LIQUID AUDIO INC
Form 10-Q
August 14, 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 JUNE 30, 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.)

800 Chesapeake Drive, 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 July 31, 2001, there were 22,633,624 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)

	June 30, 2001 (unaudited)	December 31, 2000
Assets		
Current assets:		
Cash and cash equivalents	$ 103,645	$ 96,398
Short-term investments	--	27,378
Accounts receivable from third parties, net	295	725
Accounts receivable from related parties, net	506	1,253
Other current assets	648	2,307
Total current assets	105,094	128,061
Restricted cash and cash equivalents	826	--
Investment in strategic partner	154	1,089
Property and equipment, net	5,591	8,860
Other assets	170	200
Total assets	$ 111,835	$ 138,210
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 2,267	$ 3,314
Accrued expenses and other current liabilities	3,979	3,522

Deferred revenue from third parties	301	440
Deferred revenue from related parties	876	987
Capital lease obligations, current portion	69	120
Equipment loan, current portion	437	589
Total current liabilities	7,929	8,972
Capital lease obligations, non-current portion	--	28
Equipment loan, non-current portion	--	143
Note payable to related party	361	393
Total liabilities	8,290	9,536
Stockholders' equity:		
Common stock	23	23
Additional paid-in capital	202,858	202,877
Unearned compensation	(101)	(333)
Accumulated deficit	(99,211)	(73,910)
Accumulated other comprehensive income (loss)	(24)	17
Total stockholders' equity	103,545	128,674
Total liabilities and stockholders' equity	$ 111,835	$ 138,210

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 June 30,	
	2001	2000
Net revenues:		
License...	$ 194	$ 612
Services	362	1,215
Business development (related party)	468	1,627
Total net revenues	1,024	3,454
Cost of net revenues:		
License	128	78
Services	364	849
Business development (related party)	--	68
Non-cash cost of revenue	98	(4)
Total cost of net revenues	590	991
Gross profit	434	2,463

Operating expenses:		
Sales and marketing	3,061	4,248
Non-cash sales and marketing	(72)	86
Research and development	4,731	5,842
Non-cash research and development	(26)	(25)
General and administrative	3,078	1,410
Non-cash general and administrative	(21)	16
Strategic marketing--equity instruments	340	514
Restructuring	3,672	--
Total operating expenses	14,763	12,091
Loss from operations	(14,329)	(9,628)
Other income (expense), net	1,176	2,147
Net loss in equity investment	(881)	(237)
Net loss	$(14,034)	$ (7,718)
Net loss per share:		
Basic and diluted	$ (0.62)	$ (0.35)
Weighted average shares	22,593	22,013

See accompanying notes to condensed consolidated financial statements

Liquid Audio, Inc.
Condensed CONSOLIDATED StatementS of Cash Flows
(in thousands; unaudited)

	Six Months Ended June 3	
	2001	2000
Cash flows from operating activities:		
Net loss	$ (25,301)	$ (14,24
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,193	1,46
Amortization of unearned compensation	(101)	26
Allowance for doubtful accounts and sales returns reserve	1,055	13
Net loss in equity investment	1,100	45
Strategic marketing-equity instruments	652	1,07
Non-cash cost of revenue	186	--
Loss on disposal of and write-down of property and equipment	1,742	--
Common stock issued for legal settlement	--	35
Other	(32)	(1
Changes in assets and liabilities:		
Accounts receivable from third parties	379	(1,08
Accounts receivable from related parties	(257)	(1,18
Other assets	176	(13
Accounts payable	(1,047)	1,77
Accrued expenses and other current liabilities	457	26

Deferred revenue from third parties	(139)	8
Deferred revenue from related parties	(111)	4
Net cash used in operating activities	(19,048)	(10,74
Cash flows from investing activities:		
Acquisition of property and equipment	(689)	(3,28
Proceeds from sale of fixed assets	25	--
Sales (purchases) of short-term investments, net	27,384	(45,44
Equity investment	(165)	--
Net cash provided by (used in) investing activities	26,555	(48,72
Cash flows from financing activities:		
Proceeds from issuance of common stock, net of repurchases	163	70
Payments made under capital leases	(79)	(9
Payments made under equipment loan	(295)	(29
Net cash provided by (used in) financing activities	(211)	31
Effect of exchange rates on cash and cash equivalents	(49)	--
Net increase (decrease) in cash and cash equivalents	7,247	(59,14
Cash and cash equivalents at beginning of period	96,398	138,69
Cash and cash equivalents at end of period	$ 103,645	$ 79,54
Supplemental disclosures:		
Cash paid for interest	$ 40	$ 8
Non-cash investing and financing activities:		
Issuance of warrants in connection with strategic marketing agreements	$ 151	$ 1,07
Issuance of common stock upon exercise of warrant	$ --	$ 10
Issuance of common stock for intellectual property	$ --	$ 1

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 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

The Company

Liquid Audio, Inc. (the "Company") was incorporated in California in January 1996 and reincorporated in Delaware in April 1999. In July 2000, the

Company established a wholly-owned subsidiary in the United Kingdom, Liquid Audio Europe PLC, 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 June 30, 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 (the "SEC") on March 30, 2001.

