LIQUID AUDIO INC
Form 10-Q
November 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 SEPTEMBER 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 October 31, 2001, there were 22,704,615 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)

	September 30 2001
Assets	(unaudited)
Current assets:	
Cash and cash equivalents	$ 97,009
Short-term investments	--
Accounts receivable from third parties, net	433
Accounts receivable from related parties, net	--
Other current assets	1,480
Total current assets	98,922
Restricted cash	826
Investment in strategic partner	--
Property and equipment, net	4,819
Other assets	164
Total assets	$ 104,731
Liabilities and stockholders' equity	
Current liabilities:	
Accounts payable	$ 1,559
Accrued expenses and other current liabilities	4,229
Deferred revenue from third parties	168
Deferred revenue from related parties	568

Capital lease obligations, current portion	52
Equipment loan, current portion	290
Total current liabilities	6,866
Capital lease obligations, non-current portion	--
Equipment loan, non-current portion	--
Note payable to related party	376
Total liabilities	7,242
Stockholders' equity:	
Common stock	23
Additional paid-in capital	202,831
Unearned compensation	(67)
Accumulated deficit	(105,271)
Accumulated other comprehensive income (loss)	(27)
Total stockholders' equity	97,489
Total liabilities and stockholders' equity	$ 104,731

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		
	2001	2000	2
Net revenues:			
License	$ 171	$ 174	$
Services	214	727	
Business development (related party)	890	2,454	
Total net revenues	1,275	3,355	
Cost of net revenues:			
License	68	64	
Services	212	720	
Business development (related party)	--	7	
Non-cash cost of revenue	69	2	
Total cost of net revenues	349	793	
Gross profit	926	2,562	

Operating expenses:			
Sales and marketing	2,360	4,694	
Non-cash sales and marketing	13	58	
Research and development	3,733	6,088	
Non-cash research and development	10	27	
General and administrative	1,630	2,055	
Non-cash general and administrative	1	16	
Strategic marketing--equity instruments	(45)	550	
Restructuring	--	--	
Total operating expenses	7,702	13,488	
Loss from operations	(6,776)	(10,926)	(
Other income (expense), net	870	2,209	
Loss in equity investment	(154)	(175)	
Net loss	$ (6,060)	$ (8,892)	$(
Net loss per share:			
Basic and diluted	$ (0.27)	$ (0.40)	$
Weighted average shares	22,640	22,304	

See accompanying notes to condensed consolidated financial statements.

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

	Nine Mo Septe
	2001
Cash flows from operating activities:	
Net loss	$(31,361)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	3,054
Amortization of unearned compensation	(76)
Allowance for doubtful accounts and sales returns reserve	1,458
Loss in equity investment	1,254
Strategic marketing-equity instruments	607
Non-cash cost of revenue	254
Loss on disposal of and write-down of property and equipment	1,748
Common stock issued for legal settlement	--
Other	(17)
Changes in assets and liabilities:	
Accounts receivable from third parties	344
Accounts receivable from related parties	(257)

Other assets	(698)
Accounts payable	(1,755)
Accrued expenses and other current liabilities	707
Deferred revenue from third parties	(272)
Deferred revenue from related parties	(419)
Net cash used in operating activities	(25,429)
Cash flows from investing activities:	
Acquisition of property and equipment	(792)
Proceeds from sale of fixed assets	33
Sales (purchases) of short-term investments, net	27,384
Equity investment	(165)
Net cash provided by (used in) investing activities	26,460
Cash flows from financing activities:	
Proceeds from issuance of common stock, net of repurchases	170
Payments made under capital leases	(96)
Payments made under equipment loan	(442)
Net cash provided by (used in) financing activities	(368)
Effect of exchange rates on cash and cash equivalents	(52)
Net increase (decrease) in cash and cash equivalents	611
Cash and cash equivalents at beginning of period	96,398
Cash and cash equivalents at end of period	$ 97,009
Supplemental disclosures:	
Cash paid for interest	$ 58
Non-cash investing and financing activities:	
Issuance of warrants in connection with strategic marketing agreements	$ 126
Issuance of common stock in connection with strategic marketing agreements	735
Issuance of common stock upon exercise of warrant	--
Issuance of common stock for intellectual property	--

