LIQUID AUDIO INC
Form 10-Q
August 14, 2003
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2003

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.)**
888 Seventh Ave. 17th Floor, New York, NY	**10019**
(Address of principal executive offices)	**(Zip Code)**

(212) 974-5730

(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. Yes x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of August 13, 2003, there were 23,176,858 shares of registrant s Common Stock outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LIQUID AUDIO, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands; unaudited)

	June 30, 2003	December 31, 2002
Assets		
Current assets:		
Cash and cash equivalents	$ 12,608	$ 73,985
Accounts receivable, less allowance for doubtful accounts of $146 for 2003 and 2002	11	60
Restricted cash	826	0
Other current assets	423	1,361
Total current assets	13,868	75,406
Restricted cash	0	826
Property and equipment, net	0	558
Other assets	8	7
Total assets	$ 13,876	$ 76,797
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 536	$ 1,218
Accrued liabilities	3,791	2,151
Distribution payable to stockholders		57,771
Deferred revenue		39
Total current liabilities	4,327	61,179
Stockholders equity:		
Common stock	23	23
Additional paid-in capital	146,053	146,039
Accumulated other comprehensive loss	(75)	(75)
Accumulated deficit	(136,452)	(130,369)
Total stockholders equity	9,549	15,618
Total liabilities and stockholders equity	$ 13,876	$ 76,797

See accompanying notes to condensed consolidated financial statements

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LIQUID AUDIO, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts; unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	**2002**	**2003**	**2002**
Net revenues:				
License	$	$ 40	$ 4	$ 76
Services		111	39	210
Total net revenues		151	43	286
Cost of net revenues:				
License		84	5	181
Services		174	2	302
Non-cash cost of revenue		36	0	69
Total cost of net revenues		294	7	552
Gross profit (loss)		(143)	36	(266)
Operating expenses:				
Sales and marketing	5	1,027	271	2,185
Non-cash sales and marketing		(32)		(21)
Research and development	87	2,914	165	5,937
Non-cash research and development		3		8
General and administrative	1,248	1,905	4,257	3,011
Restructuring	3,569		4,411	
Total operating expenses	4,909	5,817	9,104	11,120
Loss from operations	(4,909)	(5,960)	(9,068)	(11,386)
Other income (expense), net	15	318	118	851
Gain on sale of digital music fulfillment business			2,868	
Net loss	$ (4,894)	$ (5,642)	$ (6,082)	$ (10,535)
Net loss per share:				
Basic and diluted	$ (0.21)	$ (0.25)	$ (0.26)	$ (0.46)
Weighted average shares	23,166	22,737	23,155	22,723

See accompanying notes to condensed consolidated financial statements

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LIQUID AUDIO, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands; unaudited)

	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
Cash flows from operating activities:		
Net loss	$ (6,082)	$ (10,535)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	222	1,279
Amortization of unearned compensation		(13)
Gain on sale of digital music fulfillment business and related assets	(2,868)	
Non-cash cost of revenue		69
Changes in assets and liabilities:		
Accounts receivable	49	15
Other assets	929	471
Accounts payable	(682)	3
Accrued liabilities	1,643	(1,681)
Deferred revenue	(39)	(13)
Net cash used in operating activities	(6,828)	(10,405)
Cash flows from investing activities:		
Acquisition of property and equipment		(67)
Proceeds from sale of digital music fulfillment business and related assets	3,200	
Net cash provided by (used in) investing activities	3,200	(67)
Cash flows from financing activities:		
Cash distribution to stockholders	(57,771)	
Proceeds from issuance of common stock, net of repurchases	14	74
Payments made under capital leases		(17)
Payments made under equipment loan		(169)
Net cash used in financing activities	(57,757)	(112)
Effect of exchange rates on cash and cash equivalents	8	8
Net decrease in cash and cash equivalents	(61,377)	(10,576)
Cash and cash equivalents at beginning of period	73,985	91,594
Cash and cash equivalents at end of period	$ 12,608	$ 81,018
Non-cash investing and financing activities:		
Issuance of warrants in connection with strategic marketing agreements	$	$ 69

See accompanying notes to condensed consolidated financial statements

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1 THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

The Company

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

In September 2002, the Company sold the domestic and foreign rights to its entire patent portfolio for $7.0 million in cash to Microsoft Corporation. In addition to the cash consideration, the Company received an assignable perpetual royalty-free license to continue using the patented technology in its digital distribution system (the Microsoft License).

