubtful accounts and sales returns allowances	(60)	(24)
Depreciation and amortization	175	306
Loss on disposal of property and equipment	8	—
<b>Changes in operating assets and liabilities:</b>		
Accounts receivables and Other receivables	2,392	988
Inventories, net	(87)	(510)
Prepaid expenses and other assets	669	(7)
Accounts payable	(693)	374
Accrued expenses and other current liabilities	(163)	(285)
Accrued product warranty	(94)	(171)
Deferred revenue	(242)	20
Net cash used in operating activities	<u>(656)</u>	<u>(1,832)</u>
<b>Cash flows used in investing activities:</b>		
Purchases of property and equipment	(88)	(183)
Net cash used in investing activities:	<u>(88)</u>	<u>(183)</u>
<b>Cash flows used in financing activities:</b>		
Net cash used in financing activities	<u>—</u>	<u>—</u>
Effect of exchange rates on cash and cash equivalents	(349)	(23)
Net decrease in cash and cash equivalents	(1,093)	(2,038)
Cash and cash equivalents at beginning of period	7,298	12,491
Cash and cash equivalents at end of period	<u>\$ 6,205</u>	<u>\$ 10,453</u>
<b>Supplemental disclosure of non-cash activities:</b>		
Transfer of demo lab equipment between inventory (USA) and fixed assets (France)	\$ 219	\$ —
Reclassification of common stock warrant liability upon adoption of EITF 07-05 (Topic 815)	\$ —	\$ 848

See accompanying notes to condensed consolidated financial statements.

**TEGAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**(All amounts in thousands, except per share data)**

**1. Basis of Presentation:**

In the opinion of management, the unaudited condensed consolidated interim financial statements have been prepared on the same basis as the March 31, 2010 audited consolidated financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary to fairly state the information set forth herein. The statements have been prepared in accordance with the regulations of the Securities and Exchange Commission ("SEC"), but omit certain information and footnote disclosures necessary to present the statements in accordance with generally accepted accounting principles ("GAAP"). These interim financial statements should be read in conjunction with the audited consolidated financial statements and footnotes included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2010. The results of operations for the three months ended June 30, 2010 are not necessarily indicative of results to be expected for the entire year.

Our consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business for the foreseeable future. We incurred net losses of (\$2,468) and (\$2,607) for the three months ended June 30, 2010 and 2009, respectively. We used cash flows from operations of \$656 and \$1,832 for the three months ended June 30, 2010 and 2009, respectively. We believe that our outstanding balances, combined with continued cost containment will be adequate to fund operations through fiscal year 2011. Our declining cash balance is a key support of the Company's ongoing disclosure regarding its ability to continue as a going concern. Our business is dependent upon the sales of DRIE capital equipment, and projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, we will need to reduce expenses further and/or raise additional capital which may include capital raises through the issuance of debt or equity securities. If additional funds are raised through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of our common stock, and debt covenants could impose restrictions on our operations. Moreover, such financing may not be available to us on acceptable terms, if at all. Failure to raise any needed funds would materially adversely affect us. It is not possible to predict when our business and results of operations will improve in light of the current economic downturn that continues to dramatically affect our industry. Therefore, the realization of assets and discharge of liabilities are each subject to significant uncertainty. Accordingly, substantial doubt exists as to whether we will be able to continue as a going concern. If the going concern basis is not appropriate in future filings, adjustments will be necessary to the carrying amounts and/or classification of assets and liabilities in our consolidated financial statements included in such filings. We indicated this concern in our Annual Report on Form 10-K for fiscal year ended March 31, 2010, which was also reflected in the audit opinion at that time.

In consideration of these circumstances, we have engaged Cowen & Co., LLC to assist us in evaluating strategic alternatives for the Company, which may include a merger with or into another company, a sale of all or substantially all of our assets and the liquidation or dissolution of the Company, including through a bankruptcy proceeding. The condensed consolidated financial statements include an adjustment to the value of the DRIE related assets to reflect the value of expected realizable market values that might result from the outcome of this uncertainty. See Note 6 – Asset Acquisitions and Sales.

**Concentration of Credit Risk**

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash investments and accounts receivable. Substantially all of the Company's liquid investments are invested in money market funds. The Company's accounts receivable are derived primarily from sales to customers located in the United States, Europe and Asia. The Company performs ongoing credit evaluations of its customers and generally requires no collateral. The Company maintains reserves for potential credit losses. Write-offs during the periods presented have been insignificant.

As of June 30, 2010, three customers accounted for approximately 70% of the accounts receivable balance. As of June 30, 2009, two customers accounted for approximately 35% of the accounts receivable balance.

For the three months ended June 30, 2010, Bruckner Supply, Indo-French High-Tech Equipment, and SRI International accounted for 47%, 30%, and 12%, respectively, of total revenue. For the three months ended June 30, 2009, the University of Pennsylvania accounted for 21% of total revenues.

The Company's Note Receivable at June 30, 2010 consisted of the outstanding payments owed by OEM Group in connection with the sale of legacy assets.

### Intangible Assets

Intangible assets include patents and trademarks that are amortized on a straight-line basis over periods ranging from 5 years to 15 years. The Company performs an ongoing review of its identified intangible assets to determine if facts and circumstances exist that indicate the useful life is shorter than originally estimated or the carrying amount may not be recoverable. If such facts and circumstances exist, the Company assesses the recoverability of identified intangible assets by comparing the projected undiscounted net cash flow associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable, as well as at fiscal year end. If undiscounted expected future cash flows are less than the carrying value of the assets, an impairment loss is recognized based on the excess of the carrying amount over the fair value of the assets. During the quarter ended June 30, 2010, we reviewed our long-lived assets for indicators of impairment in accordance with SFAS No. 144, (Topic 360). No impairment charges were recorded for intangible assets for the quarters ended June 30, 2010 and 2009.

### Stock-Based Compensation

We have adopted several stock plans that provide for issuance of equity instruments to our employees and non-employee directors. Our plans include incentive and non-statutory stock options and restricted stock awards. These equity awards generally vest ratably over a four-year period on the anniversary date of the grant, and stock options expire ten years after the grant date. Certain restricted stock awards may vest on the achievement of specific performance targets. We also have an Employee Stock Purchase Plan ("ESPP") that allows qualified employees to purchase Tegal shares at 85% of the fair market value on specified dates.

Total stock-based compensation expense related to stock options and restricted stock units ("RSUs") for the three months ended June 30, 2010 and 2009 was \$108 and \$196, respectively. The total compensation expense related to non-vested stock options and RSUs not yet recognized is \$465.

The Company used the following valuation assumptions to estimate the fair value of options granted for the periods ended June 30, 2010 and 2009, respectively:

<b>STOCK OPTIONS:</b>	<b>2010</b>	<b>2009</b>
Expected life (years)	6.0	6.0
Volatility	74.1%	83.3%
Risk-free interest rate	1.79%	2.54%
Dividend yield	0%	0%

ESPP awards were valued using the Black-Scholes model with expected volatility calculated using a six-month historical volatility.

