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LIQUID AUDIO INC
Form 10-Q
May 15, 2001

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

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, 2001

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

LIQUID AUDIO, INC.
(Exact name of registrant as specified in its charter)

Delaware	77-0421089
-----	-----
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2221 Broadway, Redwood City, CA	94063
-----	-----
(Address of principal executive offices)	(Zip Code)

(650) 549-2000

(Registrant's telephone number, including area code)

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

As of April 30, 2001, there were 22,541,959 shares of registrant's Common Stock
outstanding.

LIQUID AUDIO, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LIQUID AUDIO, INC. CONDENSED CONSOLIDATED BALANCE SHEETS (in thousands)

	March 31, 2001	

Assets		(unaudited)
Current assets:		
Cash and cash equivalents.....	\$114,	
Short-term investments.....		
Accounts receivable from third parties, net.....	1,	
Accounts receivable from related parties, net.....	1,	
Other current assets.....	-----	
Total current assets.....	118,	
Investment in strategic partner.....	1,	
Property and equipment, net.....	8,	
Other assets.....	-----	
Total assets.....	\$127,	=====
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable.....	\$ 3,	
Accrued expenses and other current liabilities.....	4,	
Deferred revenue from third parties.....		
Deferred revenue from related parties.....		
Capital lease obligations, current portion.....		
Equipment loan, current portion.....	-----	
Total current liabilities.....	9,	

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Capital lease obligations, non-current portion.....
Equipment loan, non-current portion.....
Note payable to related party.....

Total liabilities.....

10,

Stockholders' equity:

Common stock.....
Additional paid-in capital.....
Unearned compensation.....
Accumulated deficit.....
Accumulated other comprehensive income.....

202,

(

(85,

Total stockholders' equity.....

117,

Total liabilities and stockholders' equity.....

\$127,

=====

See accompanying notes to condensed consolidated financial statements

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

	Three Months Ended March 31, 2001
Net revenues:	
License.....	\$ 290
Services.....	425
Business development (related party).....	946
Total net revenues.....	1,661
Cost of net revenues:	
License.....	159
Services.....	711
Non-cash cost of revenue.....	83
Total cost of net revenues.....	953
Gross profit.....	708
Operating expenses:	
Sales and marketing.....	4,656
Non-cash sales and marketing.....	9
Research and development.....	5,230
Non-cash research and development.....	9
General and administrative.....	3,194
Non-cash general and administrative.....	5
Strategic marketing--equity instruments.....	312
Total operating expenses.....	13,415

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Loss from operations.....	(12,707)
Other income (expense), net.....	1,659
Equity in net loss of investment.....	(219)
Net loss.....	<u>\$ (11,267)</u>
Net loss per share:	
Basic and diluted.....	<u>\$ (0.50)</u>
Weighted average shares.....	<u>22,528</u>

See accompanying notes to condensed consolidated financial statements

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

	Three 2001
Cash flows from operating activities:	
Net loss.....	\$ (11,
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization.....	1,
Amortization of unearned compensation.....	
Allowance for doubtful accounts and sales returns reserve.....	
Equity in net loss of investments.....	
Strategic marketing-equity instruments.....	
Non-cash cost of revenue.....	
Other.....	
Changes in assets and liabilities:	
Accounts receivable from third parties.....	
Accounts receivable from related parties.....	
Other assets.....	
Accounts payable.....	(
Accrued expenses and other current liabilities.....	
Deferred revenue.....	
Net cash used in operating activities.....	<u>(8,</u>
Cash flows from investing activities:	
Acquisition of property and equipment.....	(
Sales (purchases) of short-term investments, net.....	26,
Equity investment.....	(
Net cash provided by (used in) investing activities.....	<u>26,</u>
Cash flows from financing activities:	
Proceeds from issuance of common stock, net of repurchases.....	

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Payments made under capital leases.....	
Payments made under equipment loan.....	
Net cash used in financing activities.....	
Effect of exchange rates on cash and cash equivalents.....	
Net increase (decrease) in cash and cash equivalents.....	17,
Cash and cash equivalents at beginning of period.....	96,
Cash and cash equivalents at end of period.....	\$114,
Supplemental disclosures:	
Cash paid for interest.....	\$
Non-cash investing and financing activities:	
Issuance of warrants in connection with strategic marketing agreements.....	\$
See accompanying notes to condensed consolidated financial statements	

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LIQUID AUDIO, INC. NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

NOTE 1 - THE COMPANY AND BASIS OF PRESENTATION:

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, 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, 2001 are not necessarily indicative of the results to be expected for any subsequent quarter or for the year ending December 31, 2001. 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, 2000 as filed with the Securities and Exchange Commission on March 30, 2001.

