

LIQUID AUDIO INC  
Form 10-Q  
May 15, 2002  
Table of Contents

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

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**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2002**

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.**

**Commission File Number 000-25977**

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**LIQUID AUDIO, INC.**

(Exact name of registrant as specified in its charter)

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

**77-0421089**  
(I.R.S. Employer  
Identification No.)

**800 Chesapeake Drive, Redwood City, CA**  
(Address of principal executive offices)

**94063**  
(Zip Code)

**(650) 549-2000**  
(Registrant's telephone number, including area code)

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

As of April 30, 2002, there were 22,745,624 shares of registrant's Common Stock outstanding.

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**Table of Contents**

**LIQUID AUDIO, INC.**

**INDEX**

<b>PART I. <u>FINANCIAL INFORMATION</u></b>		1
ITEM 1.	<b><u>FINANCIAL STATEMENTS</u></b>	1
	<i><u>Condensed Consolidated Balance Sheets as of March 31, 2002 and December 31, 2001</u></i>	
	<i><u>Condensed Consolidated Statements of Operations for the three months ended March 31, 2002 and 2001</u></i>	
	<i><u>Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2002 and 2001</u></i>	
	<i><u>Notes to Condensed Consolidated Financial Statements</u></i>	
ITEM 2.	<b><u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u></b>	11
ITEM 3.	<b><u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u></b>	28
<b>PART II. <u>OTHER INFORMATION</u></b>		29
ITEM 1.	<b><u>LEGAL PROCEEDINGS</u></b>	29
ITEM 2.	<b><u>CHANGES IN SECURITIES AND USE OF PROCEEDS</u></b>	30
ITEM 4.	<b><u>SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u></b>	30
ITEM 6.	<b><u>EXHIBITS AND REPORTS ON FORM 8-K</u></b>	30
<b><u>SIGNATURES</u></b>		31

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****LIQUID AUDIO, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands)

	<b>March 31, 2002</b>	<b>December 31, 2001</b>
	<b>(unaudited)</b>	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 86,358	\$ 91,594
Accounts receivable, net	134	130
Other current assets	956	1,099
	<b>_____</b>	<b>_____</b>
Total current assets	87,448	92,823
	<b>_____</b>	<b>_____</b>
Restricted cash	826	826
Property and equipment, net	2,994	3,603
Other assets	163	163
	<b>_____</b>	<b>_____</b>
Total assets	\$ 91,431	\$ 97,415
	<b>_____</b>	<b>_____</b>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 849	\$ 1,107
Accrued liabilities	3,075	3,821
Deferred revenue	110	122
Capital lease obligations	21	28
Equipment loan	47	169
Note payable to related party	339	343
	<b>_____</b>	<b>_____</b>
Total current liabilities	4,441	5,590
	<b>_____</b>	<b>_____</b>
Stockholders' equity:		
Common stock	23	23
Additional paid-in capital	203,006	202,969
Unearned compensation	(27)	(43)
Accumulated deficit	(115,987)	(111,094)
Accumulated other comprehensive loss	(25)	(30)
	<b>_____</b>	<b>_____</b>
Total stockholders' equity	86,990	91,825
	<b>_____</b>	<b>_____</b>
Total liabilities and stockholders' equity	\$ 91,431	\$ 97,415
	<b>_____</b>	<b>_____</b>

See accompanying notes to condensed consolidated financial statements

**Table of Contents****LIQUID AUDIO, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share amounts; unaudited)

	Three Months Ended March 31,	
	2002	2001
Net revenues:		
License	\$ 36	\$ 290
Services	99	425
Business development (related party)		946
<b>Total net revenues</b>	<b>135</b>	<b>1,661</b>
Cost of net revenues:		
License	97	159
Services	128	711
Non-cash cost of revenue	33	83
<b>Total cost of net revenues</b>	<b>258</b>	<b>953</b>
<b>Gross profit</b>	<b>(123)</b>	<b>708</b>
Operating expenses:		
Sales and marketing	1,158	4,656
Non-cash sales and marketing	11	9
Research and development	3,023	5,230
Non-cash research and development	5	9
General and administrative	1,106	3,194
Non-cash general and administrative		5
Strategic marketing equity instruments		312
<b>Total operating expenses</b>	<b>5,303</b>	<b>13,415</b>
<b>Loss from operations</b>	<b>(5,426)</b>	<b>(12,707)</b>
Other income (expense), net	533	1,659
Loss in equity investment		(219)
<b>Net loss</b>	<b>\$ (4,893)</b>	<b>\$ (11,267)</b>
Net loss per share:		
Basic and diluted	\$ (0.22)	\$ (0.50)
<b>Weighted average shares</b>	<b>22,709</b>	<b>22,528</b>

See accompanying notes to condensed consolidated financial statements

**Table of Contents**

**LIQUID AUDIO, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands; unaudited)

	Three Months Ended March 31,	
	2002	2001
<b>Cash flows from operating activities:</b>		
Net loss	\$ (4,893)	\$ (11,267)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	646	1,122
Amortization of unearned compensation	16	24
Allowance for doubtful accounts and sales returns reserve		18
Equity in net loss of investments		219
Strategic marketing-equity instruments		312
Non-cash cost of revenue	33	82
Changes in assets and liabilities:		
Accounts receivable from third parties	(4)	(87)
Accounts receivable from related parties		110
Other assets	143	675
Accounts payable	(258)	(236)
Accrued liabilities	(746)	778
Deferred revenue from third parties	(12)	149
Deferred revenue from related parties		(1)
	<u>          </u>	<u>          </u>
Net cash used in operating activities	(5,075)	(8,102)
	<u>          </u>	<u>          </u>
<b>Cash flows from investing activities:</b>		
Acquisition of property and equipment	(37)	(446)
Sales of short-term investments, net		26,886
Equity investment		(165)
	<u>          </u>	<u>          </u>
Net cash provided by (used in) investing activities	(37)	26,275
	<u>          </u>	<u>          </u>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock, net of repurchases	4	
Payments made under capital leases	(7)	(36)
Payments made under equipment loan	(122)	(148)
	<u>          </u>	<u>          </u>
Net cash used in financing activities	(125)	(184)
	<u>          </u>	<u>          </u>
Effect of exchange rates on cash and cash equivalents	1	(80)
	<u>          </u>	<u>          </u>
Net increase (decrease) in cash and cash equivalents	(5,236)	17,909
Cash and cash equivalents at beginning of period	91,594	96,398
	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of period	\$ 86,358	\$ 114,307
	<u>          </u>	<u>          </u>
<b>Supplemental disclosures:</b>		
Cash paid for interest	\$ 9	\$ 22

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**Non-cash investing and financing activities:**

Issuance of warrants in connection with strategic marketing agreements	\$	33	\$	51
Issuance of common stock in connection with strategic marketing agreements				343

See accompanying notes to condensed consolidated financial statements

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**Table of Contents**

**LIQUID AUDIO, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**NOTE 1 THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

***The Company***

Liquid Audio, Inc. (the Company) was incorporated in California in January 1996 and reincorporated in Delaware in April 1999. In July 2000, the Company established a wholly-owned subsidiary in the United Kingdom, Liquid Audio Europe PLC, which reregistered in August 2001 as Liquid Audio Europe Limited, to develop sales in Europe. The Company was formed with the goal of becoming the premier provider of software applications and services that enable the secure delivery and sale of digital music over the Internet. The Company's end-to-end solutions enable the secure distribution, promotion and sale of high quality music files while providing consumers with the ability to access, preview and purchase that music via the Internet.

***Basis of presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company and reflect all adjustments, which are in the opinion of management, necessary for a fair presentation of the interim periods presented. The results of operations for the three months ended March 31, 2002 are not necessarily indicative of the results to be expected for any subsequent quarter or for the year ending December 31, 2002. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the Securities and Exchange Commission's rules and regulations. A condensed consolidated statement of comprehensive loss has not been presented because the components of comprehensive loss are not material.

These unaudited condensed consolidated interim financial statements and notes included herein should be read in conjunction with the Company's audited consolidated financial statements and notes as included in the Company's Annual Report on Form 10-K for the year ended December 31, 2001 as filed with the Securities and Exchange Commission (the SEC) on March 29, 2002.

***Reclassifications***

Certain reclassifications have been made to the prior periods' consolidated financial statements to conform to the current period presentation.

***Principles of consolidation***

The financial statements include the accounts of the Company and its subsidiary. Significant intercompany transactions and balances have been eliminated. Investments in entities in which the Company can exercise significant influence, but are less than majority owned and not otherwise controlled by the Company, are accounted for under the equity method.

***Restricted cash***

At March 31, 2002, the Company had a cash balance of \$826,000 in the form of certificates of deposit, which were restricted from withdrawal. The amount serves as collateral to a letter of credit issued by the Company's bank to the Company's lessor as security deposit on a long-term lease.

***Revenue recognition***

Software license revenues are recognized when persuasive evidence of an arrangement exists, delivery has occurred, no significant Company obligations with regard to implementation or integration exist, the fee is fixed or determinable and collection is probable as prescribed in SOP No. 97-2, Software Revenue Recognition. For arrangements with multiple elements, the total fee from the arrangement is allocated among each element based upon

**Table of Contents****LIQUID AUDIO, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(unaudited)**

vendor specific objective evidence ( VSOE ) of fair value. When VSOE of fair value exist for the undelivered elements, primarily maintenance, the Company accounts for the license portion based on the residual method as prescribed by SOP No. 98-9, Modification of SOP 97-2 with Respect to Certain Transactions. When VSOE of fair value does not exist for the undelivered elements, the total fee from the arrangement is recognized ratably over the period of the contract. The Company recognizes revenue allocated to maintenance ratably over the contract period, which is generally twelve months.

Business development revenue primarily consists of license and maintenance fees from agreements under which the Company gives its strategic partners the right to license and use the Company's digital recorded music delivery technology. These U.S. dollar-denominated, non-refundable fees are allocated among the various elements of the contract based on VSOE of fair value. When VSOE of fair value exist for the undelivered elements, primarily maintenance, the Company accounts for the license portion based on the residual method as prescribed by SOP No. 98-9. When VSOE of fair value does not exist for the undelivered elements, the total fee from the business development arrangement is recognized ratably over the period of the contract. The total fee from business development arrangements is recognized when payment becomes due if extended payment terms exist. Extended payment terms are defined as payment terms outside the Company's customary business practice, generally greater than 90 days. Revenue is not recognized if the strategic partners stop making their contractual payments.