<b>ESPP:</b>	<b>2010</b>	<b>2009</b>
Expected life (years)	0.5	0.5
Volatility	54.2%	86.5%
Risk-free interest rate	0.18%	0.19%
Dividend yield	0%	0%

### Valuation and Other Assumptions for Stock Options

*Valuation and Amortization Method.* We estimate the fair value of stock options granted using the Black-Scholes option valuation model. We estimate the fair value using a single option approach and amortize the fair value on a straight-line basis for options expected to vest. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods.

*Expected Term.* The expected term of options granted represents the period of time that the options are expected to be outstanding. We estimate the expected term of options granted based on our historical experience of exercises including post-vesting exercises and termination.

*Expected Volatility.* We estimate the volatility of our stock options at the date of grant using historical volatilities. Historical volatilities are calculated based on the historical prices of our common stock over a period at least equal to the expected term of our option grants.

*Risk-Free Interest Rate.* We base the risk-free interest rate used in the Black-Scholes option valuation model on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with remaining terms equivalent to the expected term of our option grants.

*Dividends.* We have never paid any cash dividends on common stock and we do not anticipate paying any cash dividends in the foreseeable future.

*Forfeitures.* We use historical data to estimate pre-vesting option forfeitures. We record stock-based compensation expense only for those awards that are expected to vest.

The Company does not use multiple share-based payment arrangements.

During the three months ended June 30, 2010, no stock option awards were granted.

### **Stock Options & Warrants**

A summary of stock option and warrant activity during the quarter ended June 30, 2010 is as follows:

	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term (in Years)</u>	<u>Aggregate Intrinsic Value</u>
Beginning outstanding	2,380,031	\$ 8.80		
Granted				
Price=market value	—	-		
Total	—	-		
Exercised	—	0.00		
Cancelled				
Forfeited	(17,907)	3.75		
Expired	(114,605)	7.92		
Total	<u>(132,512)</u>	<u>7.35</u>		
Ending outstanding	<u>2,247,519</u>	<u>\$ 8.88</u>	<u>2.56</u>	<u>\$ —</u>
Ending vested and expected to vest	<u>2,194,064</u>	<u>\$ 9.03</u>	<u>2.44</u>	<u>\$ —</u>
Ending exercisable	<u>1,920,616</u>	<u>\$ 9.92</u>	<u>1.76</u>	<u>\$ —</u>

The aggregate intrinsic value of stock options and warrants outstanding at June 30, 2010 is calculated as the difference between the exercise price of the underlying options and the market price of our common stock as of June 30, 2010.



The following table summarizes information with respect to stock options and warrants outstanding as of June 30, 2010:

Range of Exercise Prices		Number Outstanding As of June 30, 2010	Weighted Average Remaining Contractual Term (in years)	Weighted Average Exercise Price	Number Exercisable As of June 30, 2010	Weighted Average Exercise Price As of June 30, 2010
\$ 1.20	1.25	24,997	0.63	1.22	8,330	1.23
2.34	2.34	306,347	8.05	2.34	78,463	2.34
3.44	4.60	364,492	5.87	4.30	283,390	4.35
4.63	8.28	224,586	3.57	6.43	224,586	6.43
12.00	12.00	1,284,990	0.18	12.00	1,284,990	12.00
12.36	30.00	38,333	2.71	15.86	37,083	15.86
30.37	30.37	166	0.35	30.37	166	30.37
34.80	34.80	46	3.43	34.80	46	34.80
37.08	37.08	230	3.43	37.08	230	37.08
46.50	46.50	3,332	0.22	46.50	3,332	46.50
<u>\$ 1.20</u>	<u>\$ 46.50</u>	<u>2,247,519</u>	2.56	<u>\$ 8.88</u>	<u>1,920,616</u>	<u>\$ 9.92</u>

As of June 30, 2010, there was \$417 of total unrecognized compensation cost related to outstanding options and warrants which the Company expects to recognize over a period of 2.03 years.

### Restricted Stock Units

The following table summarizes the Company's restricted stock unit ("RSU") activity for the three months ended June 30, 2010:

	Number of Shares	Weighted Avg. Grant Date Fair Value
Balance March 31, 2010	28,027	\$ 1.18
Granted	-	\$ -
Forfeited	(6,408)	\$ -
Vested	-	\$ -
Balance, June 30, 2010	<u>21,619</u>	<u>\$ 0.78</u>

### Unvested restricted stock at June 30, 2010

As of June 30, 2010 there was \$48 of total unrecognized compensation cost related to outstanding RSUs which the Company expects to recognize over a period of 0.38 years.

### 2. Inventories:

Inventories are stated at the lower of cost or market. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis and includes material, labor and manufacturing overhead costs. Any excess and obsolete provision is only released if and when the related inventory is sold or scrapped. The Company did not sell or scrap previously reserved inventory during the three months ended June 30, 2010 and June 30, 2009, respectively. The inventory provision balance at June 30, 2010 and June 30, 2009 was \$1,021 and \$626, respectively.

Net inventories for the periods presented consisted of:

	<b>June 30, 2010</b>	<b>March 31, 2010</b>
Raw materials	\$ 766	\$ 386
Work in progress	91	39
Finished goods and spares	452	796
	<u>\$ 1,309</u>	<u>\$ 1,221</u>

The Company periodically analyzes any systems that are in finished goods inventory to determine if they are suitable for current customer requirements. At the present time, the Company's policy is that, if after approximately 18 months, it determines that a sale will not take place within the next 12 months and the system would be useable for customer demonstrations or training, it is transferred to fixed assets. Otherwise, it is expensed.

### 3. Product Warranty:

The Company provides warranties on all system sales based on the estimated cost of product warranties at the time revenue is recognized. The warranty obligation is affected by product failure rates, material usage rates, and the efficiency by which the product failure is corrected. Warranty activity for the three months ended June 30, 2010 and 2009 is as follows:

	<b>Warranty Activity for the Three Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
Balance at the beginning of the period	\$ 374	\$ 702
Additional warranty accruals for warranties issued during the period	-	41
Warranty expense during the period	(99)	(221)
Balance at the end of the period	<u>\$ 275</u>	<u>\$ 522</u>

Certain of the Company's sales contracts include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these guarantees. The Company has accrued no amounts in relation to these provisions as no such claims have been made and the Company believes it has valid, enforceable rights to the intellectual property embedded in its products.

### 4. Net Loss Per Common Share (EPS):

Basic EPS is computed by dividing income (loss) available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) for the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period. The computation of diluted EPS uses the average market prices during the period. All amounts in the following table are in thousands except per share data.

Basic net income (loss) per common share is computed using the weighted-average number of shares of common stock outstanding.