On January 24, 2003, the Company sold its digital music fulfillment business and related assets to Geneva Media, LLC (Geneva), an affiliate of Anderson Merchandisers, LP for $3.2 million. As part of the sale, the Company also transferred ownership of certain Liquid Audio related trademarks and the Microsoft License to Geneva. As a result of the sale, the Company is not currently operating any businesses and does not expect continuing revenue from sources the Company received revenue from in the past; however, the Company is continuing as an operating entity and is currently exploring options for the use of its remaining assets.

The Company s common stock currently trades over the counter on the Nasdaq OTC Bulletin Board. Previously, the Company s common stock was traded on the Nasdaq National Market. However, the market price per share dropped significantly subsequent to the payment of the $2.50 per share cash distribution to the Company s common stockholders. Thus, on June 5, 2003, the Company was notified by Nasdaq that the Company s common stock was delisted because the closing price had been below $1 per share for 30 consecutive trading days and the Company does not conduct an operating business. At that time, the Company s common stock began trading over the counter as a pink sheet security. On June 20, 2003, the Company s common stock began trading on the Nasdaq OTC Bulletin Board. The market price of the Company s common stock as of August 7, 2003 was $0.36 per share.

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 and six months ended June 30, 2003 are not necessarily indicative of the results to be expected for any subsequent quarter or for the year ending December 31, 2003. 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.

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, 2002 as filed with the Securities and Exchange Commission (the SEC) on March 31, 2003.

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Going concern consideration

The accompanying financial statements as of June 30, 2003 and for the three-month and six-month periods then ended have been prepared assuming the Company will continue as a going concern, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. The Company has incurred losses and negative cash flows from operations for every year since inception. For the six months ended June 30, 2003, the Company incurred a net loss of approximately $6.1 million and negative cash flows from operations of approximately $6.8 million. As of June 30, 2003, the Company had accumulated losses of approximately $136.5 million. The Company has not yet settled on an operating plan, and can give no assurance that the Company s existing cash and cash equivalents are sufficient to fund the Company s current operations and satisfy its obligations. The Company believes these obligations will primarily relate to costs associated with the operation as a public company (legal, accounting, insurance, etc.), as well as the satisfaction of any potential legal judgments or settlements as well as the expenses associated with any new business activities, which may be undertaken by the Company. In addition, according to a settlement agreement with BeMusic, Inc. (BeMusic) (see Note 6), the Company agreed to maintain $2.0 million in available cash on hand to pay up to 50% of reasonable attorney fees and costs in connection with the defense of the patent action brought by SightSound, Inc. (SightSound) against BeMusic, and $5.0 million in available cash on hand to apply towards the satisfaction of any adverse judgment in respect of which it is determined that the Company would be obligated to indemnify BeMusic. These factors, among others, indicate that the Company may be unable to continue operations as a going concern. No adjustment has been made in the accompanying financial statements to the amounts and classifications of assets and liabilities which could result should the Company be unable to continue as a going concern. The Company continues to consider future alternatives, including the possible acquisition of other businesses. However, the Company has not consummated any significant transactions to date and the Company s business prospects remain uncertain. To the extent that management of the Company moves forward on any alternative strategy, such strategy may have an impact on the Company s liquidity.

Principles of consolidation

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

Restricted cash

As of June 30, 2003, the Company had a restricted cash balance of $826,000 in the form of certificates of deposit, which were restricted from withdrawal. The amount serves as collateral for a letter of credit issued by the Company s bank to the Company s lessor as a security deposit on a long-term lease. In July 2003, the letter of credit was returned to the Company in accordance with a lease termination agreement reached with the Company s lessor.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Stock-based compensation

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure . SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure requirements are effective for interim periods ending after December 15, 2002.

The Company accounts for stock issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force (EITF) Issue No. 96-18 Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.