The Company also generates license and service revenues from digital music kiosk sales and hosting services. Revenue derived from hosting services include subscription fees from artists for encoding and storing music files, e-commerce services and transaction reporting. Music delivery services revenue include transaction fees from sales of digital recorded music through the Company's website affiliates and fees from music retailers and websites related to the sample digital music clips delivery service. Revenue from kiosk sales consist of software licenses and services revenue from equipment and kiosk-related services. The Company bears full credit risk with respect to substantially all sales.

**Recent accounting pronouncement**

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 addresses significant issues relating to the implementation of SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and develops a single accounting method under which long-lived assets that are to be disposed of by sale are measured at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and its provisions are to be applied prospectively. The Company is currently assessing the impact of SFAS No. 144 on its financial position and results of operations.

**NOTE 2 BALANCE SHEET COMPONENTS:**

The components of accounts receivable from third parties, net are as follows (in thousands):

	<b>March 31, 2002</b>	<b>December 31, 2001</b>
	<b>_____</b>	<b>_____</b>
Accounts receivable from third parties, net:		
Accounts receivable	\$ 454	\$ 455
Less: allowance for doubtful accounts	(320)	(325)
	<b>_____</b>	<b>_____</b>
	<b>\$ 134</b>	<b>\$ 130</b>
	<b>_____</b>	<b>_____</b>



**Table of Contents****LIQUID AUDIO, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(unaudited)**

The allowance for doubtful accounts decreased by \$0 and \$(52,000) for the three months ended March 31, 2002 and the year ended December 31, 2001, respectively. Write-offs against the allowance for doubtful accounts were \$5,000 and \$211,000 for the three months ended March 31, 2002 and the year ended December 31, 2001, respectively.

The components of accounts receivable from related parties, net are as follows (in thousands):

	<u>March 31, 2002</u>	<u>December 31, 2001</u>
Accounts receivable from related parties, net:		
Accounts receivable	\$ 1,555	\$ 1,555
Less: allowance for doubtful accounts	(1,555)	(1,555)
	<u>\$</u>	<u>\$</u>

The allowance for doubtful accounts increased by \$0 and \$1,510,000 for the three months ended March 31, 2002 and the year ended December 31, 2001, respectively. No write-offs against the allowance for doubtful accounts were made for the three months ended March 31, 2002 and the year ended December 31, 2001, respectively.

The components of property and equipment are as follows (in thousands):

	<u>March 31, 2002</u>	<u>December 31, 2001</u>
Property and equipment:		
Computer equipment and purchased software	\$ 11,051	\$ 11,016
Website and software development costs	235	235
Furniture and fixtures	555	555
Leasehold improvements	601	599
	<u>12,442</u>	<u>12,405</u>
Less: Accumulated depreciation and amortization	(9,448)	(8,802)
	<u>\$ 2,994</u>	<u>\$ 3,603</u>

Property and equipment includes \$99,000 of equipment under capital leases at March 31, 2002 and December 31, 2001. Accumulated depreciation and amortization for equipment under capital leases was \$97,000 and \$95,000 at March 31, 2002 and December 31, 2001, respectively. Depreciation expense for the three months ended March 31, 2002 and the year ended December 31, 2001 was \$547,000 and \$3,715,000, respectively. Amortization expense for purchased software, website and software development costs for the three months ended March 31, 2002 and the year ended December 31, 2001 was \$99,000 and \$144,000, respectively. Unamortized purchased software, website and software development costs was \$598,000 and \$672,000 at March 31, 2002 and December 31, 2001, respectively.

**Table of Contents**

The components of accrued liabilities are as follows (in thousands):

	<b>March 31, 2002</b>	<b>December 31, 2001</b>
Accrued liabilities:		
Compensation and benefits	\$ 1,208	\$ 1,124
Consulting and professional services	743	1,357
Restructuring	235	523
Other	889	817
	<b>\$ 3,075</b>	<b>\$ 3,821</b>

**NOTE 3 RELATED PARTIES:***Investments in related parties*

The Company owns 4.60% of the outstanding shares of Cyber Music Entertainment ( CME ), formerly Liquid Audio Japan ( LAJ ), and accounts for its investment under the equity method of accounting. The investment was written down to \$0 at December 31, 2001.

Licensing and reseller agreements with Liquid Audio Korea Co. Ltd., Liquid Audio Greater China and Liquid Audio South East Asia through the strategic partner were terminated in 2001. No revenue was recorded in the three months ended March 31, 2002 and outstanding accounts receivable from these entities has been fully reserved.

*Total business development revenue*

Total business development revenues are summarized as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2002</b>	<b>2001</b>
Cyber Music Entertainment and strategic partner	\$	946

The total fees earned from Cyber Music Entertainment relate to software licensing and maintenance fees in the three months ended March 31, 2001.

**NOTE 4 COMPREHENSIVE LOSS:**

Comprehensive loss includes net loss and other comprehensive income (loss). Other comprehensive income (loss) includes accumulated translation adjustments. For the three months ended March 31, 2002 and 2001, the components of comprehensive loss are as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2002</b>	<b>2001</b>
Comprehensive loss:		
Net loss	\$ (4,893)	\$ (11,267)
Foreign currency translation adjustments	5	(46)
Unrealized gain on investments		6
	<b>\$ (4,888)</b>	<b>\$ (11,307)</b>



**Table of Contents****NOTE 5 NET LOSS PER SHARE:**

Basic and diluted net loss per share is computed by dividing the net loss for the period by the weighted average number of common shares outstanding during the period. The calculation of diluted net loss per share excludes potential common shares if the effect is anti-dilutive. Potential common shares consist of unvested restricted common stock, incremental common shares issuable upon the exercise of stock options and common shares issuable upon the exercise of common stock warrants.

The following table sets forth the computation of basic and diluted net loss per share for the periods indicated (in thousands, except per share amounts):

	<b>Three Months Ended March 31,</b>	
	<b>2002</b>	<b>2001</b>
Numerator:		
Net loss	\$ (4,893)	\$ (11,267)
Denominator:		
Weighted average shares	22,710	22,542
Weighted average unvested common shares subject to repurchase	(1)	(14)
Denominator for basic and diluted calculation	22,709	22,528
Net loss per share:		
Basic and diluted	\$ (0.22)	\$ (0.50)

The following table sets forth potential shares of common stock that are not included in the diluted net loss per share calculation above because to do so would be anti-dilutive for the periods indicated (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2002</b>	<b>2001</b>
Common stock options	2,793	2,745
Common stock warrants	748	875
Unvested common stock subject to repurchase	1	14

**NOTE 6 STRATEGIC MARKETING EQUITY AGREEMENTS:**

In March and April 1999, the Company granted fully vested warrants to purchase 12,000 shares of common stock at \$6.56 per share. These warrants were valued at \$95,000 using the Black-Scholes option pricing model and were recognized as strategic marketing-equity instruments expense. At March 31, 2002, warrants to purchase 10,200 shares of common stock are outstanding and expire in April 2004.

In June 1999, the Company signed an Advertising Agreement with Amazon.com, Inc. ( Amazon.com ) to collaborate on event-based advertising using the Company's digital delivery services. In connection with this agreement, the Company issued a fully vested warrant to purchase approximately 254,000 shares of common stock to Amazon.com. The warrant was valued at \$2,022,000 and was recognized as strategic marketing-equity instruments expense ratably over the one-year term of the agreement, which ended in June 2000. At March 31, 2002, warrants to purchase approximately 254,000 shares of common stock are outstanding and expire in June 2004.

In August 1999, the Company signed a Digital Audio Co-Marketing and Distribution Agreement with Yahoo! to promote the distribution of digital music on its web site. In connection with this agreement, the Company granted Yahoo! three warrants to purchase a total of 250,000 shares of common stock. The first warrant for 83,334 shares vested immediately. The first warrant was valued at \$903,000 and was recognized

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ratably over the one-year term of the agreement as strategic marketing-equity instruments expense. The second warrant for 83,333 shares vested in

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**Table of Contents**

August 2000. The second warrant was initially valued at \$426,000 and was recognized ratably over the one-year period ending at the vesting date as strategic marketing-equity instruments expense. The second warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of \$426,000 was reduced to \$312,000 based on market data during the vesting period. The third warrant for 83,333 shares vested in August 2001. The third warrant was initially valued at \$105,000 and was recognized ratably over the one-year period ending at the vesting date. The third warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of \$105,000 was reduced to \$54,000 based on market data during the vesting period. In the three months ended March 31, 2001, \$17,000 was recognized as strategic marketing-equity instruments expense for the third warrant. At March 31, 2002, warrants to purchase 83,334 and 166,666 shares of common stock are outstanding and expire in September 2002 and 2003, respectively.

In December 2000, the Company signed an agreement with BMG Entertainment to obtain the right to distribute BMG sound recordings and related artwork through kiosks. In connection with this agreement, the Company issued 50,000 shares of common stock to BMG. These shares were valued at \$195,000 and which was recognized as non-cash cost of net revenues ratably over the one-year term of the agreement. As a result, \$49,000 was recognized as non-cash cost of net revenues in the three months ended March 31, 2001. Additionally, the Company granted warrants to purchase a total of 233,300 shares of common stock. Of the total, warrants to purchase 77,768 shares vested in December 2001, and the cost was remeasured each quarter until a commitment for performance was reached or the warrant vested based on market data. At December 4, 2001, the 77,768 shares under this warrant was valued at \$175,000, of which \$33,000 was recognized as non-cash cost of net revenues in the three months ended March 31, 2001. The remaining warrants to purchase common shares vest at 6,481 shares per month commencing December 2001 for one year and 6,480 shares per month commencing December 2002 for one year. We recorded a total of \$33,000 as non-cash cost of revenue in the three months ended March 31, 2002 related to the remaining warrants. Such warrants will be valued at the fair market value of the Company's common stock on each reporting date. At March 31, 2002, warrants to purchase 97,211 shares of common stock are outstanding and expire in December 2005.