The following table represents the calculation of basic and diluted net income (loss) per common share (in thousands, except per share data):

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2010</b>	<b>2009</b>
Net loss applicable to common stockholders	\$ (2,468)	\$ (2,607)
Basic and diluted:		
Weighted-average common shares outstanding	8,438	8,413
Weighted-average common shares used in diluted net (loss) income per common share	8,438	8,413
Basic net loss per common share	\$ (0.29)	\$ (0.31)
Diluted net loss per common share	\$ (0.29)	\$ (0.31)

Outstanding options, warrants and RSUs of 3,167,713 and 2,645,897 shares of common stock at a weighted-average exercise price per share of \$8.64 and \$8.71 on June 30, 2010 and 2009, respectively, were not included in the computation of diluted net (loss) income per common share for the periods presented as a result of their anti-dilutive effect. Such securities could potentially dilute earnings per share in future periods.

#### 5. Financial Instruments:

The carrying amount of the Company's financial instruments, including cash and cash equivalents, accounts receivable and accounts payable, notes payable, accrued expenses and other liabilities approximates fair value due to their relatively short maturity. The Company sells products in various global markets. As a result, the Company is exposed to changes in foreign currency exchange rates. The Company does not hold derivative financial instruments for speculative purposes. Foreign currency transaction gains and (losses) included in other income (expense), were (\$185) and \$198 for the three months ended June 30, 2010 and 2009. On June 30, 2010, the Company had no open foreign exchange contracts to sell Euros or any other foreign currencies.

#### 6. Asset Acquisitions and Sales:

On September 16, 2008, the Company acquired certain assets from Alcatel Micro Machining Systems ("AMMS") and Alcatel Lucent (together, the "Sellers"). With this acquisition, we entered the DRIE market. DRIE is a highly anisotropic etch process used to create deep, steep-sided holes and trenches in wafers, with aspect ratios of 20:1 or more. DRIE was developed for micro-electro-mechanical systems ("MEMS"), which require these features, but is also used to excavate trenches for high-density capacitors for DRAM and more recently for creating TSVs in advanced 3-D wafer level packaging technology. The acquisition was designed to enable us to pursue the high-growth markets in MEMS and certain segments of integrated semiconductor device manufacturing and packaging. Current end-markets include production of a variety of MEMS and power devices, memory stacking (flash and DRAM), logic, RF-SiP, and CMOS image sensors. The Company paid \$1,000,000 in cash and \$4,000,000 in shares of the Company's common stock. The 1,044,386 shares of common stock issued by the Company was calculated by obtaining the quotient of (a) \$4,000,000 divided by (b) the average of the closing sales prices of the Common Stock as reported on the Nasdaq Capital Market on the five (5) consecutive trading days immediately prior to (but excluding) the closing date.

In connection with this acquisition, the Company and Alcatel Lucent entered into an intellectual property agreement providing for the transfer of specified intellectual property rights to the Company, a trademark license agreement allowing for the limited use of the AMMS trademark by the Company, and a preferred supplier agreement pursuant to which the Company will purchase certain equipment from an affiliate of the Sellers. AMMS designated Mr. Gilbert Bellini to serve as a member of the Company's board of directors. AMMS' designation right terminates upon the later of (a) the termination or expiration of certain customer services related agreements, and (b) when AMMS beneficially owns less than 5% of the number of shares of Common Stock issued and outstanding (including the shares to be issued to the Sellers).

The purchase price was allocated as follows (in thousands):

Assets acquired:	
Trademarks	\$ 428
Patents	<u>2,648</u>
Total Intangible Assets	3,076
Fixed Assets	24
Inventory	<u>1,900</u>
Total Tangible Assets	<u>1,924</u>
Total Acquired Assets	<u>\$ 5,000</u>

Beginning in the fiscal third quarter of 2009, following the acquisition of the DRIE product lines from AMMS, the Company experienced a sharp decline in revenues related to its legacy Etch and PVD products, a result of the overall collapse of the semiconductor capital equipment market and the global financial crisis. The management and the Board of Directors of the Company considered several alternatives for dealing with this decline in revenues, including the sale of assets which the Company could no longer support. On March 19, 2010, the Company and its wholly owned subsidiary, SFI, sold inventory, equipment, intellectual property and other assets related to the Company's legacy Etch and PVD products to OEM Group Inc. ("OEM Group"), a company based in Phoenix, Arizona that specializes in "life cycle management" of legacy product lines for several semiconductor equipment companies. The sale included the product lines and associated spare parts and service business of the Company's 900 and 6500 series plasma etch systems, along with the Endeavor and AMS PVD systems from SFI. In connection with the sale of the assets, OEM Group assumed the Company's warranty liability for recently sold legacy Etch and PVD systems.

The Company and OEM Group entered into related agreements for the transfer and licensing of patents, trademarks and other intellectual property associated with the legacy Etch and PVD Products. These included a Trademark Assignment Agreement for certain trademarks used in the legacy Etch and PVD Products, a royalty-free Trademark License Agreement allowing for the limited use of the Tegal trademark by the Purchaser solely in connection with future sales of legacy Etch and PVD Products and solely in combination with the trademarks transferred to Purchaser, a Patent Assignment Agreement for the transfer of certain patents related to the Etch and PVD Products, and a perpetual, irrevocable, non-exclusive, worldwide, fully-paid, royalty-free, Intellectual Property Cross License Agreement, pursuant to which the Company granted OEM Group a license to certain intellectual property owned by the Company for use in OEM Group's manufacture and sale of the legacy Etch and PVD Products, and OEM Group licensed back to the Company certain intellectual property for the Company's continued use.

The consideration paid by OEM Group for the Disposition consisted of the following:

- Cash in the amount of \$250,000 paid at closing, which occurred on March 19, 2010;
- An aggregate of \$1,750,000 cash payable to the Company by four installment payments of \$250,000, \$500,000, \$500,000 and \$500,000 each on July 1, 2010, October 1, 2010, January 1, 2011 and April 1, 2011, respectively; and
- A contingent payment in cash of up to \$1,000,000 payable to the Company by April 15, 2011 based on the following percentage of applicable bookings of Etch and PVD Products in excess of \$6,000,000 received by the Company or OEM Group during the period beginning March 19, 2010 through March 31, 2011:
  - o if applicable bookings are greater than or equal to \$6,000,000 but less than \$8,000,000, the contingent payment will be 5% of the applicable bookings in excess of \$6,000,000;
  - o if applicable bookings are greater than or equal to \$8,000,000 but less than \$10,000,000, the contingent payment will be \$100,000 plus 10% of the applicable bookings in excess of \$8,000,000;

- o if applicable bookings are greater than or equal to \$10,000,000 but less than \$12,000,000, the contingent payment will be \$300,000 *plus* 15% of the applicable bookings in excess of \$10,000,000; and
- o if applicable bookings are greater than or equal to \$12,000,000, the contingent payment will be \$600,000 *plus* 20% of the applicable bookings in excess of \$12,000,000.

In no case will the contingent payment exceed \$1,000,000.