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Reclassifications

Certain reclassifications have been made to the prior periods' consolidated financial statements to conform to the current period presentation. The statement of operations reflects reclassifications to allocate the non-cash compensation expense related to the issuance of stock options from a single line presentation within operating expenses to the respective amounts in cost of net revenues, sales and marketing, research and development and general and administrative expense. The reclassifications had no effect on net loss, stockholders' equity or cash flows.

Principles of Consolidation

The financial statements include the accounts of the Company and its subsidiary. Significant intercompany transactions and balances have been eliminated.

Recent accounting pronouncements

In December 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") 101, "Revenue Recognition." SAB 101 outlines the basic criteria that must be met to recognize revenue and provides guidance for presentation of revenue and for disclosure related to revenue recognition policies in financial statements filed with the SEC. In June 2000, the SEC issued SAB 101B to defer the effective date of implementation of SAB 101 until the fourth quarter of fiscal 2000. The adoption of SAB 101 did not have a material impact on the Company's financial position or results of operations.

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LIQUID AUDIO, INC. NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

NOTE 2 - BALANCE SHEET COMPONENTS (IN THOUSANDS):

	March 31, 2001

Accounts receivable from third parties, net:	
Accounts receivable.....	\$ 1,397
Less: allowance for doubtful accounts and sales returns reserve.....	(603)

	\$ 794
	=====

The allowance for doubtful accounts and sales returns reserve increased by \$18,000 and \$271,000 for the three months ended March 31, 2001 and the year ended December 31, 2000, respectively. Write-offs against the allowance for doubtful accounts were \$3,000 and \$43,000 for the three months ended March 31, 2001 and the year ended December 31, 2000, respectively.

March 31,
2001

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Property and equipment:

Computer equipment and purchased software.....	\$12,230
Website and software development costs.....	726
Furniture and fixtures.....	775
Leasehold improvements.....	708

	14,440
Less: accumulated depreciation and amortization.....	(6,255)

	\$ 8,185
	=====

Property and equipment includes \$784,000 of equipment under capital leases at March 31, 2001 and December 31, 2000. Accumulated depreciation and amortization for equipment under capital leases was \$748,000 and \$734,000 at March 31, 2001 and December 31, 2000, respectively.

March 31,
2001

Accrued expenses and other current liabilities:

Compensation and benefits.....	\$2,226
Consulting and professional services.....	1,280
Accrued marketing expenses.....	74
Other.....	720

	\$4,300
	=====

NOTE 3 - RELATED PARTIES:

Investment in Liquid Audio Japan

In April 1998, the Company signed an agreement with a strategic partner (the "Strategic Partner") to establish a Japanese corporation, Liquid Audio Japan ("LAJ"). LAJ is the exclusive reseller and distributor of the Company's software products in Japan. In March 1999, the Company purchased 18% of the issued and outstanding shares in LAJ from the Strategic Partner for \$378,000. Due to significant doubt regarding recoverability and the significant losses that were expected to be incurred during LAJ's initial operating periods, the initial investment of \$378,000 was immediately written off. The Company retains the option, expiring on December 31, 2003, to purchase up to

20% of the capital of LAJ from the Strategic Partner, at the then fair market value of LAJ's shares. The Company also has a put option whereby the Company can require the Strategic Partner to purchase its shares in LAJ at the then fair market value, if certain performance measures of LAJ, as defined, are not met. The Company's purchase of shares in LAJ was funded by a loan from a related entity of the Japanese Strategic Partner. This loan, denominated in Japanese yen, is repayable on December 31, 2003. Interest on the loan bears interest at 0.5% above a Japanese bank's prime rate (2.6% at December 31, 2000) and is payable quarterly. The loan is classified in the balance sheet as a non-current

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note payable to a related party and recorded at the prevailing exchange rate at March 31, 2001 and December 31, 2000.

In December 1999, LAJ completed its initial public offering in Japan, which raised total proceeds of approximately \$28.3 million and resulted in the Company's ownership in LAJ reducing to 6.92%. The Company booked an investment in LAJ of \$1,959,000, which was recorded as additional paid in capital as prescribed by SAB Topic No. 5, "Miscellaneous Accounting," to reflect the increase in the Company's share of LAJ's net assets. The Company's ownership percentage was further reduced to 6.81% during the year ended December 31, 2000 due to an increase in LAJ's total outstanding shares.

In March 2001, the Company exercised its option to purchase additional shares of LAJ from the Strategic Partner for \$165,000. As a result, the Company's ownership increased to 9.81%.

The fair value of the Company's ownership in LAJ, based on the quoted trading price, was approximately \$7.1 million at March 31, 2001.