See accompanying notes to condensed consolidated financial statements

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

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

The Company

Liquid Audio, Inc. (the "Company") was incorporated in California in January 1996 and reincorporated in Delaware in April 1999. In July 2000, the Company established a wholly-owned subsidiary in the United Kingdom, Liquid Audio Europe PLC, which reregistered in August 2001 as Liquid Audio Europe

Limited, to develop sales in Europe. The Company was formed with the goal of becoming the premier provider of software applications and services that enable the secure delivery and sale of digital music over the Internet. The Company's end-to-end solutions enable the secure distribution, promotion and sale of high quality music files while providing consumers with the ability to access, preview and purchase that music via the Internet.

Basis of presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company and reflect all adjustments, which are in the opinion of management, necessary for a fair presentation of the interim periods presented. The results of operations for the three months ended September 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 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 September 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

On October 3, 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". SFAS No. 144 supercedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS No. 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30. SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale. SFAS No. 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for the Company for all financial statements issued in fiscal 2002. The Company does not believe that the adoption of SFAS No. 144 will have a material impact on its financial position or results

of operations.

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

NOTE 2 - BALANCE SHEET COMPONENTS (IN THOUSANDS):

	September 30, 2001
Accounts receivable from third parties, net:	
Accounts receivable	$ 921
Less: allowance for doubtful accounts and sales returns reserve...	(488)
	$ 433

The allowance for doubtful accounts and sales returns reserve increased (decreased) by $(52,000) and $271,000 for the nine months ended September 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 nine months ended September 30, 2001 and the year ended December 31, 2000, respectively.

	September 30, 2001
Accounts receivable from related parties, net:	
Accounts receivable	$ 1,555
Less: allowance for doubtful accounts and sales returns reserve...	(1,555)
	$ --

The allowance for doubtful accounts and sales returns reserve increased by $1,510,000 and $45,000 for the nine months ended September 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 nine months ended September 30, 2001 and the year ended December 31, 2000, respectively.

	September 30, 2001	December 31, 2000
Property and equipment:		
Computer equipment and purchased software ...	$ 11,445	$ 12,190
Website and software development costs	235	399
Furniture and fixtures	554	774
Leasehold improvements	536	682
	12,770	14,045
Less:		
Accumulated depreciation and amortization	(7,951)	(5,185)
	$ 4,819	$ 8,860

Property and equipment includes $195,000 and $784,000 of equipment under capital leases at September 30, 2001 and December 31, 2000, respectively. Accumulated depreciation and amortization for equipment under capital leases was $187,000 and $734,000 at September 30, 2001 and December 31, 2000, respectively.

	September 30, 2001	December 31, 2000
Accrued expenses and other current liabilities:		
Compensation and benefits	$ 2,087	$ 2,321
Restructuring	452	--
Consulting and professional services	324	475
Other..................................	1,366	726
	$ 4,229	$ 3,522

NOTE 3 - RELATED PARTIES:

Investment in Cyber Music Entertainment

The Company owns 8.48% of the outstanding shares of Cyber Music Entertainment ("CME"), formerly Liquid Audio Japan ("LAJ"), and accounts for its investment under the equity method of accounting. The Company's proportionate share of loss for the nine months ended September 30, 2001 is $1,254,000 (unaudited).

In June 2001, the Company and LAJ mutually agreed to terminate the licensing and reseller agreements (the "Agreements") between the two companies. As a result, Liquid Audio Japan renamed its company to Cyber Music Entertainment and no longer distributes the Company's technology nor utilizes the Company's digital distribution platform to offer services to the Japanese music market. According to the mutual termination agreement, effective September 30, 2001, CME ceased using Liquid Audio trademarks, including the company name, and returned all of the Company's products, technology and licenses. The Company does not

believe that it has any outstanding obligations in connection with the Agreements. As a result, the Company recognized the remaining deferred revenue balance of $890,000 from CME in the three months ended September 20, 2001. The Company intends to establish a new office and to build new relationships with label, retail and consumer electronic companies.