The Company has retained the DRIE products which it had acquired from AMMS, along with the Compact(TM) cluster platform and the NLD technology that it had developed over the past several years. However the DRIE products and a small amount of associated spares and service revenue, represent the sole source of the Company's revenue. Since the DRIE markets have also been seriously impacted by the downturn in the semiconductor markets and the lack of available capital for new product development globally, it is not clear that DRIE sales alone will be enough to support the Company, even with significant reductions in operating expenses. As a result, the Company continues to operate with a focus on DRIE and at the same time is seeking a strategic partner for its remaining business. The Company is also continuing to evaluate various other alternative strategies, including sale of its DRIE products, Compact(TM) platform and NLD technology, the transition to a new business model, or its voluntary liquidation.

## 7. Geographical Information:

The Company operates in one segment for the manufacture, marketing and servicing of integrated circuit fabrication equipment. In accordance with SFAS No. 131 (Topic 280), *Disclosures About Segments of an Enterprise and Related Information*, ("SFAS 131") (Topic 280) the Company's chief operating decision-maker has been identified as the President and Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the entire company.

For geographical reporting, revenues are attributed to the geographic location in which the customers' facilities are located. Long-lived assets consist of property, plant and equipment and are attributed to the geographic location in which they are located. Net sales and long-lived assets by geographic region were as follows:

	<b>Revenue for the Three Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
Sales to customers located in:		
United States	\$ 269	\$ 640
Asia	—	202
Germany	10	29
France	—	60
Europe, excluding Germany and France	40	152
<b>Total sales</b>	<b>\$ 319</b>	<b>\$ 1,083</b>

  

	<b>June 30</b>	
	<b>2010</b>	<b>2009</b>
Long-Lived assets at period-end:		
United States	\$ 260	\$ 1,035
Europe	10	159
<b>Total Long-lived assets, net</b>	<b>\$ 270</b>	<b>\$ 1,194</b>

## 8. Recent Accounting Pronouncements:

In June 2008, the Financial Accounting Standards Board (“FASB”) ratified the EITF consensus on EITF Issue No. 07-05, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity’s Own Stock* (“EITF Issue 07-05”) (Topic 815) which applies to the determination of whether any freestanding financial instruments or embedded features that have the characteristics of a derivative, as defined by SFAS No. 133 (Topic 815), *Accounting for Derivative Instruments and Hedging Activities*, and to any freestanding financial instruments are potentially indexed to an entity’s own common stock. EITF Issue No. 07-05 (Topic 815) became effective for fiscal years beginning after December 15, 2008. The Company adopted EITF 07-05 (Topic 815) as of April 1, 2009. As a result, warrants to purchase 1,427,272 shares of our common stock previously treated as equity pursuant to the derivative treatment exemption were no longer afforded equity treatment. The warrants had exercise prices ranging from \$6.00-\$99.00 and expire between February 2010 and September 2013. As such, effective April 1, 2009, the Company reclassified the fair value of these warrants to purchase common stock, which had exercise price reset features, from equity to liability status as if these warrants were treated as a derivative liability since their date of issue between February 2000 and January 2006. On April 1, 2009, the Company reclassified from additional paid-in capital, as a cumulative effect adjustment, \$346 to beginning accumulated deficit and \$502 to common stock warrant liability to recognize the fair value of such warrants on such date. As of March 31, 2010, the fair value of the warrants was estimated using the Black-Scholes pricing model with the following weighted average assumptions, risk-free interest rate of 2.55%, expected life of 1.06 years, an expected volatility factor of 74.2% and a dividend yield of 0.0%. Adoption of this standard had a material non-cash impact on the Company’s consolidated financial statements.

In September 2009, FASB ratified Accounting Standards Update (ASU) 2009-13 (ASU 2009-13) (previously Emerging Issues Task Force (EITF) Issue No. 08-1, *Revenue Arrangements with Multiple Deliverables* (EITF 08-1)). ASU 2009-13 superseded EITF 00-21 and addresses criteria for separating the consideration in multiple-element arrangements. ASU 2009-13 will require companies to allocate the overall consideration to each deliverable by using a best estimate of the selling price of individual deliverables in the arrangement in the absence of vendor-specific objective evidence or other third-party evidence of the selling price. ASU 2009-13 will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 and early adoption will be permitted. While we are currently evaluating the potential impact, if any, of the adoption of ASU 2009-13, the Company does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements.

In September 2009, the FASB ratified ASU 2009-14 (ASU 2009-14) (previously EITF No. 09-3, *Certain Revenue Arrangements That Include Software Elements*). ASU 2009-14 modifies the scope of Software Revenue Recognition to exclude (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product’s essential functionality. ASU 2009-14 has an effective date that is consistent with ASU 2009-13. While we are currently evaluating the potential impact, if any, of the adoption of ASU 2009-13, the Company does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements.

In February 2010, FASB issued ASU No. 2010-09, which amends the Subsequent Events Topic of the Accounting Standards Codification (ASC) to eliminate the requirement for public companies to disclose the date through which subsequent events have been evaluated. The Company will continue to evaluate subsequent events through the date of the issuance of the financial statements, however, consistent with the guidance, this date will no longer be disclosed. The Company does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements, financial condition or liquidity.

In January 2010, FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU No. 2010-06 amends ASC 820 and clarifies and provides additional disclosure requirements on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons for and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). Other than requiring additional disclosures, adoption of this new guidance will not have a material impact on our financial statements.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations – (Amounts in thousands)**

### **Special Note Regarding Forward Looking Statements**

*Information contained or incorporated by reference in this report contains forward-looking statements. These forward-looking statements are based on current expectations and beliefs and involve numerous risks and uncertainties that could cause actual results to differ materially from expectations. These forward-looking statements should not be relied upon as predictions of future events as we cannot assure you that the events or circumstances reflected in these statements will be achieved or will occur. You can identify forward-looking statements by the use of forward-looking terminology such as "may," "will," "expect," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology which constitutes projected financial information. These forward-looking statements are subject to risks, uncertainties and assumptions about Tegal Corporation including, but not limited to, industry conditions, economic conditions, acceptance of new technologies and market acceptance of Tegal Corporation's products and service. For a discussion of the factors that could cause actual results to differ materially from the forward-looking statements, see "Part II, Item 1A—Risk Factors" and the "Liquidity and Capital Resources" section set forth in this section and such other risks and uncertainties as set forth below in this report or detailed in our other SEC reports and filings. We assume no obligation to update forward-looking statements.*

Tegal Corporation, a Delaware corporation ("Tegal" or the "Company"), designs, manufactures, markets and services specialized plasma etch systems used primarily in the production of micro-electrical mechanical systems ("MEMS") devices, such as sensors and accelerometers as well as power devices. The Company's Deep Reactive Ion Etch ("DRIE") systems are also employed in certain sophisticated manufacturing techniques, such as 3-D interconnect structures formed by intricate silicon etching, also known as Deep Silicon Etch ("DSE") for so-called Through Silicon Vias ("TSVs"). Prior to its fiscal year FY 2011, Tegal also sold systems for the etching and deposition of materials found in other devices, such as integrated circuits ("ICs") and optoelectronic devices found in products like smart phones, networking gear, solid-state lighting, and digital imaging. Tegal's plasma etch and deposition tools enable sophisticated manufacturing techniques, such as 3-D interconnect structures formed by intricate silicon etch, also known as Deep Reactive Ion Etching ("DRIE"). Etching and deposition constitute two of the principal device production process steps and each must be performed numerous times in the production of such devices.