Investment in Liquid Audio Korea

In December 1998, the Company signed an agreement with another strategic partner to establish a Korean corporation, Liquid Audio Korea Co. Ltd. ("LAK"), to develop a local business to enable the digital delivery of music to customers in Korea. LAK is the exclusive reseller and distributor of the Company's software products in Korea, under an agreement expiring on December 31, 2003. The Company paid \$400,000 for 40% of the outstanding common stock of LAK and accounts for its investment in LAK using the equity method of accounting. The investment of \$400,000 was recorded as an offset to the business development revenue recognized from LAK in December 1998. The Company is not recording its share of additional losses beyond its investment since there is no obligation on the part of the Company to pay LAK or any other party for those losses. If LAK generates sufficient profits to recoup its initial operating losses, the Company will re-instate the equity method of accounting. LAK stopped making its contractual payments as scheduled. LAK is undergoing a recapitalization through the addition of new investment partners so that it can continue making its payments to the Company. Until such time contractual payments are resumed, the Company is deferring recognition of revenue from LAK. The Company additionally wrote off its loans of \$470,000 to LAK as of December 31, 2000.

Liquid Audio Greater China

In June 2000, the Company signed an agreement with a strategic partner to establish a British Virgin Islands corporation, Liquid Audio Greater China ("LAGC"). LAGC is the exclusive reseller of the Company's products in Taiwan and Hong Kong and will work to develop business services that enable the digital delivery of music in those local markets. The Company owns 40% of the outstanding common stock of LAGC and accounts for its investment in LAGC using the equity method of accounting. LAGC stopped making its contractual payments in late 2000 as scheduled. Until such time contractual payments are resumed, the Company is deferring recognition of revenue from LAGC.

Liquid Audio South East Asia

In September 2000, the Company signed an agreement with a strategic partner to establish a Singaporean corporation, Liquid Audio South East Asia ("LASE"). LASE will be the exclusive reseller of the Company's products in Singapore, Thailand, Malaysia, Indonesia, Philippines, Australia and New Zealand and will work to develop business services that enable the digital delivery of music in those local markets. The Company will own 30% of the outstanding common stock of LASE and will account for its investment in LASE using the equity method

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of accounting. The strategic partner of LASE did not make its contractual payments in late 2000 as scheduled. Until such time contractual payments are resumed, the Company is deferring recognition of revenue from LASE.

Other transactions

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

	Three Months Ended March 31, 2001

	2001

Liquid Audio Japan and strategic partner.....	\$ 946
Liquid Audio South East Asia and strategic partner.....	--
Liquid Audio Greater China and strategic partner.....	--
Liquid Audio Korea and strategic partner.....	--

	\$ 946
	=====

Of the total fees earned from Liquid Audio Japan and strategic partner, \$946,000 and \$2,196,000 were earned from Liquid Audio Japan and relate to software licensing and maintenance fees in the three months ended March 31, 2001 and 2000, respectively, and \$167,000 were earned from the strategic partner in Liquid Audio Japan in the three months ended March 31, 2000, and relate to a non-refundable service fee of \$1,000,000 received in March 1999 and recognized ratably over the one-year term of the service agreement. At March 31, 2001 and December 31, 2000, fees billed or received in advance of recognition as business development revenues were \$986,000 and \$987,000, respectively. These amounts are classified as deferred revenue from related parties on the balance sheet.

NOTE 4 - NET LOSS PER SHARE:

Basic and diluted net loss per share is computed by dividing the net loss available to common stockholders 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):

	Three Months Ended March 31, 2001

	2001

Numerator:	
Net loss.....	\$ (11,260)

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Denominator:

Weighted average shares.....	22,54
Weighted average unvested common shares subject to repurchase.....	(1

Denominator for basic and diluted calculation.....	22,52
--	-------

Net loss per share:

Basic and diluted.....	\$ (0.5
------------------------	---------

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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):

Common stock options.....	2
Common stock warrants.....	
Unvested common stock subject to repurchase.....	

NOTE 5 - STRATEGIC MARKETING -- EQUITY AGREEMENTS:

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. As a result, \$506,000 was recognized as strategic marketing-equity instruments expense in the three months ended March 31, 2000.

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 totaling 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 as strategic marketing-equity instruments expense. 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 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 current market data. The third warrant for 83,333 shares will vest in August 2001. The third warrant was initially valued at \$105,000 and is recognized ratably over the one-year period ending at the vesting date. The third warrant will be revalued at each balance sheet date through the vesting date based on current market data. In the three months ended March 31, 2001, \$0, \$0 and \$17,000 were recognized as strategic

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marketing-equity instruments expense for the first, second and third warrants, respectively. In the three months ended March 31, 2000, \$223,000, \$(168,000) and \$0 were recognized as strategic marketing-equity instruments expense for the first, second and third warrants, respectively.