Investment in Liquid Audio Korea

In December 1998, the Company signed an agreement with a 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. In September 2001, the Company notified LAK of its default under the licensing and reseller agreements between the two companies due to LAK's failure to make contractual payments as scheduled. LAK did not cure the default during the cure period. Accordingly, the Company exercised its rights under the agreements to terminate the licensing and reseller agreements. Outstanding accounts receivable from LAK have been fully reserved for, and no revenue from LAK was recorded in the three months ended September 30, 2001.

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"). In September 2001, the Company notified LAGC of its default under the licensing and reseller agreements between the two companies due to LAGC's failure to make contractual payments as scheduled. LAGC did not cure the defaults during the cure period. Accordingly, the Company exercised its rights under the agreements to terminate the licensing and reseller agreements. Outstanding accounts receivable from LAGC have been fully reserved for, and no revenue from LAGC was recorded in the three months ended September 30, 2001.

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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"). In September 2001, the Company notified the strategic partner of LASE of its default under the licensing and reseller agreements between the two companies due to the strategic partner's failure to make contractual payments as scheduled. The strategic partner did not cure the defaults during the cure period. Accordingly, the Company exercised its rights under the agreements to terminate the licensing and reseller agreements. Outstanding accounts receivable from the strategic partner have been fully reserved for, and no revenue from the strategic partner or LASE was recorded in the three months ended September 30, 2001.

Total business development revenue

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

	Three Months Ended September 30,		Nin S
	2001	2000	2001

Cyber Music Entertainment and strategic partner	$ 890	$ 847	$ 1,
Liquid Audio South East Asia and strategic partner	--	1,260	
Liquid Audio Greater China and strategic partner	--	347	
Liquid Audio Korea and strategic partner	--	--	
	$ 890	$ 2,454	$ 2,

At September 30, 2001, the deferred revenue from related parties balance of $568,000 relates to a payment of $568,000 received in September 2001 from a shareholder of Liquid Audio Greater China. The Company is in the process of reestablishing its operations in Greater China. The remaining deferred revenue balance of $568,000 will not be recognized as revenue until the Company has finalized its operating structure in Greater China.

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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 September 30,		
	2001	2000	
Numerator:			
Net loss	$ (6,060)	$ (8,892)	$
Denominator:			
Weighted average shares	22,645	22,355	
Weighted average unvested common shares subject to repurchase	(5)	(51)	
Denominator for basic and diluted calculation	22,640	22,304	
Net loss per share:			
Basic and diluted	$ (0.27)	$ (0.40)	$

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 September 30,		Nine M Sept
	2001	2000	2001
Common stock options	3,080	2,505	2,955
Common stock warrants	875	558	875
Unvested common stock subject to repurchase	5	51	8

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 nine months ended September 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

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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 vested in August 2001. The third warrant was initially valued at $105,000 and was recognized ratably over the one-year period ending at the vesting date. The third warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of $105,000 was reduced to $54,000 based on current fair market value. In the nine months ended September 30, 2001, $0, $0 and $16,000 were recognized as strategic marketing-equity instruments expense for the first, second and third warrants, respectively. In the nine months ended September 30, 2000, $577,000, $(114,000) and $23,000 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 was recognized as strategic marketing-equity instruments expense ratably over the one-year term of the agreement. As a result, $591,000 and $295,000 were recognized as strategic marketing-equity instruments expense in the nine months ended September 30, 2001

and 2000, respectively.

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, $144,000 was recognized as non-cash cost of net revenues in the nine months ended September 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 September 30, 2001, the 77,768 shares under this warrant was valued at $148,000, of which $110,000 was recognized as non-cash cost of net revenues in the nine months ended September 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.

