

LIQUID AUDIO INC  
Form 10-Q  
November 14, 2003  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 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

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**LIQUID AUDIO, INC.**

(Exact name of registrant as specified in its charter)

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

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

**888 Seventh Ave. 17<sup>th</sup> Floor, New York, NY**  
(Address of principal executive offices)

**10019**  
(Zip Code)

**(212) 974-5730**

(Registrant's telephone number, including area code)

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

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

As of November 11, 2003, there were 23,176,858 shares of registrant's Common Stock outstanding.

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

	<b>September 30,</b>	<b>December 31,</b>
	<b>2003</b>	<b>2002</b>
	<u>          </u>	<u>          </u>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 8,895	\$ 73,985
Accounts receivable, net	25	60
Investment in available for sale securities	470	
Other current assets	306	1,361
	<u>          </u>	<u>          </u>
Total current assets	9,696	75,406
Restricted cash		826
Property and equipment, net		558
Other assets	8	7
	<u>          </u>	<u>          </u>
Total assets	\$ 9,704	\$ 76,797
	<u>          </u>	<u>          </u>
<b>Liabilities and stockholders equity</b>		
Current liabilities:		
Accounts payable	\$ 212	\$ 1,218
Accrued liabilities	346	2,151
Distribution payable to stockholders		57,771
Deferred revenue		39
	<u>          </u>	<u>          </u>
Total current liabilities	558	61,179
	<u>          </u>	<u>          </u>
Stockholders equity:		
Common stock	23	23
Additional paid-in capital	146,053	146,039
Accumulated other comprehensive loss (net)	(62)	(75)
Accumulated deficit	(136,868)	(130,369)
	<u>          </u>	<u>          </u>
Total stockholders equity	9,146	15,618
	<u>          </u>	<u>          </u>
Total liabilities and stockholders equity	\$ 9,715	\$ 76,797
	<u>          </u>	<u>          </u>

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See accompanying notes to condensed consolidated financial statements

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2003	2002	2003	2002
<b>Net revenues:</b>				
License	\$	\$ 14	\$ 4	\$ 90
Services		87	39	297
<b>Total net revenues</b>		<b>101</b>	<b>43</b>	<b>387</b>
<b>Cost of net revenues:</b>				
License		71	5	252
Services		140	2	442
Non-cash cost of revenue		13		82
<b>Total cost of net revenues</b>		<b>224</b>	<b>7</b>	<b>776</b>
<b>Gross profit (loss)</b>		<b>(123)</b>	<b>36</b>	<b>(389)</b>
<b>Operating expenses:</b>				
Sales and marketing	6	1,018	277	3,203
Non-cash sales and marketing		(7)		(28)
Research and development		2,434	165	8,371
Non-cash research and development		(3)		5
General and administrative	472	3,642	4,730	6,653
Restructuring		798	4,411	798
<b>Total operating expenses</b>	<b>478</b>	<b>7,882</b>	<b>9,583</b>	<b>19,002</b>
<b>Loss from operations</b>	<b>(478)</b>	<b>(8,005)</b>	<b>(9,547)</b>	<b>(19,391)</b>
Other income (expense), net	52	319	180	1,170
Sale of intellectual property assets		7,000		7,000
Gain on sale of digital music fulfillment business			2,868	
<b>Net loss</b>	<b>\$ (426)</b>	<b>\$ (686)</b>	<b>\$ (6,499)</b>	<b>\$ (11,221)</b>
<b>Net loss per share:</b>				
Basic and diluted	\$ (0.02)	\$ (0.03)	\$ (0.28)	\$ (0.49)
<b>Weighted average shares</b>	<b>23,177</b>	<b>22,761</b>	<b>23,163</b>	<b>22,736</b>

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See accompanying notes to condensed consolidated financial statements

**Table of Contents****LIQUID AUDIO, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands; unaudited)

	Nine Months Ended September 30,	
	2003	2002
<b>Cash flows from operating activities:</b>		
Net loss	(6,499)	\$ (11,221)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	228	1,866
Amortization of unearned compensation		(23)
Gain on sale of digital music fulfillment business and related assets	(2,868)	
Non-cash cost of revenue		82
Loss on disposal of and write-down of property and equipment		115
Changes in assets and liabilities:		
Accounts receivable	35	36
Other assets	1,054	(839)
Accounts payable	(1,006)	78
Accrued liabilities	(1,805)	(119)
Deferred revenue	(39)	(25)
Net cash used in operating activities	<u>(10,900)</u>	<u>(10,050)</u>
<b>Cash flows from investing activities:</b>		
Acquisition of property and equipment		(85)
Purchase of available-for-sale securities	(459)	
Decrease in restricted cash	826	
Proceeds from sale of digital music fulfillment business and related assets	3,200	
Net cash provided by (used in) investing activities	<u>3,567</u>	<u>(85)</u>
<b>Cash flows from financing activities:</b>		
Cash distribution to stockholders	(57,771)	
Proceeds from issuance of common stock, net of repurchases	14	114
Payments made under capital leases		(24)
Payments made under equipment loan		(169)
Net cash used in financing activities	<u>(57,757)</u>	<u>(79)</u>
Effect of exchange rates on cash and cash equivalents		(12)
Net decrease in cash and cash equivalents	<u>(65,090)</u>	<u>(10,226)</u>
Cash and cash equivalents at beginning of period	73,985	91,594
Cash and cash equivalents at end of period	<u>8,895</u>	<u>\$ 81,368</u>
<b>Non-cash investing and financing activities:</b>		



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Issuance of warrants in connection with strategic marketing Agreements	\$	\$	82
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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. 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 has not operated any businesses since this sale and does not expect continuing revenue from sources the Company received revenue from in the past; however, the Company has continued 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. The Company's common stock was traded on The Nasdaq National Market, but was delisted on June 5, 2003. The market price per share of the Company's stock dropped significantly after the payment of a \$2.50 per share cash distribution to the Company's stockholders on January 29, 2003. On June 5, 2003, 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 November 11, 2003 was approximately \$0.32 per share.

On July 30, 2003, the Company held its 2003 Annual Meeting of Stockholders at which the stockholders elected two (2) Class 1 directors, approved a proposal to change the name of the Company to L Q Corporation, Inc. (the Name Change) and ratified the Company's independent accountants. The stockholders then adjourned the meeting until August 20, 2003, then to August 28, 2003, August 29, 2003, September 23, 2003, and finally to September 29, 2003. At the September 29, 2003 meeting, the stockholders approved amendments to the Company's certificate of incorporation to effect a 1-for-250 reverse stock split, to be followed immediately by a 35-for-1 forward stock split (collectively, the Reverse/Forward Stock Split), as well as a reduction in the number of common shares authorized for issuance from 50,000,000 shares to 30,000,000 shares (the Share Reduction).