In July 2000, the Company 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 the Company's technology. Pursuant to this agreement, the Company issued 150,000 shares of common stock to Virgin. These shares were valued at \$1,181,000 and are being recognized as strategic marketing-equity instruments expense 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.

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 are being 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 a warrant for a total of 233,300 shares of common stock. Of the total, 77,768 shares vest in December 2001, and the cost will be remeasured each quarter until a commitment for performance has been reached or the warrant vests, based on current market data. At March 31, 2001, the 77,768 shares under this warrant was valued at \$143,000, of which \$33,000 was recognized as non-cash cost of net revenues. The unamortized portion will be remeasured at each balance sheet date through the vesting date and amortized over the remaining vesting period. If BMG renews the agreement after December 2001, the remaining shares will vest at 6,481 shares per month commencing January 2002

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for one year and 6,480 shares per month commencing January 2003 for one year. Such shares will be valued at the fair market value of the Company's common stock upon BMG renewing the agreement at each renewal date.

NOTE 6 - SUBSEQUENT EVENT:

In May 2001, the Company announced a corporate restructuring program that included a reduction in the number of employees of approximately forty percent across all departments, a consolidation of its three Redwood City, California offices in one facility and other expense management initiatives. The Company is de-emphasizing its 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. The restructuring program is intended to reduce expenses to preserve the Company's cash position while the digital music market develops. The Company plans to focus on software licensing and digital music delivery services that complement its secure digital download business. The Company plans 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 the Company's core digital download services and its player software licensing business. A restructuring charge of approximately \$3.5 to \$4.0 million is expected to be recorded in the three months ended June 30, 2001.

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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," "believe," "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 2000 Form 10-K.

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 that currently links over 1,000 affiliated 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. 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 8%, 6% and 1% of total net revenues in the three months ended March 31, 2001 and the twelve months ended December 31, 2000 and 1999, respectively. Our Liquid Music Network began offering syndicated music through music retailer websites in the third quarter of 1999.

To date, we have derived our revenues primarily from the licensing of software products and service fees associated with business development contracts. Business development revenues primarily consist of license and maintenance fees

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from agreements under which we give our strategic related partners the right to license and use our digital recorded music delivery technology. These U.S. dollar-denominated, non-refundable fees are allocated among the various elements of the contract based on vendor specific objective evidence (VSOE) of fair value. When VSOE of fair value exist for the undelivered elements, primarily maintenance, we account 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, we recognize the total fee from a business development contract ratably over the term of the contract. We also license our software products to record companies, artists and websites. Software license revenues are recognized when persuasive evidence of an arrangement exists, the fee is fixed and determinable, collection is probable and delivery has occurred. Services

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revenues from maintenance fees related to our licensed software products and hosting fees from record companies and artists are recognized over the service period, typically one year. We intend to increase our services revenues by significantly expanding our music delivery 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 our LMN website affiliates and fees from musicretailers and websites related to the sample digital music clips delivery service. Revenue from kiosk sales consists of software licenses and services revenue from equipment and kiosk-related services. We bear full credit risk with respect to substantially all sales.

Business development revenues as a percentage of total net revenues were 57%, 63% and 48% in the three months ended March 31, 2001 and the twelve months ended December 31, 2000 and 1999, respectively. Liquid Audio Korea (LAK) stopped making its contractual payments as scheduled. LAK is undergoing a recapitalization through the addition of new investment partners so that it can continue making its payments to us. Until such time contractual payments are resumed, we are deferring recognition of revenue from LAK. In late 2000, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner did not make their contractual payments as scheduled. We are pursuing collection for the missed payments. No revenue will be recognized until payments are on schedule. We may be unsuccessful in receiving any additional payments from these customers.

In the first quarter of 2001, approximately 57% of total net revenues came from sales to one customer, Liquid Audio Japan. In 2000, approximately 53% of total net revenues came from sales to two customers, Liquid Audio Japan and Liquid Audio South East Asia through our strategic partner. In 1999, approximately 73% of total net revenues came from sales to three customers, Adaptec, Inc., Super Stage, Inc. and Liquid Audio Korea. International revenues represented approximately 65%, 69% and 49% of total net revenues in the three months ended March 31, 2001 and the twelve months ended December 31, 2000 and 1999, respectively. We expect international revenues will continue to represent a significant portion of our total net revenues.

In May 2001, we announced a corporate restructuring program that included a reduction in the number of employees of approximately forty percent across all departments, a consolidation of our three Redwood City, California offices in one facility and other expense management initiatives. We are de-emphasizing 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. The restructuring program is intended to reduce expenses to preserve

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our cash position while the digital music market develops. We plan to focus on software licensing and digital music 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. We expect to record a restructuring charge of approximately \$3.5 to \$4.0 million in the second quarter of 2001.