**NOTE 7 RESTRUCTURING:**

In May 2001, the Company adopted a corporate restructuring program to reduce expenses to preserve the Company's cash position while the digital music market develops. The restructuring included a worldwide workforce reduction, a consolidation of three Redwood City, California offices into one facility and other expense management initiatives. A restructuring charge of \$4,497,000 was recorded in operating expense in the twelve months ended December 31, 2001.

The restructuring charge included involuntary employee separation costs of \$1,116,000 for 79 employees worldwide, 20 in sales and marketing, 32 in research and development, 13 in general and administrative and 6 in operations functions in the U.S., and 2 in sales and marketing, 3 in research and development and 3 in operations functions outside the U.S.

Lease costs of \$1,214,000 were accrued pertaining to the estimated future obligations for non-cancelable lease payments for excess facilities that were vacated due to reductions in workforce.

Asset impairment costs of \$2,167,000 were recorded, primarily for property and equipment, furniture and fixtures, computer software and leasehold improvements for assets no longer in use from de-emphasized business lines, reductions in workforce and excess facilities.

**Table of Contents**

A summary of the restructuring cost is outlined as follows (in thousands):

	<u>Severance and Benefits</u>	<u>Facilities</u>	<u>Asset Impairments</u>	<u>Total</u>
Severance and benefits	\$ 1,116	\$	\$	\$ 1,116
Accrued lease costs		1,214		1,214
Property and equipment impairment			2,167	2,167
<b>Total</b>	<b>1,116</b>	<b>1,214</b>	<b>2,167</b>	<b>4,497</b>
Cash paid	(1,116)	(691)		(1,807)
Non-cash			(2,167)	(2,167)
<b>Restructuring reserve balance at December 31, 2001</b>		<b>523</b>		<b>523</b>
Cash paid		(288)		(288)
<b>Restructuring reserve balance at March 31, 2002</b>	<b>\$</b>	<b>\$ 235</b>	<b>\$</b>	<b>\$ 235</b>

Remaining cash expenditures related to net lease expense due to the consolidation of facilities will be paid over the lease terms through the fourth quarter of 2002.

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**Table of Contents**

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

The following Management's Discussion and Analysis contains forward-looking statements within the meaning of Federal securities laws. You can identify these statements because they use forward-looking terminology such as may, will, expect, anticipate, estimate, continue, intend or other similar words. These words, however, are not the exclusive means by which you can identify these statements. You can also identify forward-looking statements because they discuss future expectations, contain projections of results of operations or of financial conditions, characterize future events or circumstances or state other forward-looking information. We have based all forward-looking statements included in Management's Discussion and Analysis on information currently available to us, and we assume no obligation to update any such forward-looking statements. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, actual results could differ materially from those projected in the forward-looking statements. Potential risks and uncertainty include, among others, those set forth under the caption Additional Factors Affecting Future Results included in this Management's Discussion and Analysis of Financial Condition and Results of Operations.

While we believe that the discussion and analysis in this report is adequate for a fair presentation of the information, we recommend that you read this discussion and analysis with Management's Discussion and Analysis included in our Annual Report on Form 10-K for the year ended December 31, 2001 filed with the SEC.

**Overview**

We are a leading provider of software products and services that enable artists, record companies and retailers to create, syndicate and sell music digitally over the Internet. Our products and services are based on an open technical architecture that is designed to support a variety of digital music formats. From our inception in January 1996 through early 1997, we devoted substantially all of our efforts to product development, raising capital and recruiting personnel. We first generated revenues in the first quarter of 1997 through the licensing of our Liquifier Pro, Liquid Server and Liquid Player software products. In November 1997, we introduced a subscription-based hosting service for digital recorded music using our technology. In July 1998, to enhance consumer access to the music we were hosting, we launched the Liquid Music Network ( LMN ), a syndicated network leading music-related and music retailer websites.

In early 1999, we began to place greater emphasis on developing and marketing our digital music delivery services. Since that time, we have invested significant resources to increase our distribution reach by expanding the LMN, building our syndicated music catalog available for sale, actively participating in standards initiatives and establishing our international presence. We also have established international initiatives within the Pacific Rim and a subsidiary in Europe to lay the groundwork for offering digital music download services to consumers in these markets. More recently, we began focusing additional attention on licensing our server software products. As a provider of digital music delivery services, we expect our revenue sources to expand beyond software license sales to include sales of digital recorded music and digital music subscriptions. Revenues from digital music sales and transaction fees from our music delivery services represented less than 25%, 7% and 6% of total net revenues in the three months ended March 31, 2002 and the twelve months ended December 31, 2001 and 2000, respectively. Our Liquid Music Network began offering syndicated music through music retailer websites in the third quarter of 1999.

Business development revenues as a percentage of total net revenues were 0%, 61% and 63% in the three months ended March 31, 2002 and the twelve months ended December 31, 2001 and 2000, respectively. In 2001, we terminated our agreements with Liquid Audio Japan ( LAJ ), Liquid Audio Korea ( LAK ), Liquid Audio Greater China ( LAGC ) and Liquid Audio South East Asia ( LASE ) through our strategic partner.

In May 2001, we adopted a corporate restructuring program to reduce expenses to preserve our cash position while the digital music market develops. The restructuring included a worldwide workforce reduction, a consolidation of three Redwood City, California offices into one facility and other expense management initiatives. We have de-emphasized our efforts in less productive, non-core business areas that do not directly support secure digital download opportunities, including digital music kiosks, music hosting for independent artists and labels, music clips service and encoding services. We plan to continue to focus on software licensing and digital music



**Table of Contents**

delivery services that complement our secure digital download business. We plan to support the emerging market for digital music subscriptions, enabling major portals, online retailers and secure audio device manufacturers to offer subscription-based digital music download services. This strategy leverages and enhances both our core digital download services and our player software licensing business. At March 31, 2002, we have a remaining \$235,000 restructuring accrual balance related to estimated future obligations for non-cancelable lease payments for excess facilities that were vacated due to reductions in workforce. This accrual will be paid over the lease terms through the fourth quarter of 2002.

We have a limited operating history upon which investors may evaluate our business and prospects. Since inception we have incurred significant losses, and as of March 31, 2002 we had an accumulated deficit of approximately \$116.0 million. We expect to incur additional losses and continued negative cash flow from operations through at least mid-2003. Our revenues may not increase or even continue at their current levels and we may not achieve or maintain profitability or generate cash from operations in future periods. The digital music market may never develop to the extent that we are able to generate positive cash flows. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stages of development, particularly companies in new and rapidly evolving markets such as the digital delivery of recorded music. We may not be successful in addressing these risks, and our failure to do so would harm our business.

**Table of Contents****Results of Operations**

The following table sets forth, for the periods presented, certain data derived from our unaudited condensed statement of operations as a percentage of total net revenues. The operating results in any period are not necessarily indicative of the results that may be expected for any future period.

	<b>Three Months Ended March 31,</b>	
	<b>2002</b>	<b>2001</b>
Net revenues:		
License	27%	17%
Services	73	26
Business development (related party)		57
<b>Total net revenues</b>	<b>100</b>	<b>100</b>
Cost of net revenues:		
License	72	9
Services	95	43
Non-cash cost of revenue	24	5
<b>Total cost of net revenues</b>	<b>191</b>	<b>57</b>
<b>Gross profit</b>	<b>(91)</b>	<b>43</b>
Operating expenses:		
Sales and marketing	858	280
Non-cash sales and marketing	8	1
Research and development	2,239	315
Non-cash research and development	4	1
General and administrative	819	192
Non-cash general and administrative		
Strategic marketing-equity instruments		19
<b>Total operating expenses</b>	<b>3,928</b>	<b>808</b>
<b>Loss from operations</b>	<b>(4,019)</b>	<b>(765)</b>
Other income (expense), net	395	100
Loss in equity investment		(13)
<b>Net loss</b>	<b>(3,624)%</b>	<b>(678)%</b>

**Three Months Ended March 31, 2002 and 2001***Total Net Revenues*

Total net revenues decreased 92% to \$135,000 for the three months ended March 31, 2002 from \$1.7 million in the comparable period of 2001.

*License.* License revenues primarily consist of fees from licensing our software products to third parties. License revenues decreased 88% to \$36,000 for the three months ended March 31, 2002 from \$290,000 in the comparable period of 2001. This decrease was due to lower Liquid

Player software licensing.

*Services.* Services revenues primarily consist of maintenance fees related to our licensed software products, hosting fees, encoding, music delivery and transaction fees, promotion and advertising services and kiosk-related equipment sales from third parties. Services revenues decreased 77% to \$99,000 for the three months ended March 31, 2002 from \$425,000 in the comparable period of 2001. This decrease was due to decreases in encoding services, promotion and advertising services, Liquid Muze Previews service and hosting fees.

**Table of Contents**

*Business Development (Related Party).* Business development revenues primarily consist of license and maintenance fees from agreements under which we give our strategic related partners the right to license and use our digital recorded music delivery technology. Business development revenues decreased to \$0 for the three months ended March 31, 2002 from \$946,000 in the comparable period of 2001. The decrease was due to the termination of our agreements in 2001 with Liquid Audio Japan, Liquid Audio Korea, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner. Revenue for the 2001 period relates solely to software licensing and related maintenance revenues earned from Liquid Audio Japan. We do not expect to derive significant revenue from business development arrangement in the foreseeable future.

In the first three months of 2002, approximately 14% of total net revenues came from sales to one customer, Sanyo. In the first three months of 2001, approximately 57% of total net revenues came from sales to one customer, Cyber Music Entertainment. International revenues represented approximately 14% and 65% of total net revenues in the three months ended March 31, 2002 and 2001, respectively.

*Total Cost of Net Revenues*

Our gross profit decreased to approximately (91)% of total net revenues for the three months ended March 31, 2002 from approximately 43% of total net revenues in the comparable period of 2001. Total cost of net revenues decreased 73% to \$258,000 in the 2002 period from \$953,000 in the 2001 period.