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Although the Company's Board of Directors has received stockholder approval to implement the Name Change, the Reverse/Forward Stock Split and the Share Reduction, the Company has not yet consummated these corporate actions. The Company intends to file the amendments necessary to implement the Name Change, the Reverse/Forward Stock Split and the Share Reduction as soon as practicable. In the case of the Reverse/Forward Stock Split, the Company will issue a press release announcing the Reverse/Forward Stock Split prior to its effectiveness. For a more detailed discussion of the effect of the Reverse/Forward Stock Split and the Share Reduction on the capitalization of the Company, see Part II. Item 5. OTHER INFORMATION. No retroactive effect has been given to any of the share or earnings per share information in these financial statements as a result of the Reverse/Forward Stock Split. Any retroactive effect on the share or earnings per share information will be recorded in the period it takes effect.

### *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 nine months ended September 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 (SEC) rules and regulations.

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**LIQUID AUDIO, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

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 SEC on March 31, 2003.

***Going concern consideration***

The accompanying financial statements as of September 30, 2003 and for the three-months and nine-months 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 nine months ended September 30, 2003, the Company incurred a net loss of approximately \$6.5 million and negative cash flows from operations of approximately \$10.9 million. In July, 2003, the Company incurred a one-time payout of \$3,569,000 to terminate the remaining term of its property lease on its former headquarters located in Redwood City, California. In connection with the termination of this lease, a previously restricted cash balance of \$826,000 that served as collateral for the security deposit on this lease, became unrestricted when the security deposit was no longer necessary. As of September 30, 2003, the Company had an accumulated deficit of approximately \$136.9 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 and 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 a reserve of \$2.0 million in available cash for payment of 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 a reserve of \$5.0 million in available cash 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***

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Securities classified for accounting purposes as available-for-sale securities consist of marketable equity securities not classified as either held-to-maturity or trading securities. Available-for-sale securities are stated at fair value with unrealized gains and losses reported as a separate component of stockholders' equity as other comprehensive income. Dividends on marketable equity securities are recognized as income when declared. Realized gains and losses and declines in value deemed to be other-than-temporary are included in revenues. The cost basis for realized gains and losses is determined on the basis of the actual cost of the securities sold.

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**LIQUID AUDIO, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

As of September 30, 2003, the Company owned 30,207 shares of Warnaco Group Inc (NASDAQ: WRNC), an available-for-sale security with a fair market value of \$470,323 and a cost basis of \$457,639. This is the only available-for-sale security that the Company has ever owned. The gross unrealized gain as of September 30, 2003 has been recorded as a separate component of stockholders equity as accumulated other comprehensive loss.

As of November 12, 2003, the Company liquidated its entire remaining position in this security, which resulted in a realized gain of \$48,777. Following such date, the Company did not own any shares of available-for-sale securities, and all of its liquid assets are held as cash and cash equivalents. The Company does not intend to make any additional purchases of available-for-sale securities, and does not intend to trade in available-for-sale securities in the future. All of the Company's liquid assets will continue to be held as cash and cash equivalents on a going forward basis.

The Investment Company Act of 1940 provides a set of regulations for companies that are or that hold themselves out as being engaged primarily in the business of investing, reinvesting, owning, holding or trading in securities. A company may also become subject to regulation under the Investment Company Act if it owns investment securities with a value exceeding 40% of the value of its total assets (exclusive of government securities and cash items). Securities issued by companies other than majority-owned subsidiaries are generally considered investment securities for purposes of the Investment Company Act. As a result of our lack of an operating business, our significant cash balance as a percentage of our total assets and our recent trading activities, we may have inadvertently become, or may become in the future if we fail to obtain an operating business, an investment company under the Investment Company Act. Notwithstanding the foregoing, we believe that at all relevant times prior to the date of filing this Quarterly Report, we have not been subject to regulation as an investment company under the Investment Company Act. Although we continue to consider future operating alternatives, including the possible acquisition of one or more operating businesses, we could become subject to regulation under the Investment Company Act in the future. Registration as an investment company would be very expensive and further deplete our cash balances, which would leave us with fewer resources to pursue further operating alternatives. Registration would also subject us to restrictions that may be inconsistent with any future business strategy we may decide upon. In order to avoid these regulations, we may have to take actions that we would not otherwise choose to take to avoid registration under the Investment Company Act.

***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*.

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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 September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Net loss as reported	\$ 426	\$ 686	\$ 6,499	\$ 11,221
Less stock-based compensation (income) expense determined under fair value based method, net of tax effects	60	(317)	135	161
Net loss pro forma	\$ 486	\$ 369	\$ 6,634	\$ 11,382
Basic and diluted net loss per share as reported	\$ 0.02	\$ 0.03	\$ 0.28	\$ 0.49
Basic and diluted net loss per share pro forma	0.02	0.02	0.29	0.50

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**LIQUID AUDIO, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

***Recent accounting pronouncements***

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,



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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):

	<b>September 30, 2003</b>	<b>December 31, 2002</b>
	<u>          </u>	<u>          </u>
Accrued liabilities:		
Compensation and benefits	\$ 11	\$ 308
Consulting and professional services	138	431
Litigation settlement		1,079
Other	197	333
	<u>          </u>	<u>          </u>
	<b>\$ 346</b>	<b>\$ 2,151</b>
	<u>          </u>	<u>          </u>

As of September 30, 2003, the Company had accrued liabilities for consulting and professional services in the amount of \$138,000, consisting of \$105,000 for audit services and \$33,000 for legal services, and accrued liabilities described as "Other" in the amount of \$195,000, all for royalty payments.

**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):

<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
<b>September 30,</b>		<b>September 30,</b>	
<u>          </u>		<u>          </u>	
<b>2003</b>	<b>2002</b>	<b>2003</b>	<b>2002</b>

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	—	—	—	—
Comprehensive loss:				
Net loss	\$ (426)	\$ (686)	\$ (6,499)	\$ (11,221)
Foreign currency translation adjustments		(11)	1	(36)
Unrealized gain (loss) on available-for-sale securities	13		13	
	—	—	—	—
	<u>\$ (413)</u>	<u>\$ (697)</u>	<u>\$ (6,485)</u>	<u>\$ (11,257)</u>
	—	—	—	—

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2003</b>	<b>2002</b>	<b>2003</b>	<b>2002</b>
Common stock options	73	2,156	73	2,156
Common stock warrants	431	431	431	431
Unvested common stock subject to repurchase	0	0	0	0
	<b>504</b>	<b>2,587</b>	<b>504</b>	<b>2,587</b>

**NOTE 5 RESTRUCTURINGS:**

In September 2002, the Company adopted a 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 ( Alliance ). The Company terminated the merger agreement with Alliance 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 and 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 nine months ended September 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 September 30, 2003, \$24,000 related to involuntary separation costs remained unpaid and will be paid as employees are terminated through the fourth quarter of 2003.