Consistent with the disclosure provisions of SFAS 123, the Company s net loss and basic and diluted net loss per share would have been adjusted to the pro forma amounts indicated below (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	**2002**	**2003**	**2002**
Net loss as reported	$ 4,894	$ 5,642	$ 6,082	$ 10,535
Less stock-based compensation (income) expense determined under fair value based method, net of tax effects	212	185	528	477
Net loss pro forma	$ 5,106	$ 5,827	$ 6,610	$ 11,012
Basic and diluted net loss per share as reported	$ 0.21	$ 0.25	$ 0.26	$ 0.46
Basic and diluted net loss per share pro forma	0.22	0.26	0.29	0.48

Recent accounting pronouncements

In July 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 146, Accounting for Costs Associated with Exit or Disposal Activities . SFAS 146 nullifies the guidance of the Emerging Issues Task Force (EITF) in EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain

Costs Incurred in a Restructuring). Under EITF Issue No. 94-3, an entity recognized a liability for an exit cost on the date that the entity committed itself to an exit plan. In SFAS 146, the FASB acknowledges that an entity s commitment to a plan does not, by itself, create a present obligation to other parties that meets the definition of a liability and requires that a liability for a cost that is associated with an exit or disposal activity be recognized when the liability is incurred. It also establishes that fair value is the objective for the initial measurement of the liability. SFAS 146 will be effective for exit or disposal activities that are initiated after December 31, 2002. The restructuring charges incurred for the three and six months ended June 30, 2003 were recorded in accordance with SFAS 146.

In November 2002, the FASB issued FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 requires that a liability be recorded in the guarantor s balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity s product warranty liabilities. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor s fiscal year-end. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company believes that the adoption of FIN 45 will not have a material impact on its financial condition or results of operations.

In November 2002, the EITF reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company believes that the adoption of EITF Issue No. 00-21 will not have a material impact on its financial condition or results of operations.

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN 46). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. The Company believes that the adoption of FIN 46 will not have a material impact on its financial condition or results of operations.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS 133. The Statement is generally effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003 and should be applied prospectively. The Company is currently evaluating SFAS 149 and has not yet determined the impact of adopting its provisions.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 requires certain freestanding financial instruments, such as mandatorily redeemable preferred stock, to be measured at fair value and classified as liabilities. The adoption of SFAS No. 150 is not expected to have a material effect on the Company s financial position or results of operations.

NOTE 2 ACCRUED LIABILITIES:

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

	June 30, 2003	December 31, 2002
Compensation and benefits	$ 7	$ 308
Consulting and professional services	86	431
Restructuring	3,569	
Litigation settlement		1,079
Other	129	333
	$ 3,791	$ 2,151

In July 2003, the Company incurred a one-time payout of $3,569,000 to terminate the remaining term of the Company s property lease on the Company s former headquarters located in Redwood City, CA.

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 3 COMPREHENSIVE LOSS:

Comprehensive loss includes net loss and other comprehensive income (loss). Other comprehensive income (loss) includes accumulated translation adjustments and unrealized gains on investments. The components of comprehensive loss are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	**2002**	**2003**	**2002**
Comprehensive loss:				
Net loss	$ (4,894)	$ (5,642)	$ (6,082)	$ (10,535)
Foreign currency translation adjustments	1	(32)		(25)
	$ (4,893)	$ (5,674)	$ (6,082)	$ (10,560)

NOTE 4 NET LOSS PER SHARE:

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Common stock options	160	2,604	160	2,604
Common stock warrants	431	748	431	748
Unvested common stock subject to repurchase	0	1	0	1
	591	3,353	591	3,353

NOTE 5 RESTRUCTURINGS:

In September 2002, the Company adopted another corporate restructuring program, consisting of a worldwide workforce reduction, to reduce expenses in response to the digital music market not developing as soon as anticipated, the de-emphasis of the Liquid Player product line, and preparations for a then proposed merger with Alliance Entertainment Corporation. The Company terminated the merger agreement on November 8, 2002. A restructuring charge of $1,163,000 was recorded in operating expense in the twelve months ended December 31, 2002. The restructuring charge included involuntary separation costs of $852,000 for 34 employees worldwide, 5 in sales and marketing, 26 in research and development, 2 in general and administrative and 1 in operations functions in the U.S., asset impairment costs of $156,000 for property and equipment, furniture and fixtures, computer software for assets no longer in use from reductions in workforce and lease costs of $155,000 pertaining to non-cancelable lease payments for excess facilities that were vacated due to reductions in workforce.