*License.* Cost of license revenues primarily consists of royalties paid to third-party technology vendors and costs of documentation, duplication and packaging. Cost of license revenues decreased 39% to \$97,000 for the three months ended March 31, 2002 from \$159,000 in the comparable period of 2001. Cost of license revenues decreased due to lower license revenues and product mix differences, partially offset by royalties for additional third-party technologies.

*Services.* Cost of services revenues primarily consists of compensation for customer service, encoding and professional services personnel, kiosk-related equipment and an allocation of our occupancy costs and other overhead attributable to our services revenues. Cost of services revenues decreased 82% to \$128,000 for the three months ended March 31, 2002 from \$711,000 in the comparable period of 2001. The decrease in cost of services revenues was due to the reduction in the number of encoding, customer service and professional services personnel from 28 to 12 due to our corporate restructuring.

*Non-Cash Cost of Revenues.* Non-cash cost of revenues consist of expenses associated with the value of common stock and warrants issued to partners as part of our content acquisition agreements and stock-based employee compensation arrangements. Common stock expense is based on the fair value of the stock at the time it was issued. Warrant expense is based on the estimated fair value of the warrants based on the Black-Scholes option pricing model and the provisions of EITF 96-18. In December 2000, we signed an agreement with BMG Entertainment ( BMG ) to obtain the right to distribute BMG sound recordings and related artwork through kiosks. In connection with this agreement, we issued 50,000 shares of common stock to BMG, valued at \$195,000 and which was recognized ratably over the initial one-year term of the agreement; as a result, \$49,000 was recognized as non-cash cost of revenues in the three months ended March 31, 2001. Also in connection with this agreement, we granted a warrant for a total of 233,300 shares of common stock. Of the total, warrants to purchase 77,768 shares vested in December 2001, and the cost was remeasured each quarter until a commitment for performance was reached or the warrant vested, based on market data. At December 4, 2001, the 77,768 shares under this warrant were valued at \$175,000, of which \$33,000 was recognized as non-cash cost of revenues for the three months ended March 31, 2001. The remaining warrants to purchase common shares vest at 6,481 shares per month commencing December 2001 for one year and 6,480 shares per month commencing December 2002 for one year. We recorded a total of \$33,000 as non-cash cost of revenue in the three months ended March 31, 2002 related to the remaining warrants. Such warrants are valued at the fair market value of our common stock at each vesting date. Stock compensation expense for customer service, encoding and professional services personnel were \$0 and \$1,000 in the three months ended March 31, 2002 and 2001, respectively. We have fully amortized stock compensation expense related to these personnel in 2001, and accordingly no future expense related to these stock options will be incurred.

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**Table of Contents***Operating Expenses*

*Sales and Marketing.* Sales and marketing expenses consist primarily of compensation for our sales, marketing and business development personnel, compensation for customer service and professional services personnel attributable to sales and marketing activities, advertising, trade show and other promotional costs, design and creation expenses for marketing literature and our website and an allocation of our occupancy costs and other overhead. Sales and marketing expenses decreased 75% to \$1.2 million for the three months ended March 31, 2002 from \$4.7 million in the comparable period of 2001. This decrease was primarily due to decreases in the number of sales and marketing personnel from 59 to 22 due to our corporate restructuring and expense management initiatives, advertising and promotional programs.

*Research and Development.* Research and development expenses consist primarily of compensation for our research and development, network operations and product management personnel, payments to outside contractors and, to a lesser extent, depreciation on equipment used for research and development and an allocation of our occupancy costs and other overhead. Research and development expenses decreased 42% to \$3.0 million for the three months ended March 31, 2002 from \$5.2 million in the comparable period of 2001. This decrease was primarily due to decreases in the number of personnel from 88 to 50 and outside contractors due to our corporate restructuring and expense management initiatives.

*General and Administrative.* General and administrative expenses consist primarily of compensation for personnel and payments to outside contractors for general corporate functions, including finance, information systems, human resources, facilities, legal and general management, fees for professional services, bad debt expense and an allocation of our occupancy costs and other overhead. General and administrative expenses decreased 65% to \$1.1 million for the three months ended March 31, 2002 from \$3.2 million in the comparable period of 2001. This decrease was primarily due to decreases in the number of personnel from 31 to 17 and outside contractors due to our corporate restructuring and expense management initiatives.

*Strategic Marketing Equity Instruments.* Strategic marketing-equity instruments consist of expenses associated with the value of common stock and warrants issued to partners as part of our strategic marketing agreements. Common stock expense is based on the fair value of the stock at the time it was issued. Warrant expense is based on the estimated fair value of the warrants based on the Black-Scholes option pricing model and the provisions of EITF 96-18. Strategic marketing-equity instruments expense was \$0 and \$312,000 in the three months ended March 31, 2002 and 2001, respectively. In June 1999, we signed an advertising agreement with Amazon.com, Inc. ( Amazon.com ) to collaborate on event-based advertising using our digital delivery services. In connection with this agreement, we issued a fully vested warrant to purchase approximately 254,000 shares of common stock to Amazon.com. The warrant was valued at \$2.0 million and was recognized ratably over the one-year term of the agreement; as a result, \$0 and \$506,000 was recognized as strategic marketing-equity instruments expense in the three months ended March 31, 2002 and 2001, respectively. In August 1999, we signed a Digital Audio Co-Marketing and Distribution Agreement with Yahoo! to promote the distribution of digital music on its web site. In connection with this agreement, we granted Yahoo! three warrants to purchase a total of 250,000 shares of common stock. The first warrant for 83,334 shares vested immediately. The first warrant was valued at \$903,000 and was recognized ratably over the one-year term of the agreement. The second warrant for 83,333 shares vested in August 2000. The second warrant was initially valued at \$426,000 and was recognized ratably over the one-year period ending at the vesting date. The second warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of \$426,000 was reduced to \$312,000 based on market data during the vesting period. The third warrant for 83,333 shares vested in August 2001. The third warrant was initially valued at \$105,000 and was recognized ratably over the one-year period ending at the vesting date. The third warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of \$105,000 was reduced to \$54,000 based on market data during the vesting period. In the three months ended March 31, 2001, \$0, \$0 and \$17,000 were recognized as strategic marketing-equity instruments expense for the first, second and third warrants, respectively. In July 2000, we signed an agreement with Virgin Holdings, Inc. ( Virgin ), an affiliate of EMI Recorded Music, to promote the distribution of digital music over the Internet using our technology. Pursuant to this agreement, we issued 150,000 shares of common stock to Virgin. These shares were valued at \$1.2 million and recognized ratably over the one-year term of the agreement. As a result, \$295,000 was recognized as strategic marketing-equity instruments expense in the three months ended March 31, 2001.

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**Table of Contents**

*Non-Cash Sales and Marketing, Research and Development and General and Administrative.* Non-cash sales and marketing, research and development and general and administrative expenses relate to stock-based employee compensation arrangements. The total unearned compensation recorded by us from inception to March 31, 2002 was \$3.6 million. We recognized \$16,000 and \$23,000 of stock compensation expense for the three months ended March 31, 2002 and 2001, respectively. We expect quarterly amortization related to those options to be between \$15,000 and \$3,000 per quarter during 2002. These future compensation charges would be reduced if sales and marketing, research and development and general and administrative employees who hold the applicable options terminate employment prior to the expiration of their option vesting period.

*Other Income (Expense), Net.* Interest income consists of earnings on our cash, cash equivalents and short-term investments. Interest expense consists of expenses related to our financing obligations, which include borrowings under equipment loans and capital lease obligations. Other income (expense), net decreased to \$533,000 for the three months ended March 31, 2002 from \$1.7 million in the comparable period of 2001. The decrease was due to lower average cash and cash equivalent balances resulting from cash used in operating activities, and lower interest rates.

*Loss in Equity Investment.* Loss in equity investment consists of our share of losses from our investment in a related party accounted for using the equity method of accounting. Loss in equity investment was \$0 and \$219,000 for the three months ended March 31, 2002 and 2001, respectively. The net balance of our investments in Cyber Music Entertainment has been reduced to zero at December 31, 2001.

**Liquidity and Capital Resources**

Since inception, we have financed our operations primarily through the initial and follow-on public offerings of common stock, private placements of our preferred stock, equipment financing, lines of credit and short-term loans. As of March 31, 2002, we had raised \$65.9 million and \$93.7 million through our initial and follow-on public offerings of common stock, respectively, and \$29.8 million through the sale of our preferred stock. At March 31, 2002, we had approximately \$86.4 million of cash and cash equivalents.

Net cash used in operating activities was \$5.1 million and \$8.1 million for the three months ended March 31, 2002 and 2001, respectively. Net cash used for operating activities in the 2002 period was primarily the result of net losses from operations, depreciation and amortization of \$646,000, amortization of unearned compensation of \$16,000, non-cash cost of revenue of \$33,000 and a net decrease in working capital items of \$877,000. The net decrease in working capital items include an increase in accounts receivable of \$4,000, decrease in other assets of \$143,000, decrease in accounts payable of \$258,000, decrease in accrued liabilities of \$746,000 and a decrease in deferred revenue of \$12,000. Net cash used for operating activities in the 2001 period was primarily the result of net losses from operations, depreciation and amortization of \$1.1 million, amortization of unearned compensation of \$24,000, strategic marketing equity instruments charges of \$312,000, non-cash cost of revenue of \$82,000, an increase in the allowance for doubtful accounts and sales returns reserve of \$18,000, loss in equity investment of \$219,000 and a net increase in working capital items of \$1.4 million. The net increase in working capital items include a decrease in accounts receivable of \$23,000, decrease in other assets of \$675,000, decrease in accounts payable of \$236,000, increase in accrued liabilities of \$778,000 and an increase in deferred revenue of \$148,000.

Net cash provided by (used in) investing activities was \$(37,000) and \$26.3 million for the three months ended March 31, 2002 and 2001, respectively. Net cash used in investing activities in the 2002 period was primarily due to acquisition of property and equipment. Net cash provided by investing activities in the 2001 period was primarily due to net sales of short-term investments of \$26.9 million, partially offset by the acquisition of property and equipment of \$446,000 and an investment in Liquid Audio Japan of \$165,000.