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

In October 2003, the Company incurred a one-time payout of \$30,000 to terminate the remaining term of its property lease on an office located in Los Angeles, California.

### **NOTE 6 CONTINGENCIES AND LEGAL PROCEEDINGS:**

On or about April 7, 2000 SightSound, Inc. ( SightSound ) filed an Amended Complaint in a lawsuit in the United States District Court for the Western District of Pennsylvania (the Pennsylvania Court ) alleging that certain former customers of the Company, N2K, inc., CDNow, Inc. and CDNow Online, Inc., which have since merged into BeMusic, infringed one or more of three United States patents (Nos. 5,191,573; 5,675,734; and 5,996,440). SightSound has claimed compensatory damages of approximately \$16.0 million. SightSound also seeks treble damages and attorneys fees under certain statutory provisions. BeMusic has denied the allegations set forth in SightSound s pleadings. BeMusic has asserted a claim for indemnification against the Company based on certain licensing agreements between the Company and BeMusic s predecessors. In January, 2002, the Company entered into an agreement with BeMusic s predecessor, CDNow Online, Inc., in which the Company agreed to share evenly with CDNow Online, Inc. all legal fees incurred by CDNow Online, Inc. in defending the patent infringement action. The fee-sharing agreement entitles BeMusic, CDNow Online, Inc. s successor, to control the defense of the patent infringement action, but requires BeMusic to consult in good faith with the Company regarding its defense and/or

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**LIQUID AUDIO, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

settlement of the patent infringement action. In December, 2002, BeMusic filed suit against the Company seeking to prevent payment of a cash distribution to stockholders until its indemnification claims were resolved. In January, 2003, the Company entered into a settlement agreement with BeMusic pursuant to which BeMusic's lawsuit was dismissed and the Company agreed to maintain a reserve of \$2.0 million in available cash for payment of up to 50% of reasonable legal fees relating to the patent infringement action and to maintain a reserve of \$5.0 million in available cash to apply toward payment of an adverse judgment in, or a settlement of, the patent infringement action if the Company is determined to be obligated to indemnify BeMusic or its predecessors with respect to any such judgment or settlement. The agreement also continued the fee-sharing arrangement under which the Company will share evenly with BeMusic the cost of legal fees associated with BeMusic's defense of the patent infringement action. The settlement agreement did not concede any obligation by the Company to indemnify a party with regard to an adverse judgment, and specifically reserved the Company's right to challenge any claim for indemnity following final judgment in the lawsuit. The Company intends to oppose any indemnification claim by BeMusic. A recent order issued by the Pennsylvania Court denied summary judgment motions by BeMusic seeking to dismiss the lawsuit, and granted a motion by SightSound seeking to dismiss one of BeMusic's asserted defenses of inequitable conduct by the plaintiff. At the Pre-Trial/Settlement Conference held on November 12, 2003, the Pennsylvania Court set a trial date of March 1, 2004. It is our understanding that settlement negotiations are continuing between the parties in the litigation.

The Company, certain of its former 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 former 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, such directors and officers were dismissed without prejudice. A proposal has been made for the settlement and release of claims against the issuer defendants, including the Company, 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.

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**LIQUID AUDIO, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**NOTE 7 CASH DISTRIBUTION TO STOCKHOLDERS:**

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.

**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 its 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, 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 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, 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 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. 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. As of September 30, 2003, we understand that BeMusic had incurred approximately \$726,916 in legal fees and expenses. As of September 30, 2003, the Company has paid approximately \$363,458 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. For a more detailed discussion of the BeMusic litigation and settlement, see Part II, Item 1 Legal Proceedings.





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On January 24, 2003, we sold our digital music fulfillment business and related assets to Geneva 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 have not operated any businesses since such sale, and continue to explore 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 us.

On June 5, 2003, we received a notification of stock delisting from The Nasdaq National Market 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, California, and paid a one-time termination fee of \$3,569,000. Our 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.

On July 30, 2003, we held our 2003 Annual Meeting of Stockholders, at which our stockholders elected two (2) Class 1 directors, approved a Name Change proposal to change our name to L Q Corporation, Inc. and ratified our independent accountants. Our stockholders then adjourned the meeting until August 20, 2003, then to August 28, 2003, August 29, 2003, September 23, 2003, and finally to September 29, 2003. At the September 29, 2003 meeting, our stockholders approved amendments to our certificate of incorporation to effect the Reverse/Forward Stock Split as well the Share Reduction.

Although the Company's Board of Directors has received stockholder approval to implement the Name Change, the Reverse/Forward Stock Split and the Share Reduction, the Company has not consummated these corporate actions. The Company intends to file the amendments necessary to implement the Name Change, the Reverse/Forward Stock Split and the Share Reduction as soon as practicable. In the case of the Reverse/Forward Stock Split, the Company will issue a press release announcing the Reverse/Forward Stock Split prior to its effectiveness. For a more detailed discussion of the effect of the Reverse/Forward Stock Split and the Share Reduction on the capitalization of the Company, see Part II. Item 5. OTHER INFORMATION.

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In October 2003, we paid \$30,000 to terminate the remaining term of the property lease of our office located in Los Angeles, California.

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As of September 30, 2003, the Company owned 30,207 shares of Warnaco Group Inc (NASDAQ: WRNC), an available-for-sale security with a fair market value of \$470,323 and a cost basis of \$457,639. This is the only available-for-sale security that the Company has ever owned. The gross unrealized gain as of September 30, 2003 has been recorded as a separate component of stockholders equity as accumulated other comprehensive loss.

As of November 12, 2003, the Company liquidated its entire remaining position in this security, which resulted in a realized gain of \$48,777. Following such date, the Company did not own any shares of available-for-sale securities, and all of its liquid assets are held as cash and cash equivalents. The Company does not intend to make any additional purchases of available-for-sale securities, and does not intend to trade in available-for-sale securities in the future. All of the Company's liquid assets will continue to be held as cash and cash equivalents on a going forward basis.