In January 2003, the Company adopted another corporate restructuring program, consisting of a worldwide workforce reduction, in connection with the sale of the Company s digital music fulfillment business and related assets to Geneva Media, LLC (Geneva), an affiliate of Anderson Merchandisers, LP. A restructuring charge of $4,411,000 was recorded in operating expense in the six months ended June 30, 2003. The restructuring charge included involuntary separation costs of $796,000 for 29 employees worldwide, 5 in sales and marketing, 11 in research and development, 9 in general and administrative and 4 in operations functions in the U.S., lease termination fees of $3,569,000 and asset impairment costs of $46,000 for prepaid expenses related to assets sold to Geneva. As of June 30, 2003, $24,000 related to involuntary separation costs remains unpaid and will be paid as employees are terminated through the fourth quarter of 2003.

In July 2003, the Company incurred a one-time payout of $3,569,000 to terminate the remaining term of the Company s property lease on the Company s former headquarters located in Redwood City, CA. As of June 30, 2003, the Company had accrued for this liability and expensed it as a restructuring charge.

NOTE 6 CONTINGENCIES AND LEGAL PROCEEDINGS:

On or about April 7, 2000, SightSound filed an amended complaint against one of the Company s former customers, BeMusic, in the United States District Court for the Western District of Pennsylvania (Pennsylvania Court). The suit alleges that BeMusic 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. BeMusic 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. Following a claims construction hearing in 2001 and an initial report and recommendation on claim construction by the magistrate judge in February 2002 (which ruling is on appeal to the district judge), the Company renegotiated its agreement with BeMusic concerning the defense of the case going forward. On December 16, 2002, BeMusic filed a lawsuit against the Company seeking to enjoin the payment of a $2.50 per share return of capital cash distribution to our stockholders. On January 24, 2003, the Company entered into a settlement agreement with BeMusic, whereby the Company agreed to maintain $2.0 million in available cash on hand to pay up to 50% of reasonable attorney fees and costs in connection with the defense of the patent action brought by SightSound against BeMusic, and $5.0 million in available cash on hand to apply towards the satisfaction of any adverse judgment in

LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

respect of which it is determined that the Company would be obligated to indemnify BeMusic. The Company and BeMusic then dismissed the claims against each other. The Company has now ceded control of the defense of the case to BeMusic, and is splitting the costs of the defense with BeMusic. The Company did not, by entering into the settlement agreement with BeMusic, agree, concede, or intend to suggest that it has an obligation to indemnify any party with regard to an adverse judgment, and the Company specifically reserved its right to assert that it has no such obligation. The action currently is pending in the United States District Court of the Western District of Pennsylvania. No trial date has been set at this time.

The Company, certain of its officers and directors, and various of the underwriters in the Company s initial public offering (IPO) and secondary offering, were named as defendants in a consolidated action filed in the United States District Court for the Southern District of New York, *In re Liquid Audio, Inc. Initial Public Offering Securities Litigation*, CV-6611. The consolidated amended complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in the Company s IPO and secondary offering of securities. The plaintiffs brought claims for violation of several provisions of the federal securities laws against those underwriters, and also against the Company and certain of its directors and officers, seeking unspecified damages on behalf of a purported class of purchasers of the Company s common stock between July 8, 1999 and December 6, 2000. Various plaintiffs filed similar actions asserting virtually identical allegations against more than 40 investment banks and 250 other companies. All of these IPO allocation securities class actions currently pending in the Southern District of New York have been assigned to Judge Shira A. Scheindlin for coordinated pretrial proceedings as *In re Liquid Audio, Inc. Initial Public Offering Securities Litigation*, 21 MC 92. Defendants have filed motions to dismiss the actions. In October 2002, the directors and officers were dismissed without prejudice. A proposal has been made for the settlement and release of claims against the issuer defendants, including Liquid Audio, in exchange for a contingent payment to be made by the issuer defendants insurance carriers and an assignment of certain claims. On July 16, 2003, the Company s Board of Directors approved participation in the settlement. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court. If the settlement does not occur, and litigation against the Company continues, the Company believes that it has meritorious defenses and intends to defend the case vigorously.

From time to time the Company receives letters from corporations or other business entities notifying it 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.