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, 2001 we had an accumulated deficit of approximately \$85.2 million. We expect to incur additional losses and continued negative cash flow from operations through at least 2002. Our revenues may not increase or even continue at their current levels or we may not achieve or maintain profitability or generate cash from operations in future periods. 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.

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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.

	Three months ended March 31,
	2001
Net revenues:	
License.....	17
Services.....	26
Business development (related party).....	57
Total net revenues.....	100
Cost of net revenues:	
License.....	9
Services.....	43
Non-cash cost of revenue.....	5
Total cost of net revenues.....	57
Gross profit.....	43
Operating expenses:	
Sales and marketing.....	280
Non-cash sales and marketing.....	1
Research and development.....	315

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Non-cash research and development.....	1
General and administrative.....	192
Non-cash general and administrative.....	--
Strategic marketing-equity instruments.....	19

Total operating expenses.....	808

Loss from operations.....	(765)
Other income (expense), net.....	100
Equity in net loss of investment.....	(13)

Net loss.....	(678)
	=====

Three Months Ended March 31, 2001 and 2000

Total Net Revenues

Total net revenues decreased 45% to \$1.7 million for the three months ended March 31, 2001 from \$3.0 million in the comparable period of 2000.

License. License revenues increased 26% to \$290,000 for the three months ended March 31, 2001 from \$231,000 in the comparable period of 2000. This increase is due to Liquid Player license fees received under agreements with a hardware manufacturer in which the manufacturer delivers a custom-branded version of the software with certain of their compact disc recorder (CD-R) devices they sell. These fees were higher than licensing fees related to digital music kiosk sales and Secure Portable Player Protocol (SP3) technical architecture and reference specification in the comparable quarter in 2000.

Services. Services revenues increased 6% to \$425,000 for the three months ended March 31, 2001 from \$401,000 in the comparable period of 2000. This increase was due primarily to increases in encoding services in the 2001 period.

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Business Development (Related Party). Business development revenues decreased 60% to \$946,000 for the three months ended March 31, 2001 from \$2.4 million in the comparable period of 2000. The decrease was due to lower software licensing and related maintenance revenues recognized under the software license contract with Liquid Audio Japan in the 2001 period. Revenue for both periods relate solely to Liquid Audio Japan and its strategic partner.

Total Cost of Net Revenues

Our gross profit decreased to approximately 43% of total net revenues for the three months ended March 31, 2001 from approximately 82% of total net revenues in the comparable period of 2000. Total cost of net revenues increased 76% to \$953,000 in the 2001 period from \$542,000 in the 2000 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 increased 783% to \$159,000 for the three months ended March 31, 2001 from \$18,000 in the comparable period of 2000. Cost of license revenues increased due to the addition of technology licenses in 2001 and product mix differences.

Services. Cost of services revenues primarily consists of compensation for customer service, encoding and professional services personnel, kiosk-related

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equipment and an allocation of our occupancy costs and other overhead attributable to our services revenues. Cost of services revenues increased 36% to \$711,000 for the three months ended March 31, 2001 from \$521,000 in the comparable period of 2000. The increase in cost of services revenues was due to the write-off of kiosk-related inventory due to de-emphasizing the kiosk product line in connection with our announced corporate restructuring, and the addition of encoding, customer service and professional services personnel.

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 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 are being recognized ratably over the initial one-year term of the agreement; as a result, \$49,000 was recognized as non-cash cost of revenues. Also in connection with this agreement, we granted a warrant for a total of 233,300 shares of common stock. Of the total, 77,768 shares vest in December 2001, and the cost will be remeasured each quarter until a commitment for performance has been reached or the warrant vests, based on current market data. At March 31, 2001, the 77,768 shares under this warrant were valued at \$143,000, of which \$33,000 was recognized as non-cash cost of revenues. The unamortized portion will be remeasured at each balance sheet date through the vesting date and amortized over the remaining vesting period. If BMG renews the agreement after December 2001, the remaining shares will vest at 6,481 shares per month commencing January 2002 for one year and 6,480 shares per month commencing January 2003 for one year. Such shares will be valued at the fair market value of our common stock upon BMG renewing the agreement at each renewal date. Stock compensation expense for customer service, encoding and professional services personnel were \$1,000 and \$3,000 for the three months ended March 31, 2001 and 2000, respectively. We expect quarterly amortization related to these options to be less than \$1,000 per quarter during 2001 and annual amortization to be approximately \$1,000 in 2002. These future compensation charges would be reduced if any customer service, encoding or professional services employee terminates employment prior to the expiration of the employee's option vesting period.