As a result of our lack of an operating business, our significant cash balance as a percentage of our total assets and our recent trading activities, we may have inadvertently become, or may become in the future if we fail to obtain an operating business, an investment company under the Investment Company Act. Notwithstanding the foregoing, we believe that at all relevant times prior to the date of filing this Quarterly Report, we have not been subject to regulation as an investment company under the Investment Company Act. Although we continue to consider future operating alternatives, including the possible acquisition of one or more operating businesses, we could become subject to regulation under the Investment Company Act in the future. Registration as an investment company would be very expensive and further deplete our cash balances, which would leave us with fewer resources to pursue further operating alternatives. Registration would also subject us to restrictions that may be inconsistent with any future business strategy we may decide upon. In order to avoid these regulations, we may have to take actions that we would not otherwise choose to take to avoid registration under the Investment Company Act.

The accompanying financial statements as of September 30, 2003 and for the three-month and nine-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 nine months ended September 30, 2003, the Company incurred a net loss of approximately \$6.5 million and negative cash flows from operations of approximately \$10.9 million. As of September 30, 2003, the Company had an accumulated deficit of approximately \$136.9 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, the Company has agreed to reserve certain funds in connection with an ongoing dispute with BeMusic (see Part I. Item 1. Note 6 Contingencies and Legal Proceedings). 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 September 2002, we adopted a 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 the then proposed merger with Alliance. The Company terminated the merger agreement with Alliance on November 8, 2002. 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 and computer software 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.

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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 September 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 its property lease on its former headquarters located in Redwood City, California. As of September 30, 2003, the Company had paid for this liability and expensed it as a restructuring charge.

In October 2003, we paid \$30,000 to terminate the remaining term of the property lease of our office located in Los Angeles, California.

## **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 November 14, 2003, we had 1 full time employee and 1 part time employee.

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. Our common stock was traded on The Nasdaq National Market, but was delisted on June 5, 2003. The market price per share of our stock dropped significantly after the payment of a \$2.50 per share cash distribution to our stockholders on January 9, 2003. On June 5, 2003, 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 November 11, 2003 was approximately \$0.32 per share.

## **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.

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	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2003	2002	2003	2002
Net revenues:				
License	%	14%	9%	23%
Services		86	91	77
Business development (related party)				
Total net revenues		100	100	100
Cost of net revenues:				
License		70	12	65
Services		139	4	114
Non-cash cost of revenue		13		21
Total cost of net revenues		222	16	200
Gross profit (loss)		(122)	84	(100)
Operating expenses:				
Sales and marketing		1,008	645	828
Non-cash sales and marketing		(7)		(7)
Research and development		2,410	385	2,163
Non-cash research and development		(3)		1
General and administrative		3,606	11,108	1,719
Non-cash general and administrative				
Strategic marketing-equity instruments				
Restructuring		790	10,292	206
Total operating expenses		7,804	22,430	4,910
Loss from operations		(7,426)	(22,346)	(5,010)
Other income (expense), net		316	396	302
Sale of intellectual property assets		6,931		1,809
Gain on sale of digital music fulfillment business			6,692	
Net loss	%	(679)%	(15,258)%	(2,899)%

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**Three Months Ended September 30, 2003 and 2002**

*Total Net Revenues*

Total net revenues were \$0 for the three months ended September 30, 2003 as compared to \$101,000 in the comparable period of 2002. We do not expect significant revenue in the remainder of 2003.

*License.* License revenues derived from our former operating business primarily consisted of fees from licensing our software products to third parties. License revenues were \$0 for the three months ended September 30, 2003 as compared to \$14,000 in the comparable period of 2002. This decrease was due to the discontinuation of the Liquid Player product line and the sale of our digital music fulfillment business to Geneva in January 2003.

*Services.* Services revenues derived from our former operating business primarily consisted of maintenance fees related to our licensed software products, hosting fees, encoding, music delivery and transaction fees, promotion and advertising services and kiosk-related equipment sales from third parties. Services revenues were \$0 for the three months ended September 30, 2003 as compared to \$87,000 in the comparable period of 2002. This decrease was due to the discontinuation of our software license and our music hosting businesses and the sale of our digital music fulfillment business to Geneva.

*Total Cost of Net Revenues*

We had no sales or costs relating to sales for the three months ended September 30, 2003. Total cost of net revenues was \$0 in the three months ended September 30, 2003 as compared to \$224,000 in the three months ended September 30, 2002. We do not expect significant cost of net revenues in the remainder of 2003 since we are not currently operating any businesses.

*License.* Cost of license revenues primarily consists of royalties paid for third-party technology and costs of documentation, duplication and packaging. Cost of license revenues were \$0 for the three months ended September 30, 2003 as compared to \$71,000 in the comparable period of 2002. Cost of license revenues decreased due to our discontinuation of the digital music distribution business.

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*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 were \$0 for the three months ended September 30, 2003 as compared to \$140,000 in the three months ended September 30, 2002. The decrease in cost of services revenues was due to the termination of all of our encoding, customer service and professional services personnel and the sale of the digital music fulfillment business to Geneva.

### *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 were \$6,000 for the three months ended September 30, 2003 compared to \$1,018,000 in the comparable period of 2002. This decrease was due to the reduction in compensation and related expenses of approximately \$529,000 from termination of all of our sales and marketing personnel, expense management initiatives, and the sale of our digital music fulfillment service to Geneva, reduction in travel and entertainment expense of approximately \$59,000 between the two periods, and allocation of occupancy costs and other overhead of approximately \$248,000 in the comparable period of 2002. We do not expect to incur significant sales and marketing expenses in the remainder of 2003 since we are not currently operating any businesses.

*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 were \$0 for the three months ended September 30, 2003, compared to \$2,434,000 in the comparable period of 2002. This decrease was due to the reduction in compensation and related expenses of approximately \$1.2 million from termination of all of our research and development personnel and outside contractors, expense management initiatives, the sale of our digital music fulfillment business to Geneva, depreciation and amortization of approximately \$506,000 and allocation of occupancy costs and other overhead of approximately \$559,000. We do not expect to incur significant research and development expenses in the remainder of 2003 since we are not currently operating any businesses.