NOTE 7 CASH DISTRIBUTION TO STOCKHOLDERS:

On December 6, 2002, the Company announced a return of capital cash distribution to its stockholders of $2.50 per share, payable on December 20, 2002 to stockholders of record as of December 10, 2002. On December 16, 2002, BeMusic, Inc. (BeMusic), a subsidiary of Bertelsmann AG, filed a lawsuit against the Company to prevent the Company from making the $2.50 per share cash distribution, based on concerns related to the Company s ability to indemnify them in a patent infringement action against BeMusic for technology licensed from the Company. On January 24, 2003, the Company entered into a settlement with BeMusic, whereby the Company agreed to maintain $2,000,000 in available cash on hand to pay up to 50% of reasonable attorney fees and costs in connection with the defense of such action, and $5,000,000 in available cash on hand to apply towards the satisfaction of any adverse judgment in respect of which the Company would be obligated to indemnify BeMusic. The Company and BeMusic then dismissed their claims against each other. On January 29, 2003, the Company distributed $2.50 per share, for a total of $57,771,000, to its common stockholders of record as of December 10, 2002. The Company did not, by entering into the settlement agreement with BeMusic agree, concede or intend to suggest that it has an obligation to indemnify any party with regard to an adverse judgment, and the Company specifically reserved its right to assert that it had no such obligation. As of July 31, 2003, the Company understands that BeMusic had incurred approximately $570,764 in legal fees and expenses, of which the Company will be responsible for $285,382. As of June 30, 2003, the Company has paid approximately $280,000 related to this obligation. BeMusic s legal fees (and with them the Company s obligation to share the cost of defense) will continue to increase until the patent infringement action is resolved by settlement or a final court order that cannot be further appealed.

NOTE 8 DECREASE IN STOCK OPTION EXERCISE PRICE:

On March 18, 2003, the Company s Board of Directors elected to reduce the exercise price of all outstanding stock options by $2.50, but not lower than $0.10, to reflect the $2.50 cash distribution to the stockholders. Consequently, the Company will account for a portion of these stock options as variable, revaluing the outstanding stock options at each balance sheet date until they are exercised, cancelled or forfeited.

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

The following Management s Discussion and Analysis contains forward-looking statements within the meaning of Federal securities laws. You can identify these statements because they use forward-looking terminology such as may, will, expect, anticipate, estimate, continue, be and 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, but are not limited to, 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 in conjunction with Management s Discussion and Analysis included in our Annual Report on Form 10-K for the year ended December 31, 2002 filed with the Securities Exchange Commission (SEC).

Overview

During 2002, we continued to provide software products and services that enabled artists, record companies and retailers to create, syndicate and sell music digitally over the Internet.

In the spring of 2002, it became apparent to our management that we could not achieve financial success as an independent company with our current business model. In June 2002 we announced a definitive agreement to merge with Alliance Entertainment Corporation (Alliance), with the intent of combining into a physical and digital media distribution company. In November 2002, we terminated this agreement based upon the publicly expressed opposition to the proposed merger by a significant percentage of our stockholders. We consequently paid a termination fee of $2.1 million to Alliance.

In September 2002, we sold the domestic and foreign rights to our entire patent portfolio for $7.0 million in cash to Microsoft Corporation. In addition to the cash consideration, we received an assignable perpetual royalty-free license to continue using the patented technology in our digital distribution system (the Microsoft License).

On December 6, 2002, we announced a return of capital cash distribution to our stockholders of $2.50 per share, payable on December 20, 2002 to stockholders of record as of December 10, 2002. On December 16, 2002, BeMusic, Inc. (BeMusic), a subsidiary of Bertelsmann AG, filed a lawsuit against us to prevent us from making the $2.50 per share cash distribution, based on concerns related to our ability to indemnify them in a patent infringement action against BeMusic for technology licensed from us. On January 24, 2003, we entered into a settlement with BeMusic, whereby we agreed to maintain $2.0 million in available cash on hand to pay up to 50% of reasonable attorney fees and costs in connection with the defense of such action, and $5.0 million in available cash on hand to apply towards the satisfaction of any adverse judgment in respect of which we would be obligated to indemnify BeMusic. We and BeMusic then dismissed our claims against each other. On January 29, 2003, we distributed $2.50 per share, for a total of $57.8 million, to our common stockholders of record as of December 10, 2002. Following the cash distribution, we continued to explore options for the use of our remaining assets. We did not, by entering into the settlement agreement with BeMusic agree, concede or intend to suggest that we have an obligation to indemnify any party with regard to an adverse judgment, and we specifically reserved our right to assert that we have no such obligation. As of July 31, 2003, we understand that BeMusic had incurred approximately $570,764 in legal fees and expenses, of which we will be responsible for $285,382. As of June 30, 2003, the Company has paid approximately $280,000 related to this obligation. BeMusic s legal fees (and with them our obligation to share the cost of defense) will continue to increase until the patent infringement action is resolved by settlement or a final court order that cannot be further appealed.