Net cash used in financing activities was \$125,000 and \$184,000 for the three months ended March 31, 2002 and 2001, respectively. The net cash used in financing activities for both periods is due primarily to payments made under our equipment loan and capital leases.

We had a bank equipment loan facility that provided for advances of up to \$3.0 million through November 1999. Borrowings under the equipment loan facility are repayable in monthly installments over three years and bear

**Table of Contents**

interest at the bank's prime interest rate plus 0.25%. Borrowings are collateralized by the related equipment and other assets. Under the equipment loan facility, we had borrowed amounts totaling \$1.8 million through September 30, 2001. Our other significant commitments consist of obligations under non-cancelable operating leases, which totaled \$7.1 million, net of rental income of \$83,000, as of March 31, 2002 and are payable in monthly installments through 2005 and a note payable to related party in the amount of \$339,000 that was issued in the three months ended March 31, 1999. The note payable to related party is repayable in Japanese yen and bears interest at 0.5% above a Japanese bank's prime rate. The principal is due on December 31, 2003, with quarterly interest payments. The terms of the strategic related partner note payable require us to make quarterly interest payments. At March 31, 2002, we were not in compliance with the interest payment requirement. We are currently applying for a waiver from the strategic related partner with respect to our non-compliance with making quarterly interest payments. To obtain a waiver, we may have to make payments of all interest due to date and additional default interest of 10% on unpaid amounts outstanding. As a result of our default of these payments, the strategic related partner has a right to accelerate payment of all amounts outstanding under the note payable and demand immediate full payment of all amounts due, including outstanding interest and penalties. Accordingly, we have classified the outstanding balance under the note payable as a current liability. If we are successful in obtaining a waiver from the strategic partner, then the note payable will be reclassified as a long-term liability.

In the past, we derived a significant portion of our revenues from business development fees from relationships with our international partners, including Liquid Audio Japan, Liquid Audio Korea, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner. We recently terminated our relationships with these partners. Consequently, we do not expect additional revenue or cash payments will be generated from them. At March 31, 2002, we held 4.60% of the outstanding stock of Cyber Music Entertainment (CME), formerly Liquid Audio Japan, and had written down our investment to \$0 under the equity method of accounting.

We have no material commitments for capital expenditures or strategic investments and anticipate a low rate of capital expenditures. We may use cash to acquire or license technology, products or businesses related to our current business. In addition, we anticipate that we will experience low or no growth or a decline in our operating expenses for the foreseeable future and that our operating expenses will be a material use of our cash resources.

Future payments due under debt and lease obligations as of March 31, 2002 are as follows (in thousands):

	Note Payable to Related Party	Equipment Loan	Capital Leases	Operating Leases	Total
2002	\$ 339	\$ 47	\$ 21	\$ 1,937	\$ 2,344
2003				2,100	2,100
2004				2,163	2,163
2005				904	904
	<u>\$ 339</u>	<u>\$ 47</u>	<u>\$ 21</u>	<u>\$ 7,104</u>	<u>\$ 7,511</u>

We believe that existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for the foreseeable future, although we may seek to raise additional capital during that period. The sale of additional equity or convertible debt securities could result in additional dilution to our stockholders. There can be no assurance that financing will be available in amounts or on terms acceptable to us, if at all.

**Market Risk**

No material changes exist to our market risk during the three months ended March 31, 2002. For additional information, refer to Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Form 10-K for the year ended December 31, 2001 filed with the SEC.

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**Table of Contents**

**ADDITIONAL FACTORS AFFECTING FUTURE RESULTS**

**Our Limited Operating History in the New Market of Digital Delivery of Music over the Internet Increases the Possibility that the Value of Your Investment Will Decline**

We incorporated in January 1996. We did not start generating revenues until the first quarter of 1997. In early 1999 we began to place greater emphasis on developing and marketing our digital music delivery services. Accordingly, we are still in the early stages of development and have only a limited operating history upon which you can evaluate our business. You should evaluate our chances of financial and operational success in light of the risks, uncertainties, expenses, delays and difficulties associated with starting a new business in the new market of digital delivery of music, many of which may be beyond our control.

**We Have a History of Losses, We Expect Losses to Continue and We Might Not Achieve or Maintain Profitability**

Our accumulated deficit as of March 31, 2002 was approximately \$116.0 million. We had net losses of approximately \$33.7 million and \$37.2 million in 2000 and 2001, respectively and approximately \$4.9 million in the three months ended March 31, 2002. Given the level of our planned operating and capital expenditures, we expect to continue to incur losses and negative cash flows through at least mid-2003. Even if we ultimately do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis. If our revenues grow more slowly than we anticipate, or if our operating expenses exceed our expectations and cannot be adjusted accordingly, our business and operating results will be harmed.

**Several of Our Customers Have Had Limited Operating Histories, Are Unprofitable and Might Have Difficulty Meeting Their Payment Obligations to Us**

Several of our significant customers have had limited operating histories and have not achieved profitability. We believe that this will be true of other customers in the future. As of March 31, 2002, 59% or \$269,000 of our accounts receivable from third parties and 100% or \$1.6 million of our account receivables from related parties, were more than 30 days past due. You should evaluate the ability of these companies to meet their payment obligations to us in light of the risks, expenses and difficulties encountered by companies with limited operating histories. If one or more of our customers were unable to pay for our services in the future, or paid more slowly than we anticipate, recognition of revenue might be delayed and our operating results will be harmed.

**Our Business Might Be Harmed if We Fail to Price Our Products and Services Appropriately**

We have recently decided to focus on providing a subscription-based service offering and a licensing-based offering for our customers. We have limited experience in pricing such new models, and failure to properly price and adjust these new pricing models may result in a loss of customers which would have an adverse effect on our business and operating results. Moreover, the price of Internet products and services is subject to rapid and frequent change. We may be forced, for competitive or technical reasons, to reduce or eliminate prices for certain of our products or services. If we are forced to reduce or eliminate prices, it would diminish our revenues and impact our margins, which will harm our business.

**If We Do Not Establish Relationships with Additional International Partners, Our Revenues Might Decline**

In the past, we derived a significant portion of our revenues from business development fees from relationships with our international partners, including Liquid Audio Korea, Liquid Audio Japan, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner. We recently terminated our relationships with these partners. Consequently, we do not expect additional revenue will be generated from them. If we are unable to establish additional relationships with international partners, and if such additional relationships do not generate a significant amount of revenue in future periods, then our future revenues could be lower than we anticipate and our business and operating results could be harmed. Furthermore, the commercial terms for these new relationships could cause our revenues to vary from period-to-period, which might result in unpredictability of our revenues.



## **Table of Contents**

### **We Might Not Be Successful in the Development and Introduction of New Products and Services**

We depend in part on our ability to develop new or enhanced products and services, such as our subscription-based service offering and server-based license offering, in a timely manner and to provide new products and services that achieve rapid and broad market acceptance. We may fail to identify new product and service opportunities successfully and develop and bring to market new products and services in a timely manner. In addition, product innovations may not achieve the market penetration or price stability necessary for profitability.

As the online medium continues to evolve, we plan to leverage our technology by introducing complementary products and services as additional sources of revenue. Accordingly, we may change our business model to take advantage of new business opportunities, including business areas in which we do not have extensive experience. For example, we will continue to devote significant resources to the development of digital music delivery services, as well as our software licensing business. If we fail to develop these or other businesses successfully, our business would be harmed.

### **We Depend on Proprietary Rights to Develop and Protect Our Technology**

Our success and ability to compete substantially depends on our internally developed technologies and trademarks, which we protect through a combination of patent, copyright, trade secret and trademark laws. We hold fourteen existing patents and currently have nine patents pending in the United States and eight patents pending in other countries. Our existing patents expire between October 2015 and October 2018. We have had claims allowed on two of our patent applications. We are presently pursuing the registration of our trademarks. Our patent applications or trademark registrations in the United States may not be approved. Even if they are approved, our patents or trademarks may be successfully challenged by others or invalidated. If our trademark registrations in the United States are not approved because third parties own these trademarks, our use of these trademarks would be restricted unless we enter into arrangements with the third-party owners, which might not be possible on commercially reasonable terms or at all.

The primary forms of intellectual property protection for our products and services internationally are patents and copyrights. Patent protection throughout the world is generally established on a country-by-country basis. To date, we have applied for eight patents outside the United States. Copyrights throughout the world are protected by several international treaties, including the Berne Convention for the Protection of Literary and Artistic Works. Despite these international laws, the level of practical protection for intellectual property varies among countries. In particular, United States government officials have criticized countries such as China and Brazil, two countries in which we do business, for inadequate intellectual property protection. If our intellectual property is infringed in any country in which we do business without a high level of intellectual property protection, our business and operating results could be harmed.

We generally enter into confidentiality or license agreements with our employees, consultants and corporate partners, and generally control access to and distribution of our technologies, documentation and other proprietary information. Despite our efforts to protect our proprietary rights from unauthorized use or disclosure, parties may attempt to disclose, obtain or use our solutions or technologies. The steps we have taken may not prevent misappropriation of our solutions or technologies, particularly in foreign countries where laws or law enforcement practices may not protect our proprietary rights as fully as in the United States.

We have licensed, and we may license in the future, certain proprietary rights to third parties. While we attempt to ensure that the quality of our brand is maintained by our business partners, they may take actions that could impair the value of our proprietary rights or our reputation. In addition, these business partners may not take the same steps we have taken to prevent misappropriation of our solutions or technologies.

### **We Face and Might Face Intellectual Property Infringement Claims that Might Be Costly to Resolve**

From time to time, we receive letters from corporations and other entities suggesting that we review patents to which they claim rights or claiming that we infringe on their intellectual property rights. Such claims may result in

## **Table of Contents**

our being involved in litigation. Although we do not believe we infringe the proprietary rights of any party, we cannot assure you that parties will not assert additional claims in the future or that any claims will not be successful. We could incur substantial costs and diversion of management resources to defend any claims relating to proprietary rights, which could harm our business. In addition, we are obligated under certain agreements to indemnify the other party for claims that we infringe on the proprietary rights of third parties. If we are required to indemnify parties under these agreements, our business could be harmed. If someone asserts a claim against us relating to proprietary technology or information, we might seek licenses to this intellectual property. We might not be able to obtain licenses on commercially reasonable terms, or at all. The failure to obtain the necessary licenses or other rights might harm our business and operating results. See Legal Proceedings.