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.

Revenue recognition

Software license revenues are recognized when persuasive evidence of an arrangement exists, delivery has occurred, no significant Company obligations with regard to implementation or integration exist, the fee is fixed or determinable and collection is probable as prescribed in Statement of Position ("SOP") No. 97-2, "Software Revenue Recognition." For arrangements with multiple elements, the total fee from the arrangement is allocated among each element based upon vendor specific objective evidence ("VSOE") of fair value. VSOE of fair value for the service elements is based upon the standard hourly rate the Company charges for services when such services are sold separately. VSOE of fair value for annual maintenance is established based upon the optional stated renewal rate. When VSOE of fair value exist for all undelivered elements, the Company accounts for the delivered elements, primarily the license portion, based upon the "residual method" as prescribed by SOP No. 98-9, "Modification of SOP 97-2 with Respect to Certain Transactions." The Company recognizes revenue allocated to maintenance ratably over the contract period, which is generally twelve months.

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

Business development revenue primarily consists of license and maintenance fees derived from contractual agreements with the Company's strategic partners. These U.S. dollar-denominated, non-refundable fees are based upon agreements whereby the strategic partners are contractually obligated to pay to the Company a fixed fee for the right to license and use the Company's proprietary technology in various countries. The total fee from business development agreements are allocated among the various elements of the contracts based on VSOE of fair value. The fees are recognized by the Company as earned, the specific timing of which depends on the terms and conditions of the particular contractual arrangements, including payment terms. When VSOE of fair value does not exist for the undelivered elements, the total fee from the business development arrangement is recognized ratably over the period of the contract.

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

Restricted cash

At June 30, 2001, the Company had a cash balance of $826,000 in the form of certificates of deposit which were restricted from withdrawal. The amount serves as collateral to a letter of credit issued by the Company's bank to the Company's lessor as security deposit on a long-term lease.

Principles of consolidation

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

Recent accounting pronouncements

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 addresses financial accounting and reporting for business combinations and supercedes Accounting Principles Board ("APB") No. 16, Business Combinations. The provisions of SFAS No. 141 are required to be adopted July 1, 2001. The most significant changes made by SFAS No. 141 are: (1) requiring that the purchase method of accounting be used for all business combinations initiated after June 30, 2001, (2) establishing specific criteria for the recognition of intangible assets separately from goodwill and (3) requiring unallocated negative goodwill to be written off immediately as an extraordinary gain.

SFAS No. 142 primarily addresses the accounting for goodwill and intangible assets subsequent to their acquisition and supercedes APB No. 17, Intangible Assets. The provisions of SFAS No. 142 are required to be adopted as of January

1, 2002 for calendar-year entities. The most significant changes made by SFAS No. 142 are: (1) goodwill and indefinite lived intangible assets will no longer be amortized, (2) goodwill will be tested for impairment at least annually at the reporting unit level, (3) intangible assets deemed to have an indefinite life will be tested for impairment at least annually and (4) the amortization period of intangible assets with finite lives will no longer be limited to forty years.

The Company adopted SFAS No. 141 effective July 1, 2001 which will result in the Company accounting for any business combination consummated on or after that date under the purchase method of accounting. The Company will also apply the non-amortization provisions of SFAS No. 142 for any business combination

consummated on or after July 1, 2001. The adoption of SFAS No. 141 will not change the method of accounting used in previous business combinations. The Company believes that adopting SFAS No. 141 and 142 will not have a material impact on its financial position or results of operations.

NOTE 2 - BALANCE SHEET COMPONENTS (IN THOUSANDS):

	June 30, 2001	December 3 2000
Accounts receivable from third parties, net:		
Accounts receivable	$ 886	$ 1,313
Less: allowance for doubtful accounts and sales returns reserve	(591)	(588)
	$ 295	$ 725

The allowance for doubtful accounts and sales returns reserve increased by $51,000 and $271,000 for the six months ended June 30, 2001 and the year ended December 31, 2000, respectively. Write-offs against the allowance for doubtful accounts and sales returns reserve were $48,000 and $43,000 for the six months ended June 30, 2001 and the year ended December 31, 2000, respectively.