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On January 24, 2003, we sold our digital music fulfillment business and related assets to Geneva Media, LLC (Geneva), an affiliate of Anderson Merchandisers, LP for $3.2 million. As part of the sale, we also transferred ownership of the Microsoft License and certain Liquid Audio related trademarks to Geneva. As a result of the sale, we are currently not operating any businesses, and are exploring options for the use of our remaining assets.

On March 18, 2003, our Board acknowledged that many of our outstanding options, whether or not currently exercisable, have exercise prices significantly higher than the current market price of our current stock, and therefore, in recognition of the $2.50 per share cash distribution on January 29, 2003, approved a reduction in the exercise price for all options by $2.50. The Board further resolved that such reduction will in no event reduce the exercise price of any options to less than $0.10 per share.

As a result of this reduction in option exercise price, a portion of the outstanding options will be treated for financial reporting purposes as variable awards. This means that we will be required to record non-cash accounting charges or credits for compensation expense reflecting any increases and decreases in the price of our common stock. We will have to continue to reflect decreases and increases in the price of our common stock in our statement of operations with respect to these options until they are exercised, forfeited or terminated. In recording these accounting charges or credits, the higher the market value of our common stock, the greater the non-cash compensation expense.

In April 2003, our Board repealed our Preferred Stock Rights Agreement, which could have impeded or discouraged an acquisition or other transaction by any entity which is not affiliated with Liquid Audio.

On June 5, 2003, we received a notification of stock delisting from Nasdaq because the closing price of our stock had been below $1 per share for 30 consecutive trading days and we do not conduct an operating business. Our common stock now trades over the counter on the Nasdaq OTC Bulletin Board.

In July 2003, we terminated the remaining term of our property lease on our former headquarters located in Redwood City, CA. The Company s principal executive offices are now located in New York, NY, in a space maintained by Barington Capital Group, L.P., a limited partnership whose general partner is a corporation of which James Mitarotonda is Chairman, President and Chief Executive Officer. Mr. Mitarotonda is also the Co-Chairman and Co-Chief Executive Officer of the Company.

The accompanying financial statements as of June 30, 2003 and for the three-month and six-month periods then ended have been prepared assuming the Company will continue as a going concern, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. The Company has incurred losses and negative cash flows from operations for every year since inception. For the six months ended June 30, 2003, the Company incurred a net loss of approximately $6.1 million and negative cash flows from operations of approximately $6.8 million. As of June 30, 2003, the Company had accumulated losses of approximately $136.5 million. The Company has not yet settled on an operating plan, and can give no assurance that the Company s existing cash and cash equivalents are sufficient to fund the Company s current operations and satisfy its obligations. The Company believes these obligations will primarily relate to costs associated with the operation as a public company (legal, accounting, insurance, etc.), as well as the satisfaction of any potential legal judgments or settlements as well as the expenses associated with any new business activities, which may be undertaken by the Company. In addition, according to a settlement agreement with BeMusic (see Note 6), the Company agreed to maintain $2.0 million in available cash on hand to pay up to 50% of reasonable attorney fees and costs in connection with the defense of the patent action brought by SightSound against BeMusic, and $5.0 million in available cash on hand to apply towards the satisfaction of any adverse judgment in respect of which it is determined that the Company would be obligated to indemnify BeMusic. These factors, among others, indicate that the Company may be unable to continue operations as a going concern. No adjustment has been made in the accompanying financial statements to the amounts and classifications of assets and liabilities which could result should the Company be unable to continue as a going concern. The Company continues to consider future alternatives, including the possible acquisition of other businesses. However, the Company has not consummated any significant transactions to date and the Company s business prospects remain uncertain. To the extent that management of the Company moves forward on any alternative strategy, such strategy may have an impact on the Company s liquidity.