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 increased 33% to \$4.7 million for the three months ended March 31, 2001

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from \$3.5 million in the comparable period of 2000. This increase was primarily due to increases in the number of sales and marketing personnel, advertising and promotional programs. We expect that sales and marketing expenses will decrease in absolute dollars in future periods due to the corporate restructuring and expense management initiatives.

Research and Development. Research and development expenses consist primarily of compensation for our research and development, network operations and product

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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 increased 6% to \$5.2 million for the three months ended March 31, 2001 from \$4.9 million in the comparable period of 2000. This increase was primarily due to increases in the number of personnel and outside contractors needed to enhance our existing software products, develop and enhance our online services, develop new products and services and build our external network and computer data center infrastructure. We expect that research and development expenses will decrease in absolute dollars in future periods due to the 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 increased 67% to \$3.2 million for the three months ended March 31, 2001 from \$1.9 million in the comparable period of 2000. This increase was primarily due to legal fees related to patent infringement claims against us (see Part II, Item 1 "Legal Proceedings"), professional services fees and increases in the number of personnel and outside contractors needed to support the growth of our business. We expect that general and administrative expenses will decrease in absolute dollars due to the 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 \$312,000 and \$561,000 in the three months ended March 31, 2001 and 2000, respectively. In June 1999, we signed an advertising agreement with 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, \$506,000 was recognized as strategic marketing-equity instruments expense in the three months ended March 31, 2000. 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 totaling 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 current market data. The third warrant for 83,333 shares will vest in August 2001. The third warrant was initially valued at \$105,000 and is recognized ratably over the one-year period ending at the vesting date. The third warrant will be revalued at each balance sheet date through the vesting date based on current market data. 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 the three months ended March 31, 2000, \$223,000, \$(168,000) and \$0 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., an affiliate of EMI Recorded Music, to promote the distribution of digital music over the Internet using our technology. Pursuant

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to this agreement, we issued 150,000 shares of common stock to Virgin. These shares were valued at \$1.2 million and are being 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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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, 2001 was \$3.8 million. We recognized \$23,000 and \$189,000 of stock compensation expense for the three months ended March 31, 2001 and 2000, respectively. We expect quarterly amortization related to those options to be between \$66,000 and \$40,000 per quarter during the remainder of 2001 and annual amortization to be approximately \$76,000 during 2002. These future compensation charges would be reduced if any sales and marketing, research and development and general and administrative employee terminates employment prior to the expiration of the employee's 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 \$1.7 million for the three months ended March 31, 2001 from \$2.3 million in the comparable period of 2000. This decrease was primarily due to interest received on higher average cash and cash equivalent balances in the 2000 period resulting from proceeds of the initial and follow-on public offerings of our common stock in July 1999 and December 1999, respectively.

Equity in Net Loss of Investment. Equity in net loss of investment consist of our share of losses from our investment in a related party using the equity method of accounting under a 3-month lag. Equity in net loss of investment was \$219,000 and \$216,000 for the three months ended March 31, 2001 and 2000, respectively. The expenses represent our share of the loss of Liquid Audio Japan.

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, 2001, 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, 2001, we had approximately \$114.8 million of cash, cash equivalents and short-term investments.

Net cash used in operating activities was \$8.1 million and \$3.1 million for the three months ended March 31, 2001 and 2000, respectively. 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 by \$18,000, equity investment losses of \$219,000, other charges of \$(37,000) and a net increase in working capital items by \$1.4 million. The net increase in working capital items include a decrease in accounts receivable by \$23,000, decrease in other assets by \$675,000, decrease in accounts payable by \$236,000, increase in accrued expenses and other liabilities by \$779,000 and an increase in deferred revenue by

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\$148,000. Net cash used for operating activities in the 2000 period was primarily the result of net losses from operations, depreciation and amortization of \$573,000, amortization of unearned compensation of \$192,000, strategic marketing-equity instruments charges of \$561,000, an increase in the allowance for doubtful accounts and sales returns reserve by \$23,000, equity investment losses of \$216,000, other charges of \$(14,000) and a net increase in working capital items by \$1.9 million. The net increase in working capital items include an increase in accounts receivable by \$241,000, decrease in other assets by \$38,000, increase in accounts payable by \$737,000, increase in accrued expenses and other liabilities by \$1.6 million and a decrease in deferred revenue by \$295,000.

Net cash provided by (used in) investing activities was \$26.3 million and \$(89.2) million for the three months ended March 31, 2001 and 2000, respectively. Net cash provided by (used in) investing activities in each of these periods was related to net sales (purchases) of short-term investments and the acquisition of property and equipment in both periods.