	June 30, 2001	December 2000
Accounts receivable from related parties, net:		
Accounts receivable	$ 1,555	$ 1,29
Less: allowance for doubtful accounts and sales returns reserve	(1,049)	(4
	$ 506	$ 1,25

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The allowance for doubtful accounts and sales returns reserve increased by $1,004,000 and $45,000 for the six months ended June 30, 2001 and the year ended December 31, 2000, respectively. No write-offs against the allowance for doubtful accounts and sales returns reserve were made for the six months ended June 30, 2001 and the year ended December 31, 2000.

	June 30, 2001	December 3 2000
Property and equipment:		
Computer equipment and purchased software	$ 12,248	$ 12,190
Website and software development costs	235	399
Furniture and fixtures	829	774
Leasehold improvements	690	682
	14,002	14,045
Less:		
Accumulated depreciation and amortization	(7,169)	(5,185
Asset impairment	(1,242)	--
	$ 5,591	$ 8,860

Property and equipment includes $195,000 and 784,000 of equipment under capital leases at June 30, 2001 and December 31, 2000, respectively. Accumulated depreciation and amortization for equipment under capital leases was $174,000 and $734,000 at June 30, 2001 and December 31, 2000, respectively.

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	June 30, 2001	December 31, 2000
Accrued expenses and other current liabilities:		
Compensation and benefits	$1,667	$2,321
Restructuring	824	--
Consulting and professional services	454	475
Accrued marketing expenses	87	48
Other	947	678
	$3,979	$3,522

NOTE 3 - RELATED PARTIES:

Investment in Liquid Audio Japan

The Company owns 9.76% of the outstanding shares of Liquid Audio Japan ("LAJ") and accounts for its investment under the equity method of accounting. The Company's proportionate share of loss for the six months ended June 30, 2001 is $1,100,000.

LAJ stopped making its contractual payment as scheduled. Accordingly, no revenue was recognized during the three months ended June 30, 2001. In June 2001, the Company and LAJ mutually agreed to terminate the licensing and reseller agreements between the two companies. As a result, Liquid Audio Japan will rename its company and no longer distribute the Company's technology nor utilize the Company's digital distribution platform to offer services to the Japanese music market. According to the mutual termination agreement, Liquid Audio Japan has approximately 90 days to cease using Liquid Audio trademarks, including the company name; return all of the Company's products, technology and licenses; and, transition existing customer relationships to the Company. The Company intends to continue working with its Japanese customers and plans to establish a new office in Tokyo to directly service and manage existing relationships and to build new ones with label, retail and consumer electronic companies.

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 recapitalization of LAK has not been finalized and LAK is still unable to resume its contractual payments. Accordingly, the Company is deferring revenue from LAK until such time the recapitalization is finalized and contractual payments are resumed.

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 and the Company has recognized revenue from LAGC up to the amount of cash received which was attributable to the outstanding receivable.

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

Total business development revenue

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Liquid Audio Japan and strategic partner	$ --	$ 980	$ 946	$3,343
Liquid Audio South East Asia and strategic partner	--	--	--	--
Liquid Audio Greater China and strategic partner .	468	353	468	353
Liquid Audio Korea and strategic partner	--	294	--	294
	$ 468	$1,627	$1,414	$3,990

Of the total fees earned from Liquid Audio Japan and strategic partner, $167,000 were earned from the strategic partner in Liquid Audio Japan in the six months ended June 30, 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. The remaining amounts earned from Liquid Audio Japan and strategic partner relate to software licensing and maintenance fees for all other periods

The total fees earned from Liquid Audio South East Asia through the strategic partner, Liquid Audio Greater China and Liquid Audio Korea primarily consist of software licensing and maintenance fees.

At June 30, 2001 and December 31, 2000, fees billed or received in advance of recognition as business development revenues were $876,000 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 June 30,		Six
	2001	2000	2001
Numerator:			
Net loss................................	$ (14,034)	$ (7,718)	$(25,301

Denominator:			
Weighted average shares..................	22,602	22,107	22,572
Weighted average unvested common shares subject to repurchase	(9)	(94)	(9
Denominator for basic and diluted calculation	22,593	22,013	22,563
Net loss per share:			
Basic and diluted........................	$ (0.62)	$ (0.35)	$ (1.12

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):

	Three Months Ended June 30,		Six M J
	2001	2000	2001
Common stock options................................	2,960	1,975	2,891
Common stock warrants...............................	875	578	875
Unvested common stock subject to repurchase..........	9	94	9

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, $844,000 was recognized as strategic marketing-equity instruments expense in the six months ended June 30, 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 fair market value. 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 fair market value. In the six months ended June 30, 2001, $0, $0 and $61,000 were recognized as strategic marketing-equity instruments expense for the first, second and third warrants, respectively. In the six months ended June 30, 2000, $445,000, $(214,000) 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, $591,000 was recognized as strategic marketing-equity instruments expense in the six months ended June 30, 2001.