### **If Standards for the Secure, Digital Delivery of Recorded Music Are Not Adopted, the Piracy Concerns of Record Companies and Artists Might Not Be Satisfied, and They Might Not Use Our Platform for Digital Delivery of Their Music**

Because other digital recorded music formats, such as MP3, do not contain mechanisms for tracking the source or ownership of digital recordings, record companies and artists are unable to prevent users from downloading and distributing unauthorized or pirated copies of copyrighted recorded music in these formats over the Internet. This piracy is a significant concern to record companies and artists, and is the primary reason many record companies and artists are reluctant to digitally deliver their recorded music over the Internet. If record companies and artists do not adopt a standard format, however, it may permit insecure copies of recorded music to continue to be available on the Internet, and as a result record companies and artists might not permit the digital delivery of their music. Additionally, as long as pirated recordings are available, many consumers will choose free pirated recordings rather than paying for legitimate recordings. Accordingly, if a standard format for the secure digital delivery of music is not adopted, our business and operating results might be harmed.

We have designed our current products to be adaptable to different music industry and technology standards. Numerous standards in the marketplace, however, could cause confusion as to whether our products and services are compatible. If a competitor were to establish the dominant industry standard, our business would be harmed. It is too soon to determine whether our standard will be adopted as the dominant industry standard, if a standard is so adopted.

### **If Our Platform Does Not Provide Sufficient Rights Reporting Information, Record Companies and Artists Are Unlikely to Digitally Deliver Their Recorded Music Using Our Platform**

Record companies and artists must be able to track the number of times their recorded music is downloaded so that they can make appropriate payments to music rights organizations, such as the American Society of Composers, Authors and Publishers, Broadcast Music Incorporated and SESAC, Inc. If our products and services do not accurately or completely provide this rights reporting information, record companies and artists might not use our platform to digitally deliver their recorded music, and our business might be harmed.

### **If Artists and Record Labels Are Not Satisfied that They Can Securely, Digitally Deliver Their Music Over the Internet, We Might Not Have Sufficient Content to Attract Consumers**

Our success depends on our ability to aggregate a sufficient amount and variety of digital recorded music for syndication. In particular, until a significant number of artists and their record labels adopt a strategy of digitally delivering and selling music over the Internet, the growth of our business might be limited. We currently do not create our own content; rather, we rely on record companies and artists for digital recorded music to be syndicated using our format. We believe record companies will remain reluctant to distribute their recorded music digitally unless they are satisfied that the digital delivery of their music over the Internet will not result in the unauthorized copying and distribution of that music. If record companies do not believe that recorded music can be securely delivered over the Internet, they may not allow the digital distribution of their recorded music and we might not have sufficient content to attract consumers. If we cannot offer a sufficient amount and variety of digital recorded music for syndication, our business will be harmed.

## **Table of Contents**

### **Due to the Many Factors that Influence Market Acceptance, Consumers Might Not Accept Our Platform**

Our success will depend on growth in consumer acceptance of our platform as a method for digital delivery of recorded music over the Internet. Factors that might influence market acceptance of our platform include the following, over which we have little or no control:

the availability of sufficient bandwidth on the Internet to enable consumers to download digital recorded music rapidly and easily;

the willingness of consumers to invest in computer technology that facilitates the downloading of digital music;

the cost of time-based Internet access;

the number, quality and variety of digital recordings available for purchase through our system relative to those available through other online digital delivery companies, digital music websites, music swapping or sharing websites or through traditional physical delivery of recordings;

the availability of portable devices to which digital recorded music can be transferred;

the fidelity and quality of the sound of the digital recorded music;  
and

the level of consumer comfort with the process of downloading and paying for digital music over the Internet, including ease of use and lack of concern about transaction security.

It is too soon to determine whether consumers will accept our platform as their primary application to download, manage and play digital music. A lack of customer acceptance would harm our business and operating results.

### **Companies Might Not Develop or Consumers Might Not Adopt Devices That Will Play Digitally Downloaded Music**

We believe that the market for digitally recorded music delivered over the Internet will not develop significantly until consumers are able to enjoy this music other than solely through the use of a personal computer. Several consumer electronics companies have introduced or announced plans to introduce devices that will allow digital music delivered over the Internet to be played away from the personal computer. If companies fail to introduce additional devices, consumers do not adopt these devices or our products and services are incompatible with these devices, our business would be harmed. In addition, digital music can be transferred to a compact disc, but that transfer requires a compact disc recorder ( CD-R ). Many desktop computer manufacturers offer CD-Rs in their computers. If companies do not continue to offer CD-Rs in their computers, consumers do not adopt CD-Rs, or our products and services are incompatible with CD-Rs, our business might be harmed.

### **We Might Experience Delays in the Development of New Products and Services**

We must continue to innovate and develop new versions of our software to remain competitive in the market for digital delivery of recorded music solutions. Our software products and services development efforts are inherently difficult to manage and keep on schedule. Our failure to manage and keep those development projects on schedule might harm our business.

### **The Market for Digital Delivery of Music Over the Internet is Highly Competitive, and if We Cannot Compete Effectively, Our Ability to Generate Meaningful Revenues Would Suffer Dramatically**

Competition among companies in the business of digital delivery of music over the Internet is intense. We expect that present competitors will increase competitive pressure in the market for digital delivery of music.

Competition is likely to increase further as new companies enter the market and current competitors expand their products and services or merge with other competitors. Many of these potential competitors are likely to enjoy substantial competitive advantages, including the following:

## **Table of Contents**

larger audiences;

larger technical, production and editorial staffs;

greater brand recognition;

access to more recorded music content;

a more established Internet presence;

a larger advertiser base; and

substantially greater financial, marketing, technical and other resources.

If we do not compete effectively or if we experience pricing pressures, reduced margins or loss of market share resulting from increased competition, our business and operating results would be harmed.

### **If MusicNet and pressplay License its Services to Our Competitors, and We Are Unable to License Similar Content, Our Business Could be Harmed**

The major U.S. record companies have recently formed ventures for the licensing of their digital music subscription services to online music service providers. BMG Entertainment, EMI, Real Networks and Warner Music Group have formed a venture called MusicNet. Also, Universal Music Group (an unit of Vivendi Universal) and Sony Music Entertainment have formed a venture called pressplay. Musicnet and pressplay have recently launched their services, and may license their services to other third party online music service providers.

pressplay has reported that it has entered into distribution agreements with affiliates, including Yahoo!, Microsoft Network and MP3.com, and that it has entered into licensing agreements with six independent record labels including Madacy, Navarre, OWIE, Razor & Tie, Roadrunner and Rounder. The press has reported that MusicNet has licensed its service to America Online, Real Networks and Napster and that MusicNet has entered into a licensing agreement with Zomba Label Group which encompasses seven record labels: flagship Jive Records, Jive Electro, Silvertone, Verity, Brentwood, Reunion, and Volcano. If our competitors obtain licenses for digital music subscription services from MusicNet and pressplay and we are unable to obtain similar content provided by those services on commercially reasonable terms, these competitors may be able to develop a more compelling consumer product and our business could be harmed.

### **We Might Be Unable to License or Acquire Technology**

We rely on certain technologies that we license or acquire from third parties, including Dolby Laboratories Licensing Corporation, Fraunhofer Institut, RSA Data Security, Inc. and Thomson Consumer Electronics Sales GmbH. These technologies are integrated with our internally developed software and used in our products, to perform key functions and to enhance the value of our platform. These third-party licenses or acquisitions may not continue to be available to us on commercially reasonable terms or at all. Any inability to acquire these licenses or software on commercially reasonable terms might harm our business.

### **Our Business Might Be Harmed if Challenges Against Intellectual Property Laws by New Digital Music Delivery Technologies Are Successful**

New music sharing technologies allowing users to locate and download copies of digital music stored on the hard drives of other users without payment have been introduced into the market. Because some digital recorded music formats, such as MP3, do not contain mechanisms for tracking the source of ownership of digital recordings, users are able to download copies of copyrighted recorded music over the Internet without being required to compensate the owners of these copyrights. These downloads are a significant concern to record companies and artists. The Recording Industry Association of America has filed a suit seeking a permanent injunction against the use of these file-sharing technologies for exchange of copyrighted works. Several recording artists have also taken legal action against companies providing music sharing technology. If the injunction is denied, and it is determined



## **Table of Contents**

that this file sharing technology is non-infringing, record companies and artists may limit their use of the Internet to sell and distribute their copyrighted materials. Even if the technology is determined to be infringing, it may be difficult to prevent this type of file sharing because of the non-centralized character of these technologies. As long as digital music copies are available through file sharing without payment, legally or illegally, consumers may choose not to pay for downloads from retail and other music delivery sites in our Liquid Music Network, which could harm our business.

### **We Might Not Be Able to Scale Our Technology Infrastructure to Meet Demand for Our Products and Services**

Our success will depend on our ability to scale our technology infrastructure to meet the demand for our products and services. Adding this new capacity will be expensive, and we might not be able to do so successfully. In addition, we might not be able to protect our new or existing data centers from unexpected events as we scale our systems. To the extent that we do not address any capacity constraints effectively, our business would be harmed.

### **We Might Not Be Successful in Our Attempts to Keep Up With Rapid Technological Change and Evolving Industry Standards**

The markets for our products and services are characterized by rapidly changing technology, evolving industry standards, changes in customer needs, emerging competition, and frequent new product and service introductions. Our future success will depend, in part, on our ability to:

- use leading technologies effectively;

- continue to develop our strategic and technical expertise;

- enhance our current products and services;

- develop new products and services that meet changing customer needs;

- advertise and market our products and services; and

- influence and respond to emerging industry standards and other technological changes.

We may not be successful in effectively using new technologies, developing new products or services or enhancing our existing products or services on a timely basis. These new technologies or enhancements may not achieve market acceptance. Our pursuit of necessary technological advances may require substantial time and expense. Finally, we may not succeed in adapting our services to new technologies as they emerge.