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

	Severance and Benefits	Facilities	Asset Impairment
Severance and benefits	$ 1,116	$ --	$
Accrued lease costs	--	824	
Property and equipment impairment	--	--	1,7

Total	1,116	824	1,7
Cash paid	(1,116)	--	
Non-cash	--	--	(1,7
Restructuring reserve balance at June 30, 2001	--	824	
Cash paid	--	(372)	
Restructuring reserve balance at September 30, 2001	$ --	$ 452	$

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 7%, 6% and 1% of total net revenues in the nine months ended September 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 58%, 63% and 48% in the nine months ended September 30, 2001 and the twelve months ended December 31, 2000 and 1999, respectively. Liquid Audio Korea

("LAK"), Liquid Audio Greater China ("LAGC"), Liquid Audio South East Asia ("LASE") through our strategic partner and Liquid Audio Japan ("LAJ") did not make their contractual payments as scheduled in the third quarter of 2000, late 2000, late 2000 and the second quarter of 2001, respectively. We were unsuccessful in receiving any additional payments from these customers.

In June 2001, we and LAJ mutually agreed to terminate the licensing and reseller agreements (the "Agreements") between the two companies. As a result, Liquid Audio Japan renamed its company to Cyber Music Entertainment ("CME") and no longer distributes our technology nor utilizes our digital distribution platform to offer services to the Japanese music market. Effective September 30, 2001, CME ceased using Liquid Audio trademarks, including the company name, and returned all of our products, technology and licenses. We do not believe we have any outstanding obligations in connection with the Agreements. As a result, we recognized the remaining deferred revenue balance of $890,000 from CME in the three months ended September 20, 2001. We intend to establish a new office and to build new relationships with label, retail and consumer electronic companies.

In September 2001, we notified LAK, LAGC and LASE through our strategic partner of their defaults under the licensing and reseller agreements between us and the aforementioned companies due to their failures to make contractual payments as scheduled. LAK, LAGC and our strategic partner of LASE did not cure the defaults during the cure periods. Accordingly, we exercised our rights to terminate the licensing and reseller agreements. Outstanding accounts receivable from LAK, LAGC and our strategic partner of LASE have been fully reserved for, and no revenue from LAK, LAGC or LASE were recorded in the three months ended September 30, 2001.

In the first nine months of 2001, approximately 58% of total net revenues came from sales to two customers, Cyber Music Entertainment and Liquid Audio Greater China. In 2000, approximately 53% of total net revenues came from sales to two customers, Cyber Music Entertainment 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 62%, 69% and 49% of total net revenues in the nine months ended September 30, 2001 and the twelve months ended December 31, 2000 and 1999, respectively.

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 September 30, 2001 we had an accumulated deficit of approximately $105.3 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 and we may not achieve or maintain profitability or generate cash from operations in future periods. The digital music market may never develop to the extent that we are able to generate positive cash flows. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stages of development, particularly companies in new and rapidly evolving markets such as the digital delivery of recorded music. We may not be successful in addressing these risks, and our failure to do so would harm our business.

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Results of Operations

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

	Three Months Ended September 30,	
	2001	2000
Net revenues:		
License	13%	5%
Services	17	22
Business development (related party)	70	73
Total net revenues	100	100
Cost of net revenues:		
License	5	2
Services	17	22
Business development (related party)	--	--
Non-cash cost of revenue	5	--
Total cost of net revenues	27	24
Gross profit	73	76
Operating expenses:		
Sales and marketing	185	140
Non-cash sales and marketing	1	2
Research and development	293	182
Non-cash research and development	1	1
General and administrative	128	61
Non-cash general and administrative	--	--
Strategic marketing-equity instruments	(4)	16
Restructuring	--	--
Total operating expenses	604	402
Loss from operations	(531)	(326)
Other income (expense), net	68	66

Loss in equity investment	(12)	(5)
Net loss	(475)%	(265)%

Three Months Ended September 30, 2001 and 2000

Total Net Revenues

Total net revenues decreased 62% to $1.3 million for the three months ended September 30, 2001 from $3.4 million in the comparable period of 2000.

License. License revenues decreased 2% to $171,000 for the three months ended September 30, 2001 from $174,000 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 71% to $214,000 for the three months ended September 30, 2001 from $727,000 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 64% to $890,000 for the three months ended September 30, 2001 from $2.5 million in the comparable period of 2000. The decrease was primarily due to the deferment of revenue from Liquid Audio Korea, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner due to those customers stopping scheduled payments to us, partially offset by software licensing and related maintenance revenues from Cyber Music Entertainment. We do not believe we have any outstanding obligations in connection with our contracts with Cyber Music Entertainment. As a result, we recognized the remaining deferred revenue balance in the three months ended September 30, 2001.