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Net cash used financing activities was \$184,000 and \$175,000 for the three months ended March 31, 2001 and 2000, 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 interest at the bank's prime interest rate plus 0.25%. Borrowings are secured by the related equipment and other assets. Under the equipment loan facility, we had borrowed amounts totaling \$1.8 million through March 31, 2001. We also have lease financing agreements that provide for the lease of computers and office equipment of up to \$1.0 million. As of March 31, 2001, we had borrowed \$737,000 under the lease financing agreements. Our other significant commitments consist of obligations under non-cancelable operating leases, which totaled \$2.3 million as of March 31, 2001 and are payable in monthly installments through 2005 and a note payable to related party in the amount of \$356,000 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.

We have no material commitments for capital expenditures or strategic investments and anticipate a decline in the 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 a decline in our operating expenses for the foreseeable future and that our operating expenses will be a material use of our cash resources.

We believe that existing cash and cash equivalents and financing available under lease agreements 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

At March 31, 2001, we had an investment portfolio of money market funds, commercial securities and U.S. Government bonds including those classified as

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short-term investments of \$114.8 million. We had a related party loan at March 31, 2001 of \$356,000, which was denominated in Japanese yen and bore interest at 0.5% above a Japanese bank's prime rate. These instruments, like all fixed income instruments, are subject to interest rate risk. The fixed income portfolio will fall in value and the strategic related partner note payable interest would increase if there were an increase in interest rates. If market interest rates were to increase immediately and uniformly by 10% from levels as of December 31, 2000, the decline of the fair value of the fixed income portfolio and strategic related partner note payable would not be material.

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

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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, 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, 2001 was approximately \$85.2 million. We had net losses of approximately \$24.2 million and \$33.7 million in 1999 and 2000, respectively, and \$11.3 million in the three months ended March 31, 2001. Given the level of our planned operating and capital expenditures, we expect to continue to incur losses and negative cash flows through at least 2002. 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 will be harmed.

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:

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- . 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;
- . 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;
- . 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.

Some of these factors are within our control and others are outside of our control.

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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, including our international partners Liquid Audio Japan, Liquid Audio Korea, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner, 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, 2001, 24% and 76% of our trade accounts receivable and receivables from related parties, respectively, or \$188,000 and \$873,000, respectively, 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 business might be harmed.

If Our Relationships with Our International Partners Terminate, Our Revenues Might Decline

We derive a 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. These relationships vary in size and scope. If one of these relationships does not generate a similar amount of revenue in subsequent periods or if a party is unable to make its scheduled payments to us,

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then our business could be harmed. Furthermore, the commercial terms for these relationships could cause our revenues to vary from period-to-period, which might result in unpredictability of our revenues.

Our Revenues Would Be Negatively Effected by the Loss of a Significant Customer

We have derived, and we believe that we will continue to derive, a substantial portion of our net revenues from a limited number of customers and projects. Our ten largest customers for 1999, 2000 and the three months ended March 31, 2001 represented approximately 86%, 78% and 91%, respectively, of our total net revenues. The loss of any significant customer or any significant reduction of total net revenues generated by significant customers, without an increase in revenues from other sources, would harm our business. The volume of products or services we sell to specific customers is likely to vary year to year, and a major customer in one year may not use our services in a subsequent year. A customer's decision not to use our services in a subsequent year might harm our business.

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, users are able to download and distribute unauthorized or "pirated" copies of copyrighted recorded music over the Internet. This piracy is a significant concern to record companies and artists, and is the reason many record companies and artists are reluctant to digitally deliver their recorded music over the Internet. The Secure Digital Music Initiative (SDMI) is a committee formed by the Recording Industry Association of America (RIAA) to propose a standard format for the secure digital delivery and use of recorded music. If a standard format is not adopted, however, unsecure copies of recorded music may continue to be available on the Internet, and 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 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.

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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 more rapid international expansion or acquisitions of complementary businesses or technologies;
- . develop new products or services; or
- . respond to competitive pressures.

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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.

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, assimilate 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.

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. Patent applications or trademark registrations 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 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 four 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 for inadequate intellectual property protection. If our intellectual property is infringed in any country without a high level of intellectual property protection, our business could be harmed.

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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 patent rights. Such claims may result in 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. See "Other Information--Legal Proceedings."

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.

If We Do Not Increase the Number of Websites that Use Our Platform, Our Business Will Not Grow

In order to grow our business, we need to increase the number of websites, including websites operated by music retailers, that use our technology and our syndicated content to digitally deliver recorded music. To increase the number of websites, we must do the following:

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- . offer competitive products and services that meet industry standards;
- . attract more music content;
- . make it easy and cost-effective for music-related websites to sell digital music;
- . develop relationships with online retailers, music websites, online communities, broadband providers and Internet broadcasters; and
- . develop relationships with international music websites, retailers and broadband providers.