Corporate Restructurings

In May 2001, we adopted a corporate restructuring program to reduce expenses to preserve our cash position while the digital music market developed. The restructuring included a worldwide workforce reduction, a consolidation of three Redwood City, California offices into one facility and other expense management initiatives. We de-emphasized our efforts in less productive, non-core business areas that did 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 continued to focus on software licensing and digital music delivery services that complemented our secure digital download business. We supported 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.

In September 2002, we adopted another corporate restructuring program, consisting of a worldwide workforce reduction, to reduce expenses in response to the digital music market not developing as soon as anticipated and de-emphasis of the Liquid Player product line, and preparations for the then proposed merger with Alliance. A restructuring charge of $1.2 million was recorded in operating expense in the twelve months ended December 31, 2002. The restructuring charge included involuntary separation costs of $852,000 for 34 employees worldwide, 5 in sales and marketing, 26 in research and development, 2 in general and administrative and 1 in operations functions in the U.S., asset impairment costs of $156,000 for property and equipment, furniture and fixtures, computer software

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for assets abandoned from reductions in workforce and lease costs of $155,000 pertaining to non-cancelable lease payments for excess facilities that were vacated due to reductions in workforce.

In January 2003, the Company adopted another corporate restructuring program, consisting of a worldwide workforce reduction, in connection with the sale of the Company s digital music fulfillment business and related assets to Geneva. A restructuring charge of $4,411,000 was recorded in operating expense in the six months ended June 30, 2003. The restructuring charge included involuntary separation costs of $796,000 for 29 employees worldwide, 5 in sales and marketing, 11 in research and development, 9 in general and administrative and 4 in operations functions in the U.S., lease termination fees of $3,569,000 and asset impairment costs of $46,000 for prepaid expenses related to assets sold to Geneva.

As of June 30, 2003, $24,000 related to involuntary separation costs remains unpaid and will be paid as employees are terminated through the fourth quarter of 2003.

In July 2003, the Company incurred a one-time payout of $3,569,000 to terminate the remaining term of the Company s property lease on the Company s former headquarters located in Redwood City, CA. As of June 30, 2003, the Company had accrued for this liability and expensed it as a restructuring charge.

Future Operations and Financial Results

In connection with the sale of our digital music fulfillment business and related assets to Geneva, we implemented the aforementioned workforce reduction in 2003. As a result, as of July 28, 2003, we had 2 full time employees.

We are reviewing alternatives for the use of our remaining assets while settling our remaining claims and liabilities. Our management intends to pursue other business opportunities and investments unrelated to the downloading of digital music.

Our common stock currently trades over the counter on the Nasdaq OTC Bulletin Board. Previously, our common stock was traded on the Nasdaq National Market. However, the market price per share dropped significantly subsequent to the payment of the $2.50 per share cash distribution to our common stockholders. Thus, on June 5, 2003, we were notified by Nasdaq that our common stock was delisted because the closing price had been below $1 per share for 30 consecutive trading days and we do not conduct an operating business. At that time, our common stock began trading over the counter as a pink sheet security. On June 20, 2003, our common stock began trading on the Nasdaq OTC Bulletin Board. The market price of our common stock as of August 7, 2003 was $0.36 per share.

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Results of Operations

The following table sets forth, for the periods presented, certain data derived from our unaudited condensed consolidated 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. In particular, we are not currently operating any businesses and do not expect continuing revenue from sources we received revenue from in the past.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net revenues:				
License	%	26%	9%	27%
Services		74	91	73
Business development (related party)				
Total net revenues		100	100	100
Cost of net revenues:				
License		56	12	63
Services		115	5	106
Non-cash cost of revenue		24		24
Total cost of net revenues		195	17	193
Gross profit (loss)		(95)	83	(93)
Operating expenses:				
Sales and marketing	100	679	630	763
Non-cash sales and marketing		(21)		(7)
Research and development	100	1,930	384	2,076
Non-cash research and development		2		3
General and administrative	100	1,262	9,900	1,053
Non-cash general and administrative				
Strategic marketing-equity instruments				