*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 were \$472,000 for the three months ended September 30, 2003, compared to \$3,642,000 in the comparable period of 2002. This decrease was due to the reduction of rent expense of our corporate office of \$524,000, reduction in compensation and related expenses of approximately \$699,000 from decreases in the number of general and administrative personnel from 17 to 1 and increased use of outside contractors, expense management initiatives, the sale of our digital music fulfillment business to Geneva, reduction of directors and officers insurance of \$442,000, reduced accounting fees of \$213,000 and reduced legal fees of \$1.7 million, offset by allocation of occupancy costs and other overhead of approximately \$752,000. Allocations of occupancy costs and other overhead, including salaries, leases and utilities, are allocated on a headcount basis, and the reduction of headcount in all other departments will leave these expenses as a general and administrative expense. The primary components of the \$472,000 general and administrative expense for the three months ended September 30, 2003, were \$178,000 for legal services, \$99,000 for salaries, wages and consultants and \$87,000 for insurance.

*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, 2003 was \$3.5 million. We recognized \$0 and (\$10,000) of stock compensation expense for the three months ended September 30, 2003 and 2002, respectively.





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*Restructuring.* Restructuring charge relates to costs associated with our corporate restructuring program in connection with our exit of our digital music fulfillment business. Restructuring expenses were \$0 for the three months ended September 30, 2003, compared to \$798,000 in the comparable period of 2002.

*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 \$52,000 for the three months ended September 30, 2003 from \$319,000 in the comparable period of 2002. The decrease is due to the decrease in interest income of approximately \$268,000 from lower average cash and cash equivalent balances resulting from cash used in operating activities and lower interest rates.

### **Nine Months Ended September 30, 2003 and 2002**

#### *Total Net Revenues*

Total net revenues decreased 89% to \$43,000 for the nine months ended September 30, 2003 from \$387,000 in the comparable period of 2002. We do not expect significant revenue in the remainder of 2003.

*License.* License revenues decreased 96% to \$4,000 for the nine months ended September 30, 2003 from \$90,000 in the comparable period of 2002. This decrease was due to discontinuation of our software licensing business and the sale of our digital music fulfillment business to Geneva in January 2003.

*Services.* Services revenues decreased 87% to \$39,000 for the nine months ended September 30, 2003 from \$297,000 in the comparable period of 2002. This decrease was due to the discontinuation of our software license business, our music hosting business for independent artists and labels and the sale of our digital music fulfillment business to Geneva.

#### *Total Cost of Net Revenues*

Our gross profit (loss) increased to approximately 84% of total net revenues for the nine months ended September 30, 2003 from approximately (100)% of total net revenues in the comparable period of 2002. Total cost of net revenues decreased 99% to \$7,000 for the nine months ended September 30, 2003 from \$776,000 in the comparable period of 2002.

*License.* Cost of license revenues decreased 98% to \$5,000 for the nine months ended September 30, 2003 from \$252,000 in the comparable period of 2002. Cost of license revenues decreased due to the discontinuation of our licensing business.

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*Services.* Cost of services revenues decreased 99 % to \$2,000 for the nine months ended September 30, 2003 from \$442,000 in the comparable period of 2002. The decrease in cost of services revenues was due to the termination all of our encoding, customer service and professional services personnel, the elimination of all of our kiosk-related equipment due to our corporate restructuring and the sale of our digital music fulfillment business to Geneva.

*Non-Cash Cost of Revenues.* Non-cash cost of revenues were \$0 for the nine months ended September 30, 2003 and \$82,000 in the comparable period of 2002.

### *Operating Expenses*

*Sales and Marketing.* Sales and marketing expenses decreased 91% to \$277,000 for the nine months ended September 30, 2003 from \$3.2 million in the comparable period of 2002. This decrease was primarily due to decreases in the number of personnel and outside contractors due to our corporate restructuring and expense management initiatives.

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*Research and Development.* Research and development expenses decreased 98 % to \$165,000 for the nine months ended September 30, 2003 from \$8.4 million in the comparable period of 2002. This decrease was primarily due to the termination of all of our personnel and outside contractors, expense management initiatives and the sale of our digital music fulfillment business to Geneva.

*General and Administrative.* General and administrative expenses decreased 28% to \$4.7 million for the nine months ended September 30, 2003 from \$6.7 million in the comparable period of 2002. This decrease was due to a reduction in rent expense of \$1.1 million, decreases in the number of personnel and outside contractors due to our corporate restructuring and expense management initiatives of \$1.0 million, reduced accounting fees of \$209,000, reduced public company compliance expense of \$141,000, reduced building occupancy costs of \$136,000 and reduced legal fees of \$1.6 million from the comparable period in 2002, offset by allocation of occupancy costs and other overhead of approximately \$2,349,000, and directors and officers insurance premiums of \$215,000. Allocations of occupancy costs and other overhead, including salaries, leases and utilities, are allocated on a headcount basis, and the reduction of headcount in all other departments will leave these expenses as a general and administrative expense.

*Non-Cash Sales and Marketing, Research and Development and General and Administrative.* We recognized \$0 and (\$23,000) of non-cash sales and marketing, research and development and general and administrative expenses for the nine months ended September 30, 2003 and 2002, respectively.

*Restructuring.* Restructuring charge was \$4.4 million and \$798,000 for the nine months ended September 30, 2003 and 2002, respectively. Approximately \$3.6 million of the charge in the nine months ended September 30, 2003 consists of expense related to a one-time payment to terminate the remaining term of our real estate lease of our previous corporate offices, \$796,000 of involuntary employee separation costs and \$46,000 of prepaid expenses related to assets sold to Geneva.

*Other Income (Expense), Net.* Other income (expense) decreased to \$180,000 for the nine months ended September 30, 2003 from \$1.2 million in the comparable period of 2002. The decrease was due to lower average cash and cash equivalent balances resulting from cash used in operating activities, and lower interest rates.

*Gain on sale of digital music fulfillment business.* Gain on sale of digital music fulfillment business relates to the sale of our digital music fulfillment business and related assets to Geneva for \$3.2 million in January 2003.

## **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, 2003, 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. As of September 30, 2003, we had approximately \$8.9 million of cash and cash equivalents, reflecting, among other things, a one-time payout of \$3,569,000 in July 2003 to terminate the remaining term of our property lease on our former headquarters in Redwood City, CA.

Net cash used in operating activities was \$10.9 million and \$10.1 million for the nine months ended September 30, 2003 and 2002, respectively. Net cash used for operating activities in the 2003 period was the result of net losses from operations of \$6.5 million, depreciation and

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amortization of \$228,000, gain on sale of digital music fulfillment business and related assets of \$ 2.9 million and a net decrease in working capital items of \$1.7 million. The net decrease in working capital items include an increase in other assets of \$1.1 million, a decrease in accounts payable of \$1.0 million, and a decrease in accrued liabilities of \$ 1.8 million. Net cash used for operating activities in the 2002 period was the result of net losses from operations of \$11.2 million, depreciation and amortization of \$1.9 million, amortization of unearned compensation of \$(23,000), non-cash cost of revenue of \$82,000, loss on disposal of and write-down of property and equipment of \$115,000 and a net decrease in working capital items of \$869,000. The net decrease in working capital items include a decrease in accounts receivable of \$36,000, increase in other assets of \$839,000, increase in accounts payable of \$78,000, decrease in accrued liabilities of \$119,000 and a decrease in deferred revenue of \$25,000.