Total Cost of Net Revenues

Our gross profit decreased to approximately 73% of total net revenues for the three months ended September 30, 2001 from approximately 76% of total net revenues in the comparable period of 2000. Total cost of net revenues decreased 56% to $349,000 in the 2001 period from $793,000 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 6% to $68,000 for the three months ended September 30, 2001 from $64,000 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 71% to $212,000 for the three months ended September 30, 2001 from $720,000 in the comparable period of 2000. The decrease in cost of services revenues was due to 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 September 30, 2001 and $7,000 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, $48,000 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 September 30, 2001, the 77,768 shares under this warrant were valued at $148,000, of which $21,000 was recognized as non-cash cost of revenues for the three months ended September 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 $0 and $2,000 for the three months ended September 30, 2001 and 2000, respectively. We have fully amortized stock compensation expense related to these personnel in the three months ended September 30, 2001, and accordingly no future expense related to these stock options will be incurred.

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 50% to $2.4 million for the three months ended September 30, 2001 from $4.7 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 39% to $3.7 million for the three months ended September 30, 2001 from $6.1 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 decreased 21% to $1.6 million for the three months ended September 30, 2001 from $2.1 million in the comparable period of 2000. This decrease was primarily due to a reduction in legal fees related to patent infringement claims against us (see Part II, Item 1 "Legal Proceedings") and decreases in the number of personnel and outside contractors due to our corporate restructuring and expense management initiatives, partially offset by an increase in the allowance of doubtful accounts related to accounts receivable from third and related parties.

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 $(45,000) and $550,000 in the three months ended September 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, $0 was recognized as strategic marketing-equity instruments expense in the three months ended September 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 vested in August 2001. The third warrant was initially valued at $105,000 and was recognized ratably over the one-year period ending at the vesting date. The third warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of $105,000 was reduced to $54,000 based on current fair market value. In the three months ended September 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 September 30, 2000, $131,000, $100,000 and $23,000 were recognized as strategic marketing-equity instruments expense for the first, second and third warrants, respectively. In July 2000, we signed an agreement with Virgin Holdings, Inc. ("Virgin"), an affiliate of EMI Recorded Music, to promote the distribution of digital music over the Internet using our technology. Pursuant to

this agreement, we issued 150,000 shares of common stock to Virgin. These shares

were valued at $1.2 million and recognized ratably over the one-year term of the agreement. As a result, $0 and $295,000 was recognized as strategic marketing-equity instruments expense in the three months ended September 30, 2001 and 2000, respectively.

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 September 30, 2001 was $3.6 million. We recognized $24,000 and $101,000 of stock compensation expense for the three months ended September 30, 2001 and 2000, respectively. We expect quarterly amortization related to those options to be approximately $22,000 for the fourth quarter of 2001 and annual amortization to be approximately $45,000 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 $870,000 for the three months ended September 30, 2001 from $2.2 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.

Loss in Equity Investment. Loss in equity investment consists of our share of losses from our investment in a related party using the equity method of accounting under a 3-month lag. Loss in equity investment was $154,000 and $175,000 for the three months ended September 30, 2001 and 2000, respectively. The expenses represent our share of the loss of Cyber Music Entertainment, and for the 2001 period, up to our investment balance in Cyber Music Entertainment.

Nine Months Ended September 30, 2001 and 2000

Total Net Revenues

Total net revenues decreased 60% to $4.0 million for the nine months ended September 30, 2001 from $9.8 million in the comparable period of 2000.

License. License revenues decreased 36% to $655,000 for the nine months ended September 30, 2001 from $1.0 million 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 57% to $1.0 million for the nine months ended September 30, 2001 from $2.3 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 64% to $2.3 million for the nine months ended September 30, 2001 from $6.4 million in the comparable period of 2000. The decrease was primarily due to the deferment of revenue from Liquid Audio Greater China in the first and third quarters of 2001, Cyber Music Entertainment in the second quarter of 2001 and Liquid Audio Korea and Liquid Audio South East Asia through our strategic partner in the first nine months of 2001 due to those customers stopping scheduled payments to us.