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Any failure to achieve one or more of these objectives would harm our business. We may not be successful in achieving any of these objectives.

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 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 will 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 might be harmed.

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;

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- . 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.

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. 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 might be harmed.

Competition is likely to increase 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:

- . larger audiences;
- . larger technical, production and editorial staffs;

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- . 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.

New Competitors Could Enter the Industry with Alternative Business Models, Which, if Successful, Could Harm Our Business

New companies may enter our market with alternative business models. For example, companies may provide free music downloading from a website, earning revenues on an advertising or subscription basis. This model could be more attractive to consumers. If we are unable to compete with such companies or adapt our business model, products or services to a more consumer-favorable model, our business could be harmed.

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.

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

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Appropriately

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 this happens, our business might be harmed.

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 action against companies providing music sharing technology. If the injunction is denied, and it is determined 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 free shared copies are available, 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

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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

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

This must be accomplished in a timely and cost-effective manner. 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.

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 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 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.

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

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of claims and, even if these claims do not result in liability, we could incur significant costs in investigating and defending against these claims.

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 Millenium 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 is currently experiencing 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 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.

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.

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;

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- . longer payment cycles;
- . problems in collecting accounts receivable;
- . 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 have entered into individual agreements in Japan, Korea, greater China and south east Asia, and we may enter into similar arrangements in the future in other countries. We also established a wholly-owned subsidiary in the United Kingdom. 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.

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

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on the exchange of products and services on our system, our business might be harmed.

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In 1998, Congress passed the Internet Freedom Act, which imposes a three-year moratorium on state and local taxes on Internet-based transactions. We cannot assure you that this moratorium will be extended. Failure to renew this moratorium would allow various states to impose taxes on e-commerce, which might harm our business.

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.

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

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

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In February 2000, Sightsound, Inc. notified one of our customers that it intended to add the customer as a party to a pending patent litigation in the United States District Court for the Eastern District of Pennsylvania (Pittsburgh). The litigation alleges infringement of unspecified claims of three patents (United States Patent Nos. 5,191,573; 5,675,734 and 5,996,440). Damages have not been specified. Our customer has agreed to be added to the case, subject to a revision in the trial schedule. Our customer has requested indemnification, including defense costs, from us, based upon the terms of our contract with them. Based on this request, we are negotiating an agreement with our customer under which we would (i) assume control of the defense, (ii) pay the expenses of the defense and (iii) reserve certain rights as to indemnification. During negotiation of this agreement we have agreed to assume the costs of the defense for our customer. These costs could be significant. There is no assurance that we will enter into this agreement. If we do not reach an agreement with our customer and the defense is not successful, our customer might seek full indemnification from us for the damages, if any. There can be no assurance regarding the outcome of the litigation. If there is a finding of infringement, we may be required to indemnify our customer as to the full amount of the damages.

On March 31, 2000, Intouch Group, Inc. (Intouch) filed a lawsuit against us in the Northern District of California alleging patent infringement. On April 26, 2000, Intouch filed an amended complaint, which was served on us shortly thereafter. The complaint names us and Amazon.com International, Inc., Listen.com, Inc., Entertaindom LLC, Discovermusic.com, Inc. and Muze, Inc. It alleges that we infringe or induce infringement of, the claims of United States Patent Nos. 5,237,157 and 5,963,916 by operating a website and/or a kiosk that allows interactive previewing of portions of pre-recorded music products. The complaint seeks unspecified damages and injunctive relief. On May 30, 2000, we filed our answer to Intouch's first amended complaint. The action is currently in discovery, and the trial date has been set for January 11, 2002. We believe that we have meritorious defenses to Intouch's claims and we intend to vigorously defend against such claims. However, we cannot assure you that we will be successful in defending these lawsuits. If there is a finding of infringement, we might be required to pay substantial damages to Intouch and could be enjoined from selling any of our products or services that are held to infringe Intouch's patents unless and until we are able to negotiate a license from them.

On August 14, 2000, a former employee filed a charge of discrimination with the California Department of Fair Employment and Housing against us, and several of our employees and former employees. The charge alleges sexual harassment and unlawful retaliation. While we believed the charge was without merit, we reached an out-of-court settlement in April 2001 with the former employee whereby we agreed to pay her \$40,000.

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.

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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, BancBoston Robertson Stephens Inc., U.S. Bancorp Piper Jaffray, 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

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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, 2001, 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 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

None.

(b) Reports on Form 8-K

None.

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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, 2001

LIQUID AUDIO, INC.

/s/ Gerald W. Kearby

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GERALD W. KEARBY
President, Chief Executive Officer and Director
(Principal Executive Officer)

/s/ Michael R. Bolcerek

MICHAEL R. BOLCEREK
Senior Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)