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Net cash provided by (used) in investing activities was \$3.6 million and \$(85,000) for the nine months ended September 30, 2003 and 2002, respectively. Net cash provided by investing activities in the 2003 period was due to the sale of our digital music fulfillment business and related assets to Geneva, the decrease in restricted cash of \$826,000 and the purchase of available-for-sale securities of \$459,000 (see Overview in Management's Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-Q). Net cash used by investing activities in the 2002 period was due to the acquisition of property and equipment.

Net cash used in financing activities was \$57.8 million and \$79,000 for the nine months ended September 30, 2003 and 2002, respectively. The net cash used in financing activities in the 2003 period is due to the payments made to our stockholders in connection with the return of capital cash distribution declared on December 6, 2002 to stockholders of record on December 10, 2002. The net cash used in financing activities in the 2002 period is due primarily to payments made under our equipment loan and capital leases.

We currently are in the process of negotiating settlements with respect to ongoing litigation matters. The largest potential payment relates to the ongoing matter with SightSound (see Part II. Item 1. LEGAL PROCEEDINGS). SightSound has claimed compensatory damages of approximately \$16 million. SightSound also seeks treble damages and attorneys fees under certain statutory provisions. We might not be able to agree to a settlement on reasonable terms, if at all. A significant settlement or the failure to obtain a settlement on acceptable terms would significantly decrease cash available for other purposes. We have also approved participation in a settlement with respect to currently pending IPO allocation securities class actions (see Part II. Item 1. LEGAL PROCEEDINGS) Although the settlement is subject to a number of conditions, including approval of the proposed settling parties and the court, if the settlement occurs, such settlement and related legal costs would also decrease cash available for other purposes.

As we settle our commitments and ongoing litigation, we continue to incur legal fees, salary expense and other costs that decrease cash available for other purposes.

We have no material commitments for capital expenditures or strategic investments and anticipate no capital expenditures during the remainder of 2003. 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. For instance, we had a \$503,000 general and administrative charge in the three months ended September 30, 2003. Allocations of occupancy costs and other overhead, including salaries, leases and utilities, are allocated on a headcount basis, and the reduction of headcount in all other departments will leave these expenses as a general and administrative expense. The primary components of the \$503,000 general and administrative expense were \$178,000 for legal services, \$99,000 for salaries, wages and consultants and \$87,000 for insurance.

We also, as permitted under Delaware law and in accordance with our Bylaws, indemnify our officers and directors for certain events or occurrences, subject to certain limits, while the officer or director is or was serving at our request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum amount of potential future indemnification is unlimited; however, we have a Director and Officer Insurance Policy that limits our exposure and enables us to recover a portion of any future amounts paid. As a result of our insurance policy coverage, we believe the fair value of these indemnification agreements is minimal.

In our sales agreements, we typically agree to indemnify our customers for any expenses or liability resulting from claimed infringements of patents, trademarks or copyrights of third parties. The terms of these indemnification agreements are generally perpetual any time after execution of the agreement. The maximum amount of potential future indemnification is unlimited. Except for the SightSound legal matter (see Part II. Item 1. LEGAL PROCEEDINGS), to date we have not paid any amounts to settle claims or defend lawsuits related to indemnification under our sales agreements.



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We believe that our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for working capital and capital expenditures in the near future. However, uncertainties exist as to the precise value of claims and liabilities, which may exceed our current existing cash and cash equivalents. In particular, we may be unable to negotiate settlements with respect to our remaining liabilities and we face and might face intellectual property infringement claims, either of which, or collectively, could exceed our current existing cash and cash equivalents. Additionally, we do not currently have an operating business and, consequently, we are currently exploring various options for the use of our remaining assets, including pursuit of a business strategy unrelated to digital music distribution. Acquisition and/or operation of any future business strategy may require additional cash resources. See **ADDITIONAL FACTORS AFFECTING FUTURE RESULTS** below.

## **Market Risk**

No material changes exist to the market risk our investment portfolio of cash and money market funds faced during the nine months ended September 30, 2003. As detailed in **Overview** in **Management's Discussion and Analysis of Financial Condition and Results of Operations** in this Form 10-Q, we began trading in available-for-sale securities on August 8, 2003, and as of November 12, 2003, completely liquidated our position. Our trading activities resulted in a gain of \$48,777. We do not intend to invest in such securities in the future, and will maintain only cash and cash equivalents. For additional information, refer to **Item 7A Quantitative and Qualitative Disclosures About Market Risk** in **Management's Discussion and Analysis of Financial Condition and Results of Operations** included in our Form 10-K for the year ended December 31, 2002 filed with the SEC.

## **ADDITIONAL FACTORS AFFECTING FUTURE RESULTS**

Before deciding to invest in us or to maintain or increase your investment, you should carefully consider the risks described below, in addition to the other information contained in this report and in our other filings with the SEC, including our Annual Report on Form 10-K filed March 31, 2003. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. If any of these risks actually occur, our business, financial condition or results of operations could be seriously harmed. In that event, the market price of our common stock could decline and you may lose all or part of your investment.

### **We Currently Do Not Have an Operating Business, But Also Do Not Intend to Pursue a Course of Complete Liquidation and Dissolution, and Accordingly, the Value of Your Shares May Decrease**

We currently do not have any operating business; we are considering various options for the use of our remaining assets, but have yet to approve any definitive plans. In the meantime, we will continue to incur operating expenses while we consider alternative operating plans. These plans may include business combinations with or investments in other operating companies, or entering into a completely new line of business. We have not yet identified any such opportunities, and thus, you will not be able to evaluate the impact of such a business strategy on the value of your stock. In addition, we cannot assure you that we will be able to identify any appropriate business opportunities. Even if we are able to identify business opportunities that our Board deems appropriate, we cannot assure you that such a strategy will provide you with a positive return on your investment, and it may in fact result in a substantial decrease in the value of your stock. These factors will substantially increase the uncertainty, and thus the risk, of investing in our shares. You should also not expect any further cash distributions.