In the recent past, our business objective has been to utilize the technologies that we have developed internally or acquired externally in order to increase our market share in process equipment for MEMS and power device fabrication, advanced 3-D packaging, and certain areas of semiconductor manufacturing. In September 2008, we acquired the products lines of AMMS and the related intellectual property of Alcatel, in order to pursue more fully the smaller, but higher-growth markets of MEMS and 3-D packaging. Our acquisition of these products served two purposes: (i) to increase revenue, and (ii) to enable us to focus our various technologies on specific applications that served the common markets of MEMS and 3-D device manufacturing and packaging.

At the present time, we are continuing to transition our involvement in specialized aspects of traditional semiconductor markets to the faster-growth but smaller markets for MEMS, power devices and specialized compound semiconductors. However, given the severe economic downturn generally, and in the semiconductor capital equipment industry in particular, achieving wins with customers in these markets has been extremely challenging for us. We expect that orders for our systems will continue to fluctuate from quarter to quarter, and we expect demand to continue to be low and our ability to forecast demand will be limited as the global financial crisis and the resulting recession continues. Although we have over the past several years streamlined our cost structure by headcount reductions, salary and benefit reductions and limits on discretionary spending of all types, our costs for maintaining our research and development efforts and our service and manufacturing infrastructure have remained constant or in some cases increased. We intend to continue our cost-containment measures, including outsourcing certain activities, such as engineering and software development, and maintaining or further reducing our headcount as we strive to improve operational efficiency within this challenging economic environment. However, since we are unable to predict the timing of a stable reemergence of demand for our products and services, we believe that the realization of assets and discharge of liabilities are each subject to significant uncertainty and a substantial doubt exists as to whether we will be able to continue as a going concern. In consideration of these circumstances, we continue to evaluate strategic alternatives for the Company, which may include a merger with or into another company, a sale of all or substantially all of our assets and the liquidation or dissolution of the Company, including through a bankruptcy proceeding. We cannot assure you that we will be successful in pursuing any of these strategic alternatives. As we pursue various strategic alternatives and determine that some are more or less likely than others, the consequences of such determinations will be reflected in our financial statements as required by generally accepted accounting principles ("GAAP") or the Financial Accounting Standards Board ("FASB").

Beginning in the fiscal third quarter of 2009, following the acquisition of the DRIE product lines from AMMS, the Company experienced a sharp decline in revenues related to its legacy Etch and PVD products, a result of the collapse of the semiconductor capital equipment market and the global financial crisis. The management and the Board of Directors of the Company considered several alternatives for dealing with this decline in revenues, including the sale of assets which the Company could no longer support. On March 19, 2010, the Company and its wholly owned subsidiary, SFI, sold inventory, equipment, intellectual property and other assets related to the Company's legacy Etch and PVD products to OEM Group Inc. ("OEM Group"), a company based in Phoenix, Arizona that specializes in "life cycle management" of legacy product lines for several semiconductor equipment companies. The sale included the product lines and associated spare parts and service business of the Company's 900 and 6500 series plasma etch systems, along with the Endeavor and AMS PVD systems from SFI. In connection with the sale of the assets, OEM Group assumed the Company's warranty liability for recently sold legacy Etch and PVD systems.

The Company retained the DRIE products which it had acquired from AMMS, along with the Compact(TM) cluster platform and the NLD technology that it had developed over the past several years. However, the DRIE products and a small amount of associated spares and service revenue, represent the sole source of the Company's revenue. Since the DRIE markets have also been seriously impacted by the downturn in the semiconductor markets and the lack of available capital for new product development globally, it is not clear that DRIE sales alone will be enough to support the Company, even with significant reductions in operating expenses. As a result, the Company continues to operate with a focus on DRIE and at the same time is seeking a strategic partner for its remaining business. The Company is also continuing to evaluate various other alternative strategies, including sale of its DRIE products, Compact(TM) platform and NLD technology, the transition to a new business model, or its voluntary liquidation.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The audited consolidated financial statements have been prepared using the going concern basis, which assumes that we will be able to realize our assets and discharge our liabilities in the normal course of business for the foreseeable future. However, it is not possible to predict when our business and results of operations will improve in light of the current economic downturn that continues to dramatically affect our industry. Therefore, the realization of assets and discharge of liabilities are each subject to significant uncertainty. Accordingly, substantial doubt exists as to whether we will be able to continue as a going concern. If the going concern basis is not appropriate in future filings, adjustments will be necessary to the carrying amounts and/or classification of assets and liabilities in our consolidated financial statements included in such filings.

The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, bad debts, sales returns allowance, inventory, intangible and long lived assets, warranty obligations, restructure expenses, deferred taxes and freight charged to customers. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

In consideration of these circumstances, we continue to evaluate strategic alternatives for the Company, which may include a merger with or into another company, a sale of all or substantially all of our assets or the liquidation or dissolution of the Company, including through a bankruptcy proceeding. We cannot assure you that we will be successful in pursuing any of these strategic alternatives. As we pursue various strategic alternatives and determine that some are more or less likely than others, the consequences of such determinations will be reflected in our financial statements as required by GAAP or FASB.

We believe the following critical accounting policies are the most significant to the presentation of our consolidated financial statements:

### **Revenue Recognition**

Each sale of our equipment is evaluated on an individual basis in regard to revenue recognition. We have integrated in our evaluation the related interpretative guidance included in Topic 13 of the codification of staff accounting bulletins, and recognize the role of the consensus on Emerging Issues Task Force Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables* ("EITF Issue 00-21") (Topic 605). We first refer to EITF Issue 00-21 (Topic 605) in order to determine if there is more than one unit of accounting and then we refer to Staff Accounting Bulletin ("SAB") 104 (Topic 605) for revenue recognition topics for the unit of accounting. We recognize revenue when persuasive evidence of an arrangement exists, the seller's price is fixed or determinable and collectability is reasonably assured.



For products produced according to our published specifications, where no installation is required or installation is deemed perfunctory and no substantive customer acceptance provisions exist, revenue is recognized when title passes to the customer, generally upon shipment. Installation is not deemed to be essential to the functionality of the equipment since installation does not involve significant changes to the features or capabilities of the equipment or building complex interfaces and connections. In addition, the equipment could be installed by the customer or other vendors and generally the cost of installation approximates only 1% of the sales value of the related equipment.

For products produced according to a particular customer's specifications, revenue is recognized when the product has been tested and it has been demonstrated that it meets the customer's specifications and title passes to the customer. The amount of revenue recorded is reduced by the amount (generally 10%), which is not payable by the customer until installation is completed and final customer acceptance is achieved.