In December 2000, the Company signed an agreement with BMG Entertainment ("BMG") to obtain the right to distribute BMG sound recordings and related artwork through kiosks. In connection with this agreement, 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, $96,000 was recognized as non-cash cost of net revenues in the six months ended June 30, 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 fair market value. At June 30, 2001, the 77,768 shares under this warrant was valued at $178,000, of which $90,000 was recognized as non-cash cost of net revenues in the six months ended June 30, 2001. 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 the Company's common stock upon BMG renewing the agreement at each renewal date.

NOTE 6 - RESTRUCTURING:

In May 2001, the Company adopted a corporate restructuring program to reduce expenses to preserve the Company's cash position while the digital music market develops. The restructuring included a worldwide workforce reduction, a consolidation of three Redwood City, California offices into one facility and other expense management initiatives. A restructuring charge of $3,672,000 was recorded in operating expense in the three months ended June 30, 2001.

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

Lease costs of $824,000 were accrued in the three months ended June 30, 2001 pertaining to the estimated future obligations for non-cancelable lease payments for excess facilities that were vacated due to reductions in workforce.

Asset impairment costs of $1,732,000 were recorded, primarily for property and equipment, furniture and fixtures, computer software and leasehold improvements for assets no longer in use from de-emphasized business lines,

reductions in workforce and excess facilities.

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

	Severance and Benefits	Facilities	Asset Impairments
Severance and benefits....................	$ 1,116	$ --	$ --
Accrued lease costs.......................	--	824	--
Property and equipment impairment..........	--	--	1,732
Total....................................	1,116	824	1,732
Cash paid................................	(1,116)	--	--
Non-cash.................................	--	--	(1,732)
Restructuring reserve balance at June 30, 2001.........................	$ --	$ 824	$ --

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

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 Annual Report on Form 10-K for the year ended December 31, 2000 filed with the SEC.

Overview

We are a leading provider of software products and services that enable artists, record companies and retailers to create, syndicate and sell music digitally over the Internet. Our products and services are based on an open technical architecture that is designed to support a variety of digital music formats. From our inception in January 1996 through early 1997, we devoted substantially all of our efforts to product development, raising capital and recruiting personnel. We first generated revenues in the first quarter of 1997 through the licensing of our Liquifier Pro, Liquid Server and Liquid Player software products. In November 1997, we introduced a subscription-based hosting service for digital recorded music using our technology. In July 1998, to enhance consumer access to the music we were hosting, we launched the Liquid Music Network ("LMN"), a syndicated network 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 six months ended June 30, 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 from agreements under which we give our strategic related partners (the "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. The total fee from business development arrangements is recognized when payment becomes due if extended payment terms exist. Revenue recognition is deferred if the Partners stop making their contractual payments. 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 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 music retailers 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 53%, 63% and 48% in the six months ended June 30, 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. Until such time the recapitalization is finalized and 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, and in the second quarter of 2001, Liquid Audio Japan ("LAJ"), 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 June 2001, we and LAJ mutually agreed to terminate the licensing and reseller agreements between the two companies. As a result, Liquid Audio Japan will rename its company and no longer distribute our technology nor utilize our digital distribution platform to offer services to the Japanese music market. According to the mutual termination agreement, Liquid Audio Japan has approximately 90 days to cease using Liquid Audio trademarks, including the company name; return all of our products, technology and licenses; and, transition existing customer relationships to us. We intend to continue working with its Japanese customers and plan to establish a new office in Tokyo to directly service and manage existing relationships and to build new ones with label, retail and consumer electronic companies.

In the first six months of 2001, approximately 53% of total net revenues came from sales to two customers, Liquid Audio Japan and Liquid Audio Greater China. 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 59%, 69% and 49% of total net revenues in the six months ended June 30, 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 adopted a corporate restructuring program to reduce expenses to preserve our cash position while the digital music market develops. The restructuring included a worldwide workforce reduction , a consolidation of three Redwood City, California offices into one facility and other expense management initiatives. We 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. 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 recorded a restructuring

charge of $3.7 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 June 30, 2001 we had an accumulated deficit of approximately $99.2 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. The digital music market may never

develop to the extent that we are able to generate positive cash flows. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stages of development, particularly companies in new and rapidly evolving markets such as the digital delivery of recorded music. We may not be successful in addressing these risks, and our failure to do so would harm our business.

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 June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Net revenues:				
License	19%	18%	18%	13%
Services	35	35	29	25
Business development (related party) .	46	47	53	62
Total net revenues	100	100	100	100
Cost of net revenues:				
License	12	2	11	2
Services	36	25	40	21
Business development (related party) .	--	2	--	1
Non-cash cost of revenue	10	--	7	--
Total cost of net revenues	58	29	58	24
Gross profit	42	71	42	76
Operating expenses:				
Sales and marketing	299	123	287	120
Non-cash sales and marketing	(7)	2	(2)	3

Research and development	462	169	371	167
Non-cash research and development	(3)	--	(1)	--
General and administrative	301	41	234	51
Non-cash general and administrative ..	(2)	--	(1)	1
Strategic marketing-equity instruments	33	15	24	17
Restructuring	358	--	137	--
Total operating expenses	1,441	350	1,049	359
Loss from operations	(1,399)	(279)	(1,007)	(283)
Other income (expense), net	114	62	106	69
Net loss in equity investment	(86)	(7)	(41)	(7)
Net loss	(1,371)%	(224)%	(942)%	(221)%

Three Months Ended June 30, 2001 and 2000

Total Net Revenues

Total net revenues decreased 70% to $1.0 million for the three months ended June 30, 2001 from $3.5 million in the comparable period of 2000.

License. License revenues decreased 68% to $194,000 for the three months ended June 30, 2001 from $612,000 in the comparable period of 2000. This decrease was due to a reduction in kiosk software and other technology licenses as a result of our de-emphasis in the digital music kiosk business area.

Services. Services revenues decreased 70% to $362,000 for the three months ended June 30, 2001 from $1.2 million in the comparable period of 2000. This decrease was due to decreases in encoding services, kiosk-related equipment sales, promotion and advertising services and Liquid Muze Previews service in the 2001 period.

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Business Development (Related Party). Business development revenues decreased 71% to $468,000 for the three months ended June 30, 2001 from $1.6 million in the comparable period of 2000. The decrease was primarily due to the deferment of revenue from Liquid Audio Japan and Liquid Audio Korea due to those customers stopping scheduled payments to us, partially offset by an increase in software licensing and related maintenance revenues from Liquid Audio Greater China, resulting from revenue recognition of up to the amount of cash received from Liquid Audio Greater China which was attributable to the outstanding receivable.

Total Cost of Net Revenues

Our gross profit decreased to approximately 42% of total net revenues for the three months ended June 30, 2001 from approximately 71% of total net revenues in the comparable period of 2000. Total cost of net revenues decreased 40% to $590,000 in the 2001 period from $991,000 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 64% to $128,000 for the three months ended June 30, 2001 from $78,000 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 equipment and an allocation of our occupancy costs and other overhead attributable to our services revenues. Cost of services revenues decreased 57% to $364,000 for the three months ended June 30, 2001 from $849,000 in the comparable period of 2000. The decrease in cost of services revenues was due the reduction in the number of encoding, customer service and professional services personnel and kiosk-related equipment due to our corporate restructuring.

Business Development (Related Party). Cost of business development revenues primarily consists of kiosk-related equipment and royalties paid to third-party technology vendors. Cost of business development revenues was $0 for the three months ended June 30, 2001 and $68,000 in the comparable period of 2000.

Non-Cash Cost of Revenues. Non-cash cost of revenues consist of expenses associated with the value of common stock and warrants issued to partners as part of our content acquisition agreements and stock-based employee compensation arrangements. Common stock expense is based on the fair value of the stock at the time it was issued. Warrant expense is based on the estimated fair value of the warrants based on the Black-Scholes option pricing model and the provisions of EITF 96-18. In December 2000, we signed an agreement with BMG Entertainment ("BMG") to obtain the right to distribute BMG sound recordings and related artwork through kiosks. In connection with this agreement, we issued 50,000 shares of common stock to BMG, valued at $195,000 and 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 fair market value. At June 30, 2001, the 77,768 shares under this warrant were valued at $178,000, of which $55,000 was recognized as non-cash cost of revenues for the three months ended June 30, 2001. 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 was $(6,000) and $(4,000) for the three months ended June 30, 2001 and 2000, respectively. We expect quarterly amortization related to these options to be less than $1,000 for the third quarter of 2001. This future compensation charge would be reduced if customer service, encoding or professional services employees who hold the applicable options terminate employment prior to the expiration of their option vesting period.

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Operating Expenses

Sales and Marketing. Sales and marketing expenses consist primarily of compensation for our sales, marketing and business development personnel, compensation for customer service and professional services personnel attributable to sales and marketing activities, advertising, trade show and other promotional costs, design and creation expenses for marketing literature and our website and an allocation of our occupancy costs and other overhead. Sales and marketing expenses decreased 28% to $3.1 million for the three months ended June 30, 2001 from $4.2 million in the comparable period of 2000. This

decrease was primarily due to decreases in the number of sales and marketing personnel due to our corporate restructuring and expense management initiatives, advertising and promotional programs.

Research and Development. Research and development expenses consist primarily of compensation for our research and development, network operations and product management personnel, payments to outside contractors and, to a lesser extent, depreciation on equipment used for research and development and an allocation of our occupancy costs and other overhead. Research and development expenses decreased 19% to $4.7 million for the three months ended June 30, 2001 from $5.8 million in the comparable period of 2000. This decrease was primarily due to decreases in the number of personnel and outside contractors due to our corporate restructuring and expense management initiatives.

General and Administrative. General and administrative expenses consist primarily of compensation for personnel and payments to outside contractors for general corporate functions, including finance, information systems, human resources, facilities, legal and general management, fees for professional services, bad debt expense and an allocation of our occupancy costs and other overhead. General and administrative expenses increased 118% to $3.1 million for the three months ended June 30, 2001 from $1.4 million in the comparable period of 2000. This increase was primarily due to an increase in the allowance of doubtful accounts related to accounts receivables from related parties and legal fees related to patent infringement claims against us (see Part II, Item 1 "Legal Proceedings").

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 $340,000 and $514,000 in the three months ended June 30, 2001 and 2000, respectively. In June 1999, we signed an advertising agreement with Amazon.com, Inc. ("Amazon.com") to collaborate on event-based advertising using our digital delivery services. In connection with this agreement, we issued a fully vested warrant to purchase approximately 254,000 shares of common stock to Amazon.com. The warrant was valued at $2.0 million and was recognized ratably over the one-year term of the agreement; as a result, $337,000 was recognized as strategic marketing-equity instruments expense in the three months ended June 30, 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 fair market value. 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 fair market value. In the three months ended June 30, 2001, $0, $0 and $45,000 were recognized as strategic marketing-equity instruments expense for the first, second and third warrants, respectively. In the three months ended June 30, 2000, $223,000, $(46,000) 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. ("Virgin"), an

affiliate of EMI Recorded Music, to promote the distribution of digital music over the Internet using our technology. Pursuant to this agreement, we issued 150,000 shares of common stock to Virgin. These shares were valued at $1.2 million and 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 June 30, 2001.

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 June 30, 2001 was $3.6 million. We recognized $(119,000) and $77,000 of stock compensation expense for the three months ended June 30, 2001 and 2000, respectively. We expect quarterly amortization related to those options to be between $33,000 and $22,000 per quarter during the remainder of 2001 and annual amortization to be approximately $46,000 during 2002. These future compensation charges would be reduced if sales and marketing, research and development and general and administrative employees who hold the applicable options terminate employment prior to the expiration of their option vesting period.

Other Income (Expense), Net. Interest income consists of earnings on our cash, cash equivalents and short-term investments. Interest expense consists of expenses related to our financing obligations, which include borrowings under equipment loans and capital lease obligations. Other income (expense), net decreased to $1.2 million for the three months ended June 30, 2001 from $2.1 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.

Net Loss in Equity Investment. Net loss in equity 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. Net loss in equity investment was $881,000 and $237,000 for the three months ended June 30, 2001 and 2000, respectively. The expenses represent our share of the loss of Liquid Audio Japan.

Six Months Ended June 30, 2001 and 2000

Total Net Revenues

Total net revenues decreased 58% to $2.7 million for the six months ended June 30, 2001 from $6.4 million in the comparable period of 2000.

License. License revenues decreased 43% to $484,000 for the six months ended June 30, 2001 from $843,000 in the comparable period of 2000. This decrease was due to a reduction in kiosk software and other technology licenses as a result of our de-emphasis in the digital music kiosk business area.

Services. Services revenues decreased 51% to $787,000 for the six months ended June 30, 2001 from $1.6 million in the comparable period of 2000. This decrease was due to decreases in encoding services, kiosk-related equipment sales, promotion and advertising services and Liquid Muze Previews service in the 2001 period.

Business Development (Related Party). Business development revenues

decreased 65% to $1.4 million for the six months ended June 30, 2001 from $4.0 million in the comparable period of 2000. The decrease was primarily due to the deferment of revenue from Liquid Audio Japan in the second quarter of 2001 and Liquid Audio Korea in the first half of 2001 due to those customers stopping scheduled payments to us.

Total Cost of Net Revenues

Our gross profit decreased to approximately 42% of total net revenues for the six months ended June 30, 2001 from approximately 76% of total net revenues in the comparable period of 2000. Total cost of net revenues remained flat at $1.5 million for the six months ended June 30, 2001 and 2000.

License. Cost of license revenues increased 199% to $287,000 for the six months ended June 30, 2001 from $96,000 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 decreased 22% to $1.1 million for the six months ended June 30, 2001 from $1.4 million in the comparable period of 2000. The decrease in cost of services revenues was due the reduction in the number of encoding, customer service and professional services personnel and kiosk-related equipment due to our corporate restructuring.

Business Development (Related Party). Cost of business development revenues was $0 for the six months ended June 30, 2001 and $68,000 in the comparable period of 2000.

Non-Cash Cost of Revenues. Non-cash cost of revenue was $181,000 for the six months ended June 30, 2001 and $(1,000) in the comparable period of 2000.

Operating Expenses

Sales and Marketing. Sales and marketing expenses remained flat at $7.7 million for the six months ended June 30, 2001 and 2000. The increase in the number of sales and marketing personnel through the first quarter of 2001 compared to the first six months of 2000 were offset by reduction of such personnel in the second quarter of 2001 due to our corporate restructuring and expense management initiatives, advertising and promotional programs.

Research and Development. Research and development expenses decreased 7% to $10.0 million for the six months ended June 30, 2001 from $10.8 million in the comparable period of 2000. This decrease was primarily due to decreases in the number of personnel and outside contractors due to our corporate restructuring and expense management initiatives.

General and Administrative. General and administrative expenses increased 89% to $6.3 million for the six months ended June 30, 2001 from $3.3 million in the comparable period of 2000. This increase was primarily due to an increase in the allowance of doubtful accounts related to accounts receivables from related parties and legal fees related to patent infringement claims against us (see Part II, Item 1 "Legal Proceedings").

Strategic Marketing--Equity Instruments. Strategic marketing-equity instrument expense was $652,000 for the six months ended June 30, 2001 and $1.1 million in the comparable period in 2000.

Non-Cash Sales and Marketing, Research and Development and General and

Administrative. We recognized $(96,000) and $266,000 of non-cash sales and marketing, research and development and general and administrative expenses for the six months ended June 30, 2001 and 2000, respectively.

Other Income (Expense), Net. Other income (expense), net decreased to $2.8 million for the six months ended June 30, 2001 from $4.5 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.

Net Loss in Equity Investment. Net loss in equity investment was $1.1 million and $453,000 for the six months ended June 30, 2001 and 2000, respectively.

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 June 30, 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 June 30, 2001, we had approximately $103.6 million of cash, cash equivalents and short-term investments.

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Net cash used in operating activities was $19.0 million and $10.7 million for the six months ended June 30, 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 $2.2 million, amortization of unearned compensation of $(101,000), strategic marketing-equity instruments charges of $652,000, non-cash cost of revenue of $186,000, an increase in the allowance for doubtful accounts and sales returns reserve of $1.1 million, equity investment losses of $1.1 million, loss on disposal of and increase in the asset impairment for property and equipment of $1.7 million, other charges of $(32,000) and a net decrease in working capital items of $542,000. The net decrease in working capital items include an increase in accounts receivable of $122,000, decrease in other assets of $176,000, decrease in accounts payable of $1.0 million, increase in accrued expenses and other liabilities of $457,000 and an decrease in deferred revenue of $250,000. Net cash used for operating activities in the 2000 period was primarily the result of net losses from operations, depreciation and amortization of $1.5 million, amortization of unearned compensation of $265,000, strategic marketing-equity instruments charges of $1.1 million, an increase in the allowance for doubtful accounts and sales returns reserve of $133,000, equity investment losses of $453,000, common stock issued for legal settlement of $354,000, other charges of $(13,000) and a net decrease in working capital items of $227,000. The net decrease in working capital items include an increase in accounts receivable of $2.3 million, increase in other assets of $136,000, increase in accounts payable of $1.8 million, increase in accrued expenses and other liabilities of $269,000 and an increase in deferred revenue of $134,000.

Net cash provided by (used in) investing activities was $26.6 million and $(48.7) million for the six months ended June 30, 2001 and 2000, respectively. Net cash provided by (used in) investing activities in each of these periods was primarily related to net sales (purchases) of short-term investments and the acquisition of property and equipment in both periods.

Net cash provided by (used in) financing activities was $(211,000) and $319,000 for the six months ended June 30, 2001 and 2000, respectively. The net cash used in financing activities for the 2001 period is due primarily to payments made under our equipment loan and capital leases. The net cash provided in financing activities for the 2000 is due primarily to proceeds from the issuance of stock under the employee stock purchase plan, partially offset by 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 June 30, 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 June 30, 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 $8.0 million, net of rental income of $248,000, as of June 30, 2001 and are payable in monthly installments through 2005 and a note payable to related party in the amount of $361,000 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. 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.

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Market Risk

At June 30, 2001, we had an investment portfolio of money market funds, commercial securities and U.S. Government bonds. We had a related party loan at June 30, 2001 of $361,000, 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.

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 June 30, 2001 was approximately $99.2 million. We had net losses of approximately $24.2 million and $33.7 million in 1999 and 2000, respectively, and $25.3 million in the six months ended June 30, 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:

- 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.

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 June 30, 2001, 53% and 65% of our accounts receivable from third parties and accounts receivables from related parties, respectively, or $470,000 and $1.0 million, 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. We recently terminated our relationship with Liquid Audio Japan. Consequently, we do not expect additional revenue will be generated from Liquid Audio Japan. If one of our remaining 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, then our future revenues could be lower than we anticipate and 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 six months ended June

30, 2001 represented approximately 86%, 78% and 86%, 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.

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."

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.

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 (the "SDMI") is a committee formed by the Recording Industry Association of America (the "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.

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

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

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

- develop new products or services; or

- respond to competitive pressures.

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

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.

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.

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:

- 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.

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.

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

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

- the availability of sufficient bandwidth on the Internet to enable consumers to download digital recorded music rapidly and easily;
- the willingness of consumers to invest in computer technology that facilitates the downloading of digital music;
- the cost of time-based Internet access;
- the number, quality and variety of digital recordings available for purchase through our system relative to those available through other online digital delivery companies, digital music websites, music swapping or sharing websites or through traditional physical delivery of recordings;
- the availability of portable devices to which digital recorded music can be transferred;
- the fidelity and quality of the sound of the digital recorded music; and

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

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;
- 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 competitors 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 Musicnet and Pressplay/Duet License Content to Our Competitors, Our Business Could be Harmed

The major U.S. record companies have recently formed ventures for the licensing of their content to online music service providers. BMG Entertainment, EMI, Real Networks and Warner Music Group have formed a venture called "Musicnet." Also, Universal Music Group and Sony Music Entertainment, Inc. have formed a venture called "Pressplay/Duet." If Musicnet or Pressplay/Duet launch their services, they may license significant quantities of content to other third party online music service providers.

The press has reported that Pressplay/Duet entered into distribution agreements with Yahoo! and Microsoft Network and that Musicnet intends to license its service to America Online, Real Networks and Napster. If our

competitors obtain licenses for significant amount of content from Musicnet and Pressplay/Duet, they may be able to develop a more compelling consumer product and 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 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 legal 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

digital music copies are available through file sharing without payment, legally or illegally, consumers may choose not to pay for downloads from retail and other music delivery sites in our Liquid Music Network, which could harm our business.

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

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

any capacity constraints effectively, our business would be harmed.

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

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

- use leading technologies effectively;
- continue to develop our strategic and technical expertise;
- enhance our current products and services;
- develop new products and services that meet changing customer needs;
- advertise and market our products and services; and
- influence and respond to emerging industry standards and other technological changes.

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

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

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

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

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 July and August 2001, several law firms announced that they had filed class action lawsuits in the United States District Court for the Southern District of New York on behalf of purchasers of the our securities during the period between July 8, 1999 and December 6, 2000. The complaint names us, certain former and current officers and directors of the Company, Lehman Brothers Inc., BancBoston Robertson Stephens, Inc. and U.S. Bancorp Piper Jaffray Inc. and allege violation of Sections 11, 12(a) (2) and 15 of the Securities Act of 1933, as amended, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. To date, we have not been served with any complaints.

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

On March 31, 2000, Intouch Group, Inc. ("Intouch") filed a lawsuit against us in the United States District Court for the Northern District of California alleging patent infringement. The Complaint names us, Amazon.com, Inc., Listen.com, Inc., Entertaindom LLC, DiscoverMusic.com, Inc. and Muze, Inc. It alleges that these parties infringe, or induce infringement of, the claims of U.S. Patent Nos. 5,237,157 (the"`157 patent") and 5,963,916 (the"`916 patent") by operating a web site and/or a kiosk that allows interactive previewing of pre-recorded music products. The Complaint seeks unspecified damages and injunctive relief. We answered Intouch's first amended complaint, denying the material allegations of the amended complaint, and asserting counterclaims for declaratory judgment of non-infringement, patent invalidity and inequitable conduct. In May 2001, the parties reached an agreement in principle to settle Intouch's claims on the `157 patent. Fact discovery is currently ongoing, and is scheduled to close on September 27, 2001. Expert discovery is scheduled to close on December 13, 2001. The trial date has been set for April 15, 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 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.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

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

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

From the time of receipt through June 30, 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

On August 8, 2001, we filed a report on Form 8-K which announced that our Board of Directors approved the adoption of a Preferred Stock Rights Agreement. A copy of our press release announcing this matter was attached and incorporated by reference therein.

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: August 14, 2001

LIQUID AUDIO, INC.

/s/ Gerald W. Kearby

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)