### **We May Not Be Able to Identify or Fully Capitalize on Any Appropriate Business Opportunities**



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We are considering various options for the use of our remaining assets, which may include business combinations with or investments in other operating companies, or entering into a completely new line of business. Nevertheless, we have not yet identified any appropriate business opportunities, and, due to a variety of factors outside of our control, we may not be able to identify or fully capitalize on any such opportunities. These factors include: (1) competition from other potential acquirors and partners of and investors in potential acquisitions, many of whom may have greater financial resources than we do; (2) in specific cases, failure to agree on the terms of a potential acquisition, such as the amount or price of our acquired interest, or incompatibility between us and management of the company we wish to acquire; and (3) the possibility that we may lack sufficient capital and/or

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expertise to develop promising opportunities. Even if we are able to identify business opportunities that our Board deems appropriate, we cannot assure you that such a strategy will provide you with a positive return on your investment, and may in fact result in a substantial decrease in the value of your stock. In addition, if we enter into a combination with a business that has operating income, we cannot assure you that we will be able to utilize all or even a portion of our existing net operating loss carryover for federal or state tax purposes following such a business combination. If we are unable to make use of our existing net operating loss carryover, the tax advantages of such a combination may be limited, which could negatively impact the price of our stock and the value of your investment. These factors will substantially increase the uncertainty, and thus the risk, of investing in our shares.

### **We May Have to Take Actions that Are Disruptive to Our Business Strategy to Avoid Registration Under the Investment Company Act of 1940.**

As discussed more fully in Note 1 to the Company's Financial Statements **THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES: INVESTMENTS**, we traded shares of an available-for-sale security in August and September of 2003. Although we liquidated our entire remaining position in this security as of November 12, 2003 and do not intend to make any additional purchases of available-for-sale securities, we may have become, or may become in the future, an inadvertent investment company under the Investment Company Act as a result of our lack of an operating business, our significant cash balance as a percentage of our total assets and our recent trading activities. Although we continue to consider future operating alternatives, including the possible acquisition of one or more operating businesses, we could become subject to regulation under the Investment Company Act. Registration as an investment company would be very expensive and further deplete our cash balances, which would leave us with fewer resources to pursue further operating alternatives. Registration would also subject us to restrictions that may be inconsistent with any future business strategy we may decide upon. In order to avoid these regulations, we may have to take actions that we would not otherwise choose to take to avoid registration under the Investment Company Act.

### **Our Stock Has Been Delisted from The Nasdaq National Market, And Is Therefore Significantly Less Liquid than Before**

Our stock has been delisted from trading on The Nasdaq National Market by reason of not maintaining listing requirements due to the lack of tangible business operations and significantly reduced market price of our common stock. As a result, our common stock currently trades over the counter on the Nasdaq OTC Bulletin Board.

### **We May Be Unable to Negotiate Settlements with Respect to Our Remaining Liabilities**

We currently are in the process of negotiating settlements with respect to our remaining obligations and liabilities, which include ongoing litigation matters. If we are unable to successfully negotiate the termination of these obligations, we will have fewer cash proceeds to use for ongoing business ventures.

### **Stockholders May Be Liable to Our Creditors for Up to Amounts Received From Us if Our Reserves Are Inadequate**

Under the Delaware General Corporation Law, in the event we fail to create an adequate contingency reserve for payment of our expenses and liabilities, each stockholder could be held liable for payment to our creditors for such stockholder's pro rata share of amounts owed to creditors in excess of the contingency reserve. The liability of any stockholder would be limited, however, to the amounts previously received by such stockholder from us, including the return of capital cash distribution of \$2.50 per share paid to stockholders on January 29, 2003. Accordingly,

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in such event a stockholder could be required to return all distributions previously made to such stockholder. Moreover, in the event a stockholder has paid taxes on amounts previously received, a repayment of all or a portion of such amount could result in a stockholder incurring a net tax cost if the stockholder's repayment of an amount previously distributed does not cause a commensurate reduction in taxes payable. There can be no assurance that the contingency reserve maintained by us will be adequate to cover any expenses and liabilities.

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

From time to time, we have received letters from corporations and other entities suggesting that we review patents to which they claim rights or claiming that we infringe on their intellectual property rights. Such claims may result in our being involved in litigation. Although we sold our digital music distribution business, we still have one outstanding claim of patent infringement. Further, we cannot assure you that other parties will not assert additional claims in the future or that we will prevail against any such claims. We could incur substantial costs to defend any claims relating to proprietary rights, which would deplete our remaining cash assets. 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 remaining assets could be substantially reduced. If someone asserts a claim against us relating to proprietary technology or information, we might seek settlement of such claim. We might not be able to agree to a settlement on reasonable terms, or at all. The failure to obtain a settlement on acceptable terms would decrease cash for other purposes. See Legal Proceedings.

### **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.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **(a) Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our Co-Chief Executive Officers and Chief Financial Officer, we performed an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rules 13a-14(c) and 15d-14(c) of the Securities Exchange Act of 1934 (the Exchange Act), within the 90-day period prior to the date of this report. Based upon that evaluation, the Co-Chief Executive Officers and Chief Financial Officer concluded that our disclosure controls and procedures are effective at ensuring that required information relating to us will be disclosed on a timely basis in our reports filed under the Exchange Act.

#### **(b) Changes in Internal Controls**

We maintain a system of internal controls that are designed to provide reasonable assurance that our books and records accurately reflect our transactions and that our established policies and procedures are followed. For the nine months ended September 30, 2003, there were no significant changes to our internal controls or in other factors that could significantly affect our internal controls. There were no significant deficiencies or material weaknesses, and therefore there were no corrective actions taken.