For new products, new applications of existing products, or for products with substantive customer acceptance provisions where performance cannot be fully assessed prior to meeting customer specifications at the customer site, 100% of revenue is recognized upon completion of installation and receipt of final customer acceptance. Since title to goods generally passes to the customer upon shipment and 90% of the contract amount becomes payable at that time, inventory is relieved and accounts receivable is recorded for the entire contract amount. The Company relieves the entire amount from inventory at the time of sale, and the related deferred revenue liability is recognized upon installation and customer acceptance. The revenue on these transactions is deferred and recorded as deferred revenue. We reserve for warranty costs at the time the related revenue is recognized.

The Company's return policy is for spare parts and components only. A right of return does not exist for systems. Customers are allowed to return spare parts if they are defective upon receipt. The potential returns are offset against gross revenue on a monthly basis. Management reviews outstanding requests for returns on a quarterly basis to determine that the reserves are adequate.

### **Accounting for Stock-Based Compensation**

The Company has adopted several stock plans that provide for issuance of equity instruments to our employees and non-employee directors. Our plans include incentive and non-statutory stock options and restricted stock awards. These equity awards generally vest ratably over a four-year period on the anniversary date of the grant, and stock options expire ten years after the grant date. Certain restricted stock awards may vest on the achievement of specific performance targets. The Company also has an Employee Stock Purchase Plan ("ESPP") that allows qualified employees to purchase Tegal shares at 85% of the fair market value on specified dates. The stock-based compensation for our ESPP was determined using the Black-Scholes option pricing model and the provisions of SFAS No. 123 (revised 2004), *Share Based Payment* ("SFAS 123R") (Topic 718).

### **Accounts Receivable – Allowance for Sales Returns and Doubtful Accounts**

The Company maintains an allowance for doubtful accounts receivable for estimated losses resulting from the inability of the Company's customers to make required payments. If the financial condition of the Company's customers were to deteriorate, or even a single customer was otherwise unable to make payments, additional allowances may be required. As of June 30, 2010, three customers accounted for approximately 70% of the accounts receivable balance. As of June 30, 2009, two customers accounted for approximately 35% of the accounts receivable balance.

The Company's return policy is for spare parts and components only. A right of return does not exist for systems. Customers are allowed to return spare parts if they are defective upon receipt. The potential returns are offset against gross revenue on a monthly basis. Management reviews outstanding requests for returns on a quarterly basis to determine that the reserves are adequate.

### **Inventories**

Inventories are stated at the lower of cost or market. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis and includes material, labor and manufacturing overhead costs. Any excess and obsolete provision is only released if and when the related inventory is sold or scrapped. The Company did not sell or scrap previously reserved inventory during the three months ended June 30, 2010 and June 30, 2009, respectively. The inventory provision balance at June 30, 2010 and June 30, 2009 was \$1,021 and \$626, respectively.

The Company periodically analyzes any systems that are in finished goods inventory to determine if they are suitable for current customer requirements. At the present time, the Company's policy is that, if after approximately 18 months, it determines that a sale will not take place within the next 12 months and the system would be useable for customer demonstrations or training, it is transferred to fixed assets. Otherwise, it is expensed.

The carrying value of systems used for demonstrations or training is determined by assessing the cost of the components that are suitable for sale. Any parts that may be rendered unsellable as a result of such use are removed from the system and are not included in finished goods inventory. The remaining saleable parts are valued at the lower of cost or market, representing the system's net realizable value. The depreciation period for systems that are transferred to fixed assets is determined based on the age of the system and its remaining useful life (typically five to eight years).

#### **Impairment of Long-Lived Assets**

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable as well as at fiscal year end. If undiscounted expected future cash flows are less than the carrying value of the assets, an impairment loss is recognized based on the excess of the carrying amount over the fair value of the assets. During the quarter ended June 30, 2010, we reviewed our long-lived assets for indicators of impairment in accordance with SFAS No. 144, (Topic 360). No impairment charges were recorded for long-lived assets for the quarters ended June 30, 2010 or 2009.

#### **Warranty Obligations**

We provide for the estimated cost of our product warranties at the time revenue is recognized. Our warranty obligation is affected by product failure rates, material usage rates and the efficiency by which the product failure is corrected. The warranty reserve is based on historical cost data related to warranty. Should actual product failure rates, material usage rates and labor efficiencies differ from our estimates, revisions to the estimated warranty liability may be required. Actual warranty expense is typically low in the period immediately following installation.

#### **Deferred Taxes**

We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Based on the uncertainty of future taxable income, we have fully reserved our deferred tax assets. In the event we were to determine that we would be able to realize our deferred tax assets in the future, an adjustment to the deferred tax asset would increase income in the period such determination was made.

## Results of Operations

The following table sets forth certain financial data for the three months ended June 30, 2010 and 2009 as a percentage of revenue:

	Three Months Ended June 30,	
	2010	2009
Revenue	100.0%	100.0%
Cost of revenue	172.4%	91.4%
Gross (loss)/profit	(72.4)%	8.6%
Operating expenses:		
Research and development	320.4%	114.6%
Sales and marketing	49.4%	65.0%
General and administrative	360.3%	107.1%
Total operating expenses	730.1%	286.7%
Operating loss	(802.5)%	(278.1)%
Other income, net	30.1%	32.7%
Loss before income tax benefit	(772.4)%	(245.4)%
Tax Expense	0.5%	(4.7)%
Net loss	(772.9)%	(240.7)%

The following table sets forth certain financial items for the three months ended June 30, 2010 and 2009:

	Three Months Ended June 30,	
	2010	2009
Revenue	\$ 319	\$ 1,083
Cost of revenue	550	990
Gross (loss)/profit	(231)	93
Operating expenses:		
Research and development expenses	1,023	1,241
Sales and marketing expenses	158	704
General and administrative expenses	1,150	1,160
Total operating expenses	2,331	3,105
Operating loss	(2,562)	(3,012)
Other income, net	96	354
Loss before income tax benefit	(2,466)	(2,658)
Income tax expense (benefit)	2	(51)
Net loss	\$ (2,468)	\$ (2,607)
Net loss per share:		
Basic	\$ (0.29)	\$ (0.31)
Diluted	\$ (0.29)	\$ (0.31)
Weighted average shares used in per share computation:		
Basic	8,438	8,413
Diluted	8,438	8,413

## **Revenue**

Our revenue is derived from sales of new and refurbished systems, spare parts and non-warranty service. Revenue of \$319 for the three months ended June 30, 2010 decreased 71% from revenue for the three months ended June 30, 2009. The revenue decrease was due principally to the sale of legacy Etch and PVD assets to OEM Group, as well as the number and mix of systems sold and the global economic recession that dramatically impacted our industry. During the three months ended June 30, 2010 we sold no systems. Our revenue for the three months ended June 30, 2010 consisted primarily of spare parts and service sales. During the three months ended June 30, 2009, we sold one new Endeavor system. Our revenue for the three months ended June 30, 2009 consisted of the sale of one new Endeavor system, as well as spare parts and service sales, including sales derived from our legacy assets.