Total Cost of Net Revenues

Our gross profit decreased to approximately 52% of total net revenues for the nine months ended September 30, 2001 from approximately 76% of total net revenues in the comparable period of 2000. Total cost of net revenues

decreased 19% to $1.9 million for the nine months ended September 30, 2001 from $2.3 million in the comparable period of 2000.

License. Cost of license revenues increased 122% to $355,000 for the nine months ended September 30, 2001 from $160,000 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 38% to $1.3 million for the nine months ended September 30, 2001 from $2.1 million in the comparable period of 2000. The decrease in cost of services revenues was due to 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 nine months ended September 30, 2001 and $75,000 in the comparable period of 2000.

Non-Cash Cost of Revenues. Non-cash cost of revenues were $250,000 for the nine months ended September 30, 2001 and $1,000 in the comparable period of 2000.

Operating Expenses

Sales and Marketing. Sales and marketing expenses decreased 19% to $10.1 million for the nine months ended September 30, 2001 from $12.4 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 decreased 19% to $13.7 million for the nine months ended September 30, 2001 from $16.9 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 47% to $7.9 million for the nine months ended September 30, 2001 from $5.4 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 and third 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 expense was $607,000 for the nine months ended September 30, 2001 and $1.6 million in the comparable period in 2000.

Non-Cash Sales and Marketing, Research and Development and General and Administrative. We recognized $(72,000) and $367,000 of non-cash sales and marketing, research and development and general and administrative expenses for the nine months ended September 30, 2001 and 2000, respectively.

Other Income (Expense), Net. Other income (expense), net decreased to $3.7 million for the nine months ended September 30, 2001 from $6.7 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.

Loss in Equity Investment. Loss in equity investment was $1.3 million and $628,000 for the nine months ended September 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 September 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 September 30, 2001, we had approximately $97.0 million of cash, cash equivalents and short-term investments.

Net cash used in operating activities was $25.4 million and $18.4 million for the nine months ended September 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 $3.1 million, amortization of unearned compensation of $(76,000), strategic marketing-equity instruments charges of $607,000, non-cash cost of revenue of $254,000, an increase in the allowance for doubtful accounts and sales returns reserve of $1.5 million, loss in equity investment of $1.3 million, loss on disposal of and increase in asset impairment for property and equipment of $1.7 million, other charges of $(17,000) and a net decrease in working capital items of $2.4 million. The net decrease in working capital items include a decrease in accounts receivable of $87,000, increase in other assets of $698,000, decrease in accounts payable of $1.8 million, increase in accrued expenses and other liabilities of $707,000 and a decrease in deferred revenue of $691,000. Net cash used for operating activities in the 2000 period was primarily the result of net losses from operations, depreciation and amortization of $2.3 million, amortization of unearned compensation of $368,000, strategic marketing-equity instruments charges of $1.6 million, an increase in the allowance for doubtful accounts and sales returns reserve of $155,000, loss in equity investment of $628,000, common stock issued for legal settlement of $354,000, other charges of $(22,000) and a net decrease in working capital items of $737,000. The net decrease in working capital items include an increase in accounts receivable of $2.0 million, increase in other assets of $672,000, increase in accounts payable of $932,000, increase in accrued expenses and other liabilities of $1.1 million and a decrease in deferred revenue of $51,000.

Net cash provided by (used in) investing activities was $26.5 million and $(39.9) million for the nine months ended September 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 $(368,000) and $151,000 for the nine months ended September 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 period 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 September 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 September 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 $206,000, as of September 30, 2001 and are payable in monthly installments through 2005 and a note payable to related party in the amount of $376,000 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.

Market Risk

At September 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 September 30, 2001 of $376,000, 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 September 30, 2001 was approximately $105.3 million. We had net losses of approximately $24.2 million and $33.7 million in 1999 and 2000, respectively, and $31.4 million in the nine months ended September 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.