### **Our Products and Services Might Contain Errors**

We offer complex products and services. They may contain undetected errors when first introduced or when new versions are released. If we market products and services that have errors or that do not function properly, then we may experience negative publicity, loss of or delay in market acceptance, or claims against us by customers, any of which might harm our business.

### **We Might Have Liability for the Content of the Recorded Music That We Digitally Deliver**

Because we digitally deliver recorded music to third parties, we might be sued for negligence, copyright or trademark infringement or other reasons. These types of claims have been brought, sometimes successfully, against providers of online products and services in the past. Others could also sue us for the content that is accessible from our website through links to other websites. These claims might include, among others, claims that by hosting, directly or indirectly, the websites of third parties, we are liable for copyright or trademark infringement or other wrongful actions by these third parties through these websites. Our insurance may not adequately protect us against these types of claims and, even if these claims do not result in liability, we could incur significant costs in investigating and defending against these claims.

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## **Table of Contents**

We have taken steps to prevent these claims. For example, we have arrangements with companies that use our hosting services that will allow us to delete potentially infringing or misappropriating materials quickly and securely. We also have put into place indemnification agreements with music content providers, where practicable. Under the Digital Millennium Copyright Act of 1999, Internet service providers are insulated from several types of these claims, upon compliance with the requirement that they appoint an agent to receive claims relating to their service, and we have appointed an agent.

### **System Failures or Delays Might Harm Our Business**

Our operations depend on our ability to protect our computer systems against damage from fire, water, power loss, telecommunications failures, computer viruses, vandalism and other malicious acts, and similar unexpected adverse events. Our corporate headquarters are located in northern California. California had recently experienced power outages due to a shortage in the supply of power within the state. Although we maintain a comprehensive disaster recovery plan, if the power outages recur or increase in severity, they could disrupt our operations. Interruptions or slowdowns in our services have resulted from the failure of our telecommunications providers to supply the necessary data communications capacity in the time frame we required, as well as from deliberate acts. Despite precautions we have taken, unanticipated problems affecting our systems could in the future cause temporary interruptions or delays in the services we provide. Our customers might become dissatisfied by any system failure or delay that interrupts our ability to provide service to them or slows our response time. Sustained or repeated system failures or delays would affect our reputation, which would harm our business. Slow response time or system failures could also result from straining the capacity of our software or hardware due to an increase in the volume of products and services delivered through our servers. While we carry business interruption insurance, it might not be sufficient to cover any serious or prolonged emergencies, and our business might be harmed.

### **Our Future Success Depends on Our Key Personnel**

Our future success depends to a significant extent on the continued service of our key technical, sales and senior management personnel and their ability to execute our growth strategy. The loss of the services of any of our senior level management, or other key employees, could harm our business. Our future performance will depend, in part, on the ability of our executive officers to work together effectively. Our executive officers may not be successful in carrying out their duties or running our company. Any dissent among executive officers could impair our ability to make strategic decisions quickly in a rapidly changing market.

Our future success also depends on our ability to attract, retain and motivate highly skilled employees. Competition for employees in our industry is intense. Although we provide compensation packages that include incentive stock options, cash incentives and other employee benefits, the volatility and current market price of our common stock may make it difficult for us to attract and retain highly qualified employees in the future. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications.

### **Fluctuations in Our Quarterly Revenues and Operating Results Might Lead to Reduced Prices for Our Stock**

Our quarterly results of operations have varied in the past, and you should not rely on quarter-to-quarter comparisons of our results of operations as an indication of our future performance. In some future periods, our results of operations are likely to be below the expectations of public market analysts and investors. In this event, the price of our common stock would likely decline. Factors that have caused our results to fluctuate in the past and that are likely to affect us in the future include the following:

- the timing of individual software licenses to customers;

- competition for consumers from traditional retailers as well as providers of online music services;

- the announcement and introduction of new products and services by us and our competitors;

- distribution of the player through OEM and retail partners;

## **Table of Contents**

the upgrade percentage of our promotional player to the paid Player Plus version;

our ability to increase the number of websites that will use our platform for digital music delivery;

the timing of our partners' introduction of new products and services for digital music sales; and

variability and length of the sales cycle associated with our product and service offerings.

In addition, other factors may also affect us, including:

market adoption and growth of sales of digitally downloaded recorded music over the Internet;

legal developments with respect to copyright law and downloadable music;

our ability to attract significant numbers of music recordings to be syndicated in our format;

our ability to provide reliable and scalable service, including our ability to avoid potential system failures;

market acceptance of new and enhanced versions of our products and services; and

the price and mix of products and services we offer.

### **We Might Need Additional Capital in the Future and Additional Financing Might Not Be Available**

We currently anticipate that our available cash resources and financing available under existing lease agreements will be sufficient to meet our anticipated working capital and capital expenditure requirements for the foreseeable future. However, we may need to raise additional funds through public or private debt or equity financing in order to:

take advantage of opportunities, including acquisitions of complementary businesses or technologies;

develop new products or services; or

respond to competitive pressures.

Any additional financing we may need may not be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, we might not be able to take advantage of unanticipated opportunities, develop new products or services, or otherwise respond to unanticipated competitive pressures, and our business could be harmed. Our forecast of the period of time through which our financial resources will be adequate to support our operations is a forward-looking statement that involves risks and uncertainties, and actual results could vary materially as a result of a number of factors, including those set forth in this Additional Factors Affecting Future Results section.

### **Difficulties Presented by International Economic, Political, Legal, Accounting and Business Factors Could Harm Our Business in International Markets**

A key component of our strategy is to expand into international markets. The following risks are inherent in doing business on an international level and we have little or no control over them:



unexpected changes in regulatory requirements;

export restrictions;

export controls relating to encryption technology;

longer payment cycles;

problems in collecting accounts receivable;

## **Table of Contents**

political and economic  
instability; and

potentially adverse tax  
consequences.

In addition, other factors that may also affect us and over which we have some control include the following:

difficulties in staffing and managing international  
operations;

differences in music rights reporting  
structures; and

seasonal reductions in business  
activity.

We recently terminated our individual agreements in Japan, Korea, greater China and south east Asia. We may enter into similar arrangements in the future in these and other countries. We also established a wholly-owned subsidiary in the United Kingdom and an office in Tokyo. One or more of the factors listed above may harm our present or future international operations and, consequently, our business.

### **Our Management and Internal Systems Might Be Inadequate to Handle the Potential Growth of Our Personnel**

To manage future growth, our management must continue to improve our operational and financial systems and expand, train, retain and manage our employee base. Our management may not be able to manage our growth effectively. If our systems, procedures and controls are inadequate to support our operations, our expansion would be halted and we could lose our opportunity to gain significant market share. Any inability to manage growth effectively may harm our business.

### **Our Charter Documents and Delaware Law May Impede Or Discourage A Takeover, Which Could Lower Our Stock Price**

Provisions of our restated certificate of incorporation and bylaws, and provisions of Delaware law, may have the effect of making it more difficult for a third party to acquire, or of discouraging a third party from attempting to acquire, control of us. For example, we have a classified board of directors which may tend to discourage a third party from making a tender offer or otherwise attempting to obtain control of us and may maintain the incumbency of our board of directors, as the classification of the board of directors increases the difficulty of replacing a majority of the directors. These provisions may have the effect of deferring hostile takeovers, delaying changes in our control or management, or may make it more difficult for stockholders to take certain corporate actions. Consequently, these provisions could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

### **Our Rights Plan May Impede Or Discourage a Takeover, Which Could Lower Our Stock Price**

Our board of directors has approved a shareholders rights plan. The rights will become exercisable the tenth day after a person or group announces acquisition of 15% or more of our common stock or announces commencement of a tender or exchange offer the consummation of which would result in ownership by the person or group of 15% or more of our common stock. If the rights become exercisable, the holders of the rights (other than the person acquiring 15% or more of our common stock) will be entitled to acquire, in exchange for the rights exercise price, shares of our common stock or shares of any company in which we are merged, with a value equal to twice the rights exercise price. The rights may have the effect of rendering more difficult or discouraging an acquisition of the Company deemed undesirable by the board of directors. As a result, the rights could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

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**Table of Contents**

**Risks Related to Our Industry**

**Internet Security Concerns Could Hinder E-Commerce**

A significant barrier to e-commerce and communications over the Internet has been the need for secure transmission of confidential information. Internet usage may not increase at the rate we expect unless some of those concerns are adequately addressed and found acceptable by the market. Internet usage could also decline if any well-publicized compromise of security occurs. We may incur significant costs to protect against the threat of security breaches or to alleviate problems caused by these breaches. Protections may not be available at a reasonable price or at all. If a third person were able to misappropriate a user's personal information, users could bring claims against us.

**Imposition of Sales and Other Taxes On E-Commerce Transactions Might Hinder E-Commerce**

We do not collect sales and other taxes when we sell our products and services over the Internet. State or local governments may seek to impose sales tax collection obligations on out-of-state companies, such as ours, which engage in or facilitate e-commerce. A number of proposals have been made at the state and local level that would impose additional taxes on the sale of products and services through the Internet. These proposals, if adopted, could substantially impair the growth of e-commerce and could reduce our opportunity to derive profits from e-commerce. Moreover, if any state or local government or foreign country were to successfully assert that we should collect sales or other taxes on the exchange of products and services on our system, our business might be harmed.

In 1998, Congress passed the Internet Tax Freedom Act, which imposed a three-year moratorium on state and local taxes on Internet-based transactions. The moratorium was scheduled to expire in October 2001. Recently, Congress extended the Internet Tax Freedom Act until November 1, 2003. We cannot assure you that this moratorium will be extended beyond November 1, 2003. Failure to extend this moratorium beyond that date would allow various states to impose taxes on e-commerce, which might harm our business.

In February 2002, European Finance Ministers announced that beginning July 2003 Value Added Tax ( VAT ) will be imposed on services delivered electronically over the Internet from suppliers outside the European Union ( EU ). The tax may substantially impair the growth of e-commerce in the EU and may reduce our opportunity to derive e-commerce in the EU, and our business could be harmed.