As a percentage of total revenue for the three months ended June 30, 2010 international sales were approximately 16%. International sales as a percentage of total revenue for the three months ended June 30, 2009 was approximately 41%. The decrease in international sales as a percentage of revenue can be attributed to no systems being sold in the first quarter of fiscal year 2011. The Company typically sells more systems in international markets.

## **Gross (Loss) Profit**

Gross loss of (\$231) for the three months ended June 30, 2010 decreased by \$324 from gross profit of \$93 for the three months ended June 30, 2009, representing a 349% decrease. The decrease in the gross margin was primarily attributable to the sale of legacy Etch and PVD assets to OEM Group and the lack of systems sold and product mix. The decrease in the gross margin is also affected by the increased costs associated with the outsourcing of the manufacturing of the DRIE systems while also absorbing the costs of our existing manufacturing, purchasing and support infrastructure. At our existing revenue levels, the Company cannot fully absorb its fixed manufacturing related expenses.

Gross margins for our DRIE series systems are typically lower than those of our more mature systems due to the competitive differences in the MEMS market compared to the semi-conductor industry. We believe that the dominant business model driving the lower margins in this market segment is unsustainable and expect gross margins for this product to eventually normalize to levels comparable with our previous product lines.

Our gross profit as a percentage of revenue has been, and will continue to be, affected by a variety of factors, including the mix and average selling prices of systems sold and the costs to manufacture, service and support new product introductions and enhancements. Gross margins for our DRIE systems are generally lower than we have experienced in the past from the sale of our legacy Etch and PVD products, which were sold to OEM Group in March 2010. The principal reasons for the lower margins are: (i) price pressure resulting from customers' historic expectations for the equipment for MEMS productions versus semiconductors; (ii) extreme competition from competitors seeking to gain market share; and (iii) our current manufacturing model, which includes substantial outsourcing of system assembly and final testing.

At the present time, we are focusing our efforts on the continued operation of the Company with the DRIE product lines acquired from AMMS as our main business. Due to limited resources, we have discontinued our development efforts in NLD, but we are offering these assets for sale to third-parties. Since the DRIE markets have also been seriously impacted by the downturn in the semiconductor markets and the lack of available capital for new product development globally, we believe that DRIE sales alone may not be enough to continue supporting the Company, even with significant reductions in the Company's operating expenses resulting from the sale of the legacy Etch and PVD business, as well as a continuation of cost containment measures. Accordingly, while we continue to focus our efforts on the operation of the DRIE business, we continue to seek and evaluate strategic alternatives, which include a continued operation of the Company as a stand-alone business with a different business plan, a merger with or into another company, a sale of all or substantially all of our assets, and the liquidation or dissolution of the Company, including through a voluntary dissolution or a bankruptcy proceeding. We cannot assure you that we will be successful in pursuing any of these strategic alternatives.

## **Research and Development**

Research and development ("R&D") expenses consist primarily of salaries, prototype material and other costs associated with our ongoing systems and process technology development, applications and field process support efforts for our DRIE product line. The spending decrease for the three months ended June 30, 2010 compared to the three months ended June 30, 2009 resulted primarily from a decrease in consulting, payroll, and DRIE amortization and depreciation expense. These decreases were partially offset by increased spending on our R&D operations conducted by our subsidiary, Tegal France.

### **Sales and Marketing**

Sales and marketing expenses consist primarily of salaries, commissions, trade show promotion and travel and living expenses associated with those functions. The decrease in sales and marketing spending of \$546 for the three months ended June 30, 2010, as compared to the same period in 2009 was primarily due to the decrease of employee costs and decreased sales commissions for systems.

### **General and Administrative**

General and administrative expenses consist of salaries, legal, accounting and related administrative services and expenses associated with general management, finance, information systems, human resources and investor relations activities. Overall general and administrative expenses for the three months ended June 30, 2010 as compared to the three months ended June 30, 2009 were relatively unchanged. The increase in accounting and bad debt expenses was offset by a decrease in consulting costs, stock compensation charges and payroll costs. Bad debt increased comparatively due to the net of the collection of previously reserved balances in the three months ended June 30, 2009. In addition, during the three months ended June 30, 2010, the Company reserved an additional \$60 for outstanding balances related to the legacy product line, which was sold in the fourth quarter of fiscal year 2010.

### **Other Income, net**

Other income, net consists of interest income, other income, gains and losses on foreign exchange and gain and losses on the disposal of fixed assets. For the three months ended June 30, 2010 compared to the three months ended June 30, 2009, other income, net decreased by \$258, primarily due to changes in foreign exchange rates offset by the change in fair value of the common stock warrant liability pursuant to EITF 07-05 (Topic 815).

### **Contractual Obligation**

The following summarizes our contractual obligations at June 30, 2010, and the effect such obligations are expected to have on our liquidity and cash flows in future periods (in thousands).

Contractual obligations:	<b>Less than</b>				
	<b>Total</b>	<b>1 Year</b>	<b>1-3 Years</b>	<b>3-5 Years</b>	<b>After 5 Years</b>
Non-cancelable operating lease obligations	\$ 152	\$ 117	\$ 35	\$ -	\$ -

Certain of our sales contracts include provisions under which customers would be indemnified by us in the event of, among other things, a third party claim against the customer for intellectual property rights infringement related to our products. There are no limitations on the maximum potential future payments under these guarantees. We have accrued no amounts in relation to these provisions as no such claims have been made and we believe we have valid, enforceable rights to the intellectual property embedded in its products.

### **Liquidity and Capital Resources**

For the three months ended June 30, 2010, we financed our operations from existing cash on hand. In fiscal year ended March 31, 2010 we financed our operations through the use of existing cash balances. The primary significant changes in our cash flow statement for the three months ended June 30, 2010 were decreases in accounts receivable and prepaid expenses offset by our net loss of (\$2,468) and accounts payable.

Net cash used in operating activities during the three months ended June 30, 2010 was (\$656), primarily due to our net loss of (\$2,468) and decreases in accounts receivable of \$2,392. Net cash used in operating activities during the three months ended June 30, 2009 was (\$1,832), due primarily to the net loss of (\$2,607), increases in inventory of \$510, offset by decreases in accounts receivable of \$988.

The consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business for the foreseeable future. We incurred net losses of (\$2,468) and (\$2,607) for the three months ended June 30, 2010 and 2009, respectively. We used cash flows from operations of (\$656) and (\$1,832) for the three months ended June 30, 2010 and 2009, respectively. Although we believe that our outstanding cash balances, combined with continued cost containment will be adequate to fund operations through fiscal year 2011, we believe there is substantial doubt as to our ability to continue as a going concern if there is not significant improvement in the semiconductor capital equipment industry that has been dramatically impacted by the global economic recession. Our long-term viability of our operations is dependent upon our ability to generate sufficient cash to support our operating needs, fulfill business objectives and fund continued investment in technology and product development without incurring substantial indebtedness that will hinder our ability to compete, adapt to market changes and grow our business in the future. More specifically, our business is dependent upon the sales of our capital equipment, and projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, we would need to reduce expenses further and/or raise additional capital which may include capital raises through the issuance of debt or equity securities in order to continue our business. If additional funds are raised through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of our common stock, and debt covenants could impose restrictions on our operations. Moreover, such financing may not be available to us on acceptable terms, if at all. Failure to raise any needed funds would materially adversely affect us. Therefore, the realization of assets and discharge of liabilities are each subject to significant uncertainty. Accordingly, substantial doubt exists as to whether we will be able to continue as a going concern. If the going concern basis is not appropriate in future filings, no adjustments will be necessary to the carrying amounts and/or classification of assets and liabilities in our consolidated financial statements included in such filings as the consolidated financial statements have been prepared using the going concern basis, which assumes that we will be able to realize our assets and discharge our liabilities in the normal course of business for the foreseeable future.

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

#### ***Foreign Currency Exchange Risk***

At June 30, 2010 and 2009, all of the Company's investments were classified as cash equivalents in the consolidated balance sheets. The investment portfolio at June 30, 2010 and 2009 was comprised of money market funds. Our exposure to foreign currency fluctuations is primarily related to purchases in Europe and Japan, which are denominated in the Euro and Yen. Foreign currency transaction gains and (losses) included in other income (expense), net were \$185 and (\$198) for the three months ended June 30, 2010 and 2009, respectively. Changes in the exchange rate between the Euro and the U.S. dollar could adversely affect our operating results. Exposure to foreign currency exchange rate risk may increase over time as our business evolves and our products continue to be sold into international markets. Periodically, the Company enters into foreign exchange contracts to sell Euros, which are used to hedge a sales transaction in which costs are denominated in U.S. dollars and the related revenue is generated in Euros. As of June 30, 2010 there were no outstanding foreign exchange contracts.

#### ***Interest Rate Risk***

We are only marginally exposed to interest rate risk through interest earned on money market accounts. Interest rates that may affect these items in the future will depend on market conditions and may differ from the rates we have experienced in the past. We do not hold or issue derivatives, commodity instruments or other financial instruments for trading purposes.

### **Item 4. *Controls and Procedures***

#### ***Evaluation of Disclosure Controls and Procedures.***

As of the period covered by this quarterly report, management performed, with the participation of our Chief Executive Officer and Chief Financial Officer, an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) and 15d-15(e) of the Exchange Act. Our disclosure controls and procedures are designed to ensure that information required to be disclosed in the report we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures. Based on the evaluation, our Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2010, such disclosure controls and procedures were effective.

#### ***Changes in Internal Control Over Financial Reporting***

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2010 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## ***Disclosure Controls and Internal Controls for Financial Reporting***

Disclosure controls are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Exchange Act such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Internal controls for financial reporting are procedures which are designed with the objective of providing reasonable assurance that our transactions are properly authorized, our assets are safeguarded against unauthorized or improper use and our transactions are properly recorded and reported, all to permit the preparation of our financial statements in conformity with U.S. GAAP.

## **PART II — OTHER INFORMATION**

### **Item 1A. Risk Factors**

*We wish to caution you that there are risks and uncertainties that could affect our business. A description of the risk factors associated with our business that you should consider when evaluating our business is included under "Risk Factors" contained in Item 1A. of our Annual Report on Form 10-K for the year ended March 31, 2010. In addition to those factors and to other information in this Form 10-Q, the following updates to the risk factors should be considered carefully when evaluating Tegal or our business.*

**We have incurred operating losses and may not be profitable in the future. Our plans to maintain and increase liquidity may not be successful.**

We had net (loss) income of (\$18,469), (\$7,902), and \$18,104 for the years ended March 31, 2010, 2009, and 2008, respectively. We used cash flows from operations of (\$4,887), (\$5,541), and (\$5,057) in these respective years. For the three months ended June 30, 2010 and 2009, we had a net loss of (\$2,468) and (\$2,607), respectively. Although we believe that our outstanding cash balances, combined with continued cost containment will be adequate to fund operations through fiscal year 2011, we believe there is substantial doubt as to our ability to continue as a going concern if there is not significant improvement in the semiconductor capital equipment industry that has been dramatically impacted by the global economic recession. Our long-term viability of our operations is dependent upon our ability to generate sufficient cash to support our operating needs, fulfill business objectives and fund continued investment in technology and product development without incurring substantial indebtedness that will hinder our ability to compete, adapt to market changes and grow our business in the future. More specifically, our business is dependent upon the sales of our capital equipment, and projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, we would need to reduce expenses further and/or raise additional capital which may include capital raises through the issuance of debt or equity securities in order to continue our business. If additional funds are raised through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of our common stock, and debt covenants could impose restrictions on our operations. Moreover, such financing may not be available to us on acceptable terms, if at all. Failure to raise any needed funds would materially adversely affect us.

In consideration of these circumstances, we have engaged Cowen & Co., LLC to assist us in evaluating strategic alternatives for the Company, which may include a merger with or into another company, a sale of all or substantially all of our assets and the liquidation or dissolution of the company, including through a bankruptcy proceeding. We cannot assure you that we will be successful in pursuing any of these strategic alternatives. If we were to liquidate or dissolve the company through or outside of a bankruptcy proceeding, you could lose all of your investment in Tegal common stock.

**Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Description</b>
31.1	Certifications of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certifications of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



**SIGNATURES**

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

TEGAL CORPORATION  
(Registrant)

\_\_\_\_\_  
/s/ CHRISTINE HERGENROTHER

Christine Hergenrother  
*Chief Financial Officer*

Date: August 13, 2010

**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER  
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Thomas R. Mika, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Tegal Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: August 13, 2010

/s/ Thomas R. Mika

\_\_\_\_\_  
Chief Executive Officer and President

---

**CERTIFICATION OF THE CHIEF FINANCIAL OFFICER  
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Christine Hergenrother, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Tegal Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: August 13, 2010

\_\_\_\_\_  
/s/ Christine Hergenrother  
Chief Financial Officer

---

**CERTIFICATION PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(18 U.S.C. SECTION 1350)**

In connection with the Quarterly Report of Tegal Corporation, a Delaware corporation (the "Company"), on Form 10-Q for the quarter ended June 30, 2010 as filed with the Securities and Exchange Commission (the "Report"), I, Thomas R. Mika, President and Chief Executive Officer of the Company, certify, pursuant to Sec. 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Sec. 1350), that to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Thomas R. Mika

Chief Executive Officer and President

August 13, 2010

---

**CERTIFICATION PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(18 U.S.C. SECTION 1350)**

In connection with the Quarterly Report of Tegal Corporation, a Delaware corporation (the "Company"), on Form 10-Q for the quarter ended June 30, 2010 as filed with the Securities and Exchange Commission (the "Report"), I, Christine Hergenrother, Chief Financial Officer of the Company, certify, pursuant to Sec. 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Sec. 1350), that to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Christine Hergenrother  
Chief Financial Officer  
August 13, 2010

---