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

Several of our significant customers 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 September 30, 2001, 52% and 65% of our accounts receivable from third parties and accounts receivables from related parties, respectively, or $474,000 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.

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. 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.

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

In the past, we derived 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 relationships with these partners. Consequently, we do not expect additional revenue will be generated from them. If we are unable to establish additional relationships with international partners, and if such additional relationships do not generate a significant amount of revenue in future periods, then our future revenues could be lower than we anticipate and our business 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 nine months ended September 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 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.

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.

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 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 (an unit of Vivendi Universal) and Sony Music Entertainment have formed a venture called "Pressplay." If Musicnet or Pressplay launch their services, they may license significant quantities of content to other third party online music service providers.

Pressplay has reported that it has entered into distribution agreements with affiliates, including Yahoo!, Microsoft Network and MP3.com, and that it has entered into licensing agreements with six independent record labels including Madacy, Navarre, OWIE, Razor & Tie, Roadrunner and Rounder. The press has reported that MusicNet has licensed its service to America Online, Real Networks and Napster and that MusicNet has entered into a licensing agreement with Zomba Label Group which encompasses seven record labels: flagship Jive Records, Jive Electro, Silvertone, Verity, Brentwood, Reunion, and Volcano. If our competitors obtain licenses for significant amount of content from MusicNet and Pressplay and we are unable to obtain similar rights on commercially reasonable terms, these competitors 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.

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 recently terminated our individual agreements in Japan, Korea, greater China and south east Asia. We may enter into similar arrangements in the future in these and other countries. We also established a wholly-owned subsidiary in the United Kingdom. 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 Tax Freedom Act, which imposed a three-year moratorium on state and local taxes on Internet-based transactions. The moratorium expired on October 1, 2001. A bill to extend the moratorium until 2003 passed the U.S. House of Representatives in October 2001. The extension of the moratorium has not been passed by the U.S. Senate or signed into law by the President. We cannot assure you that this moratorium will be extended. Failure to extend 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.

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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

On or about September 27, 2001, Network Commerce, Inc. ("NCI") filed a Complaint against us in the United States District Court for the Western District of Washington (Seattle). The suit alleges that we infringe the claims of United States Patent No. 6,073,124. NCI requests that we be enjoined from our allegedly infringing activities and seeks unspecified damages. We were served with the Complaint on November 2, 2001.

On August 23, 2001, we received a demand letter from a current employee's legal counsel alleging claims for sexual harassment and retaliation. On September 13, 2001, the employee filed a charge with the California Department of Fair Employment and Housing alleging such claims against us and one of our current employees. We completed an investigation and believe that there is no merit to the employee's allegations. We do not know at this time whether a settlement can be achieved. To date, we have not been served with a complaint.

On July 20, 2001, a putative securities class action, captioned Murowa Financial v. Liquid Audio, Inc. et al., Civil Action No. 01-CV-6661, was filed against us, certain of our officers and directors (the "Individual Defendants") and three underwriters in our initial public offering (the "IPO"), in the United States District Court for the Southern District of New York. The Complaint alleges violations of Section 11 of the Securities Act of 1933, as amended (the "Securities Act") against all defendants, a violation of Section 15 of the Securities Act against the Individual Defendants and violations of Section 12(a)(2) of the Securities Act and Section 10(b) of the Securities Exchange Act of 1934 (and Rule 10b-5 promulgated thereunder) against the underwriters. The Complaint seeks unspecified damages on behalf of a purported class of purchasers of our common stock between July 8, 1999 and December 6, 2000. On August 7 and August 15, 2001, two similar complaints, captioned Ree v. Liquid Audio, Inc. et al., Civil Action No. 01-CV-7332, and Demetriades v. Liquid Audio, Inc. et al., Civil Action No. 01-CV-7017, respectively, were filed against us, the Individual Defendants, and several of the IPO underwriters in the United States District Court for the Southern District of New York. These complaints are substantially similar to the Murowa complaint. These lawsuits are currently pending for coordinated pretrial proceedings. To date, there have been no significant developments in these lawsuits. We believe that we have meritorious defenses to the claims and intend to vigorously defend against such claims.