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

On or about April 7, 2000 SightSound, Inc. ( SightSound ) filed an Amended Complaint in a lawsuit in the United States District Court for the Western District of Pennsylvania (the Pennsylvania Court ) alleging that certain former customers of the Company, N2K, inc., CDNow, Inc. and CDNow Online, Inc., which have since merged into BeMusic, infringed one or more of three United States patents (Nos. 5,191,573; 5,675,734; and 5,996,440). SightSound has claimed compensatory damages of approximately \$16.0 million. SightSound also seeks treble damages and attorneys fees under certain statutory provisions. BeMusic has denied the allegations set forth in SightSound s pleadings. BeMusic has asserted a claim for indemnification against the Company based on certain licensing agreements between the Company and BeMusic s predecessors. In January, 2002, the Company entered into an agreement with BeMusic s predecessor, CDNow Online, Inc., in which the Company agreed to share evenly with CDNow Online, Inc. all legal fees incurred by CDNow Online, Inc. in defending the patent infringement action. The fee-sharing agreement entitles BeMusic, CDNow Online, Inc. s successor, to control the defense of the patent infringement action, but requires BeMusic to consult in good faith with the Company regarding its defense and/or settlement of the patent infringement action. In December, 2002, BeMusic filed suit against the Company seeking to prevent payment of a cash distribution to stockholders until its indemnification claims were resolved. In January, 2003, the Company entered into a settlement agreement with BeMusic pursuant to which BeMusic s lawsuit was dismissed and the Company agreed to maintain a reserve of \$2.0 million in available cash for payment of up to 50% of reasonable legal fees relating to the patent infringement action and to maintain a reserve of \$5.0 million in available cash to apply toward payment of an adverse judgement in, or a settlement of, the patent infringement action if the Company is determined to be obligated to indemnify BeMusic or its predecessors with respect to any such judgement or settlement. The agreement also continued the fee-sharing arrangement under which the Company will share evenly with BeMusic the cost of legal fees associated with BeMusic s defense of the patent infringement action. The settlement agreement did not concede any obligation by the Company to indemnify a party with regard to an adverse judgment, and specifically reserved the Company s right to challenge any claim for indemnity following final judgement in the lawsuit. The Company intends to oppose any indemnification claim by BeMusic. A recent order issued by the Pennsylvania Court denied summary judgment motions by BeMusic seeking to dismiss the lawsuit, and granted a motion by SightSound seeking to dismiss one of BeMusic s asserted defenses of inequitable conduct by the plaintiff. At the Pre-Trial/Settlement Conference held on November 12, 2003, the Pennsylvania Court set a trial date of March 1, 2004. It is our understanding that settlement negotiations are continuing between the parties in the litigation.

We, certain of our former officers and directors, and various of the underwriters in our 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 our 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 us and certain of our former directors and officers, seeking unspecified damages on behalf of a purported class of purchasers of our 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, such directors and officers were dismissed without prejudice. A proposal has been made for the settlement and release of claims against the issuer defendants, including the Company, 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 us continues, we believe that we have meritorious defenses to the claims against us and intend to defend ourselves vigorously.

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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 stockholders, net of expenses of approximately \$847,000, were approximately \$16.1 million.

From the time of receipt through September 30, 2003, our proceeds from the offerings, except for the return of capital cash distribution paid to our stockholders on January 29, 2003 of \$57.8 million, 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 April 15, 2003, our Board of Directors approved the repeal of our Preferred Stock Rights Agreement. The Preferred Stock Rights Agreement gave rights to stockholders, exercisable after a person or group announced acquisition of 10% or more of our common stock or announced commencement of a tender or exchange offer the consummation of which would have resulted in ownership by the person or group of 10% or more of our common stock to acquire shares of our common stock or shares of any company in which we were merged.

Our common stock currently trades over the counter on the Nasdaq OTC Bulletin Board. Our common stock was traded on The Nasdaq National Market, but was delisted on June 5, 2003. The market price per share of our stock dropped significantly after the payment of a \$2.50 per share cash distribution to our stockholders on January 9, 2003. On June 5, 2003, 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 November 11, 2003 was \$0.32 per share.

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

We held our 2003 Annual Meeting of Stockholders on June 30, 2003 in New York, New York.

At this June 30, 2003 meeting, the stockholders elected the following individuals to serve as Class I Directors for the succeeding year or until their successors are duly qualified and elected:

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<u>Name</u>	<u>Votes For</u>	<u>Votes Withheld</u>
William J. Fox	19,583,623	1,367,633
Michael A. McManus, Jr.	19,583,623	1,367,633

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The stockholders also voted upon the following proposals:

The stockholders approved a proposal to change the name of the Company to L Q Corporation, Inc. There were 20,885,740 votes cast for the proposal, 53,043 votes cast against the proposal and 42,473 abstentions.

The stockholders approved the ratification of the appointment of Rothstein, Kass & Company, P.C. as the Company's independent auditors for the 2003 fiscal year. There were 20,791,322 votes cast for the ratification, 101,306 votes cast against the ratification and 58,628 abstentions.

The stockholders then adjourned this meeting until August 20, 2003, then to August 28, 2003, August 29, 2003, September 23, 2003, and finally to September 29, 2003. At the September 29, 2003 meeting, the stockholders voted upon the following proposals:

The stockholders approved a proposal to effect a 1 for 250 reverse stock split. There were 15,740,532 votes cast for the proposal, 959,587 votes cast against the proposal and 31,460 abstentions.

The stockholders approved a proposal to effect a 35 for 1 forward stock split and a decrease in the authorized number of shares of common stock from 50,000,000 to 30,000,000. There were 15,466,979 votes cast for the proposal, 1,230,672 votes cast against the proposal and 33,928 abstentions.

## **ITEM 5. OTHER INFORMATION**

(a) As discussed more fully in Note 1 to the Company's Financial Statements **THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES: INVESTMENTS**, we traded shares of an available-for-sale security in August and September of 2003. Although we liquidated our entire remaining position in this security as of November 12, 2003, and do not intend to make any additional purchases of available-for-sale securities, we may have become, or may become in the future, an inadvertent investment company under the Investment Company Act as a result of our lack of an operating business, our significant cash balance as a percentage of our total assets and our recent trading activities. Although we continue to consider future operating alternatives, including the possible acquisition of one or more operating businesses, we could become subject to regulation under the Investment Company Act. Registration as an investment company would be very expensive and further deplete our cash balances, which would leave us with fewer resources to pursue further operating alternatives. Registration would also subject us to restrictions that may be inconsistent with any future business strategy we may decide upon. In order to avoid these regulations, we may have to take actions that we would not otherwise choose to take to avoid registration under the Investment Company Act.

(b) On July 30, 2003, the Company held its 2003 Annual Meeting of Stockholders, at which our stockholders approved, among other things, a Name Change proposal to change our name to L Q Corporation, Inc. Our stockholders then adjourned the meeting until August 20, 2003, then to August 28, 2003, August 29, 2003, September 23, 2003, and finally to September 29, 2003. At the September 29, 2003 meeting, our stockholders approved amendments to our certificate of incorporation to effect the Reverse/Forward Stock Split, as well as the Share Reduction.

Although the Company's Board of Directors has received stockholder approval to implement the Name Change, the Reverse/Forward Stock Split and the Share Reduction, the Company has not consummated these corporate actions. The Company intends to file the amendments necessary to implement the Name Change, the Reverse/Forward Stock Split and the Share Reduction as soon as practicable. In the case of the Reverse/Forward Stock Split, the Company will issue a press release announcing the Reverse/Forward Stock Split prior to its effectiveness. No