**Demand for Our Products and Services Might Decrease if Growth in the Use of the Internet Declines**

Our future success substantially depends upon the continued growth in the use of the Internet. The number of users on the Internet may not increase and commerce over the Internet may not become more accepted and widespread for a number of reasons, including the following, over which we have little or no control:

actual or perceived lack of security of information, such as credit card numbers;

lack of access and ease of use;

inconsistent quality of service and lack of availability of cost-effective, high speed service;

possible outages due to damage to the Internet;

excessive governmental regulation; and

uncertainty regarding intellectual property rights.

If the necessary infrastructure, products, services or facilities are not developed, or if the Internet does not grow as a commercial medium, our business would be harmed.

**Table of Contents**

**Government Regulation of the Internet Might Harm Our Business**

The applicability to the Internet of existing laws governing issues such as property ownership, libel and personal privacy is uncertain. In addition, governmental authorities may seek to further regulate the Internet with respect to issues such as user privacy, pornography, acceptable content, e-commerce, taxation, and the pricing, characteristics and quality of products and services. Finally, the global nature of the Internet could subject us to the laws of a foreign jurisdiction in an unpredictable manner. Any new legislation regulating the Internet could inhibit the growth of the Internet and decrease the acceptance of the Internet as a communications and commercial medium, which might harm our business.

In addition, the growing use of the Internet has burdened the existing telecommunications infrastructure and has caused interruptions in telephone service. Telephone carriers have petitioned the government to regulate the Internet and impose usage fees on Internet service providers. Any regulations of this type could increase the costs of using the Internet and impede its growth, which could in turn decrease the demand for our services or otherwise harm our business.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

See Market Risk in Part I, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations.

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**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

On or about May 3, 2002, a lawsuit was filed in the Court of Chancery of the State of Delaware naming us as defendant. The action is captioned *musicmaker.com, Inc. v. Liquid Audio, Inc.*, Civil Action No. 19601-NC. The plaintiff is musicmaker.com, Inc., one of our stockholders owning approximately 2.9% of our outstanding common stock and a Schedule 13D filer with other Liquid Audio stockholders holding an aggregate of approximately 6.9% of our common stock. At the same time it filed its complaint, musicmaker.com also filed a motion for expedited proceedings. musicmaker.com's complaint alleges mismanagement by our Board of Directors and states musicmaker.com's intent to nominate its own slate of board nominees at our 2002 Annual Meeting of stockholders. The complaint seeks, among other things, an order to compel us to hold its 2002 Annual Meeting. On May 13, 2002, we filed a motion to dismiss the complaint; that motion is currently pending. On May 14, 2002, we announced we had scheduled our 2002 Annual Meeting for July 1, 2002; we believe musicmaker.com's complaint is now mooted. We intend to vigorously defend the action; however there is no assurance concerning the outcome, or whether the action would have a material effect on our financial condition or business operations.

In November 2001, two lawsuits were filed in Delaware Chancery Court naming us and certain of our officers and directors as defendants. Both actions related to our response to recent acquisition offers and purported to be class actions brought on behalf of our shareholders. On February 1, 2002, the two complaints were consolidated into a single action, titled *In Re Liquid Audio, Inc., Shareholders Litigation*, Consolidated Civil Action No. 19212-NC. That action was brought against Gerald W. Kearby, Silvia Kessel, Ann L. Winblad and us. The complaint alleges that defendants had breached their fiduciary duties owed to our shareholders in connection with our response to acquisition offers from Steel Partners II, LLP and an investor group formed by musicmaker.com, Inc. The complaint seeks, among other things, a court order barring us from adopting or maintaining measures that would make us less attractive as a takeover candidate or, alternatively, awarding compensatory damages to the purported plaintiff class. To date, we have not responded to the complaint, nor has the court set a date for discovery cutoff or trial. We intend to vigorously defend the action. There is no assurance concerning the outcome of either action, or whether either action would have a material effect on our financial condition or business operations.

On or about September 27, 2001, Network Commerce, Inc. ( NCI ) filed a Complaint against us in the United States District Court for the Western District of Washington (Seattle). The suit alleges that we infringe the claims of United States Patent No. 6,073,124. NCI requests that we be enjoined from our allegedly infringing activities and seeks unspecified damages. We were served with the Complaint on November 2, 2001 and subsequently submitted an answer to the Complaint that included counterclaims. In February 2002, we entered into settlement negotiations but have yet to reach a settlement.

On August 23, 2001, we received a demand letter from a former employee's legal counsel alleging claims for sexual harassment and retaliation. On September 13, 2001, the former employee filed a charge with the California Department of Fair Employment and Housing alleging such claims against us and one of our former employees. While we believed the charge was without merit, we reached an out-of-court settlement in May 2002 with the former employee whereby we agreed to pay her \$25,000.

On July 20, 2001, a putative securities class action, captioned *Murowa Financial v. Liquid Audio, Inc. et al.*, Civil Action No. 01-CV-6661, was filed against us, certain of our officers and directors (the Individual Defendants ) and three underwriters in our initial public offering (the IPO ), in the United States District Court for the Southern District of New York. The Complaint seeks unspecified damages on behalf of a purported class of purchasers of our common stock between July 8, 1999 and December 6, 2000. Several complaints substantially identical to *Murowa* were later filed against us, the Individual Defendants, and several of the IPO underwriters in the Southern District of New York. These cases have been consolidated under Civil Action No. 01-CV-6661. These complaints generally allege that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in our initial public offering and secondary offering of securities. The complaints bring claims for violation of several provisions of the federal securities laws against those underwriters, and also against us and certain of our directors and officers. Various plaintiffs have filed similar actions asserting virtually identical allegations against more than 300 other companies. The lawsuit and all other IPO allocation securities class actions currently pending in the Southern District of New York have been assigned to Judge Shira A. Scheindlin for coordinated pretrial proceedings. We believe that we have meritorious defenses to the claims and intend to vigorously defend against such claims.

On or about April 7, 2000, SightSound, Inc. ( SightSound ) filed an Amended Complaint against one of our customers in the United States District Court for the Eastern District of Pennsylvania (Pittsburgh). The suit alleges that our customer infringes one or more of three patents (United States Patent Nos. 5,191,573; 5,675,734 and 5,996,440). SightSound claims damages of \$20 million plus an unspecified royalty. We have entered into an agreement with our customer whereby we have agreed to assume control of the defense and pay the defense costs, while reserving our rights as to indemnification obligations. The customer filed an Answer to the Amended Complaint on April 27, 2000 denying the material allegations of the complaint, and asserting counterclaims for declaratory judgment of non-infringement and patent invalidity. A trial date had been set for September 28, 2001 in the matter, but that date will be reset after the Court rules on pending matters.



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**Table of Contents**

On March 31, 2000, Intouch Group, Inc. ( Intouch ) filed a lawsuit against us in the United States District Court for the Northern District of California alleging patent infringement. The Complaint names us, Amazon.com, Inc., Listen.com, Inc., Entertaindom LLC, DiscoverMusic.com, Inc. and Muze, Inc. It alleges that these parties infringe, or induce infringement of, the claims of United States Patent Nos. 5,237,157 ( the 157 patent ) and 5,963,916 ( the 916 patent ) by operating a web site and/or a kiosk that allows interactive previewing of pre-recorded music products. The Complaint seeks unspecified damages and injunctive relief. We answered Intouch s first amended complaint, denying the material allegations of the amended complaint, and asserting counterclaims for declaratory judgment of non-infringement, patent invalidity and inequitable conduct. In May 2001, the parties reached an agreement in principle to settle Intouch s claims on the 157 patent. On February 6, 2002, the parties executed a final settlement regarding the 916 patent. Pursuant to the settlement, the terms of which are confidential, Intouch has dismissed its suit with prejudice as to us and granted us a nonexclusive license on the 916 patent. The settlement did not have a material impact on our financial position or results of operations.

From time to time we receive letters from corporations or other business entities notifying us of alleged infringement of patents held by them or suggesting that we review patents to which they claim rights. These corporations or entities often indicate a willingness to discuss licenses to their patent rights.

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

The effective date of our first registration statement, filed on Form S-1 under the Securities Act of 1933 (No. 333-82521) relating to our initial public offering of common stock, was July 8, 1999. A total of 4,800,000 shares of common stock were sold at a price of \$15.00 per share to an underwriting syndicate led by Lehman Brothers Inc., BancBoston Robertson Stephens Inc. and U.S. Bancorp Piper Jaffray Inc. Offering proceeds, net of aggregate expenses of approximately \$6.1 million, were approximately \$65.9 million.

The effective date of our second registration statement, filed on Form S-1 under the Securities Act of 1933 (No. 333-91541) relating to our follow-on public offering of common stock, was December 14, 1999. A total of 2,946,076 shares of Common Stock were sold at a price of \$33.63 per share to an underwriting syndicate led by Lehman Brothers Inc., BancBoston Robertson Stephens Inc., U.S. Bancorp Piper Jaffray Inc., Dain Rauscher Wessells and Fidelity Capital Markets. An additional 503,924 shares of Common stock were sold on behalf of selling stockholders as part of the same offering. Offering proceeds to us, net of aggregate expenses of approximately \$5.4 million, were approximately \$93.7 million. Offering proceeds to selling shareholders, net of expenses of approximately \$847,000, were approximately \$16.1 million.

From the time of receipt through March 31, 2002, our proceeds were applied toward general corporate purposes, including the purchase of temporary investments consisting of cash, cash equivalents and short-term investments, working capital and capital expenditures, enhancing research and development and attracting key personnel.

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

There were no submissions of matters to a vote of securities holders during the quarter ended March 31, 2002.

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

(a) Exhibits

None.

(b) Reports on Form 8-K

None.

**Table of Contents**

**LIQUID AUDIO, INC.**

**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.

DATE: May 15, 2002

LIQUID AUDIO, INC.

By:

/s/ GERALD W. KEARBY

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**Gerald W. Kearby**  
**President, Chief Executive Officer and Director**  
**(Principal Executive Officer)**

By:

/s/ MICHAEL R. BOLCEREK

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**Michael R. Bolcerek**  
**Senior Vice President and Chief Financial Officer**  
**(Principal Financial and Accounting Officer)**