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

On March 31, 2000, Intouch Group, Inc. ("Intouch") filed a lawsuit against us in the United States District Court for the Northern District of California alleging patent infringement. The Complaint names us, Amazon.com, Inc., Listen.com, Inc., Entertaindom LLC, DiscoverMusic.com, Inc. and Muze, Inc. It alleges that these parties infringe, or induce infringement of, the claims of United States Patent Nos. 5,237,157 ("the `157 patent") and 5,963,916 ("the `916 patent") by operating a web site and/or a kiosk that allows interactive previewing of pre-recorded music products. The Complaint seeks unspecified damages and injunctive relief. We answered Intouch's first amended complaint, denying the material allegations of the amended complaint, and asserting counterclaims for declaratory judgment of non-infringement, patent invalidity and inequitable conduct. In May 2001, the parties reached an agreement in principle to settle Intouch's claims on the `157 patent. Fact discovery closed 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 you that we will be successful in defending these lawsuits. If there is a finding of infringement, we might be required to pay substantial damages to Intouch and could be enjoined from selling any of

our products or services that are held to infringe Intouch's patents unless and

until we are able to negotiate a license from them.

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 September 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.

On August 7, 2001, our Board of Directors adopted a Preferred Stock Rights Agreement under which we declared a dividend of one Right to purchase one one-thousandth share of our Series A Participating Preferred Stock for each outstanding share of Common Stock. Prior to the Distribution Date referred to below, the Rights will be evidenced by and trade with the certificates for the Common Stock. After the Distribution Date, we will mail Rights certificates to the stockholders and the Rights will become transferable apart from the Common Stock. Rights will separate from the Common Stock and become exercisable following (i) the tenth day (or such later date as may be determined by our Board of Directors) after a person or group of affiliated or associated persons has acquired, or obtained the right to acquire, beneficial ownership of 15% or more of the Common Stock then outstanding or (ii) the tenth business day (or such later date as may be determined by the our Board of Directors) after a person or group announces a tender of exchange offer, the consummation of which would result in ownership by a person or group of 15% or more of our then outstanding Common Stock. After the Distribution Date, each Right will entitle the holder to purchase for $17.00 one one-thousandth of a share of Series A Preferred Stock with economic terms similar to that of one share of our Common Stock.

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

We held our annual meeting of stockholders on June 9, 2001 to elect two Class II directors to our Board of Directors and to ratify the appointment of our independent auditors, PricewaterhouseCoopers LLP.

Ann Winblad and Silvia Kessel were elected to continue as a Class II director for the ensuing three years. A Class I director was not elected. Class III director Gerald Kearby continues his term as director. 13,482,717 votes were cast in favor of the election of Ms. Winblad and Ms. Kessel while 0 votes were cast against and 42,985 votes were withheld.

13,504,579 votes were cast in favor of the appointment of PricewaterhouseCoopers LLP as our independent auditors, 9,257 votes were cast against the appointment and 11,866 votes abstained.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

3.1+ Amended and Restated Certificate of Incorporation

4.1++ Preferred Stock Rights Agreement, dated as of August 7, 2001, between Liquid Audio, Inc. and Mellon Investor Services LLC, including the Certificate of Designation, the form of Rights Certificate and the Summary of Rights attached thereto as Exhibits A, B and C respectively.

\+ Incorporated herein by reference to Exhibits to the Company's Registration Statement on Form S-1 and all amendments thereto, Registration No. 333-77707, filed with the Securities and Exchange Commission on May 4, 1999 and declared effective on July 8, 1999.

++ Incorporated herein by reference to Exhibits to the Company's Form 8-A filed with the Securities and Exchange Commission on August 15, 2001.

(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: November 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)

LIQUID AUDIO, INC.

INDEX TO EXHIBITS FOR FORM 10-Q

FOR QUARTER ENDED SEPTEMBER 30, 2001

EXHIBIT NO.	EXHIBIT DESCRIPTION
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++ Incorporated herein by reference to Exhibits to the Company's Form 8-A filed with the Securities and Exchange Commission on August 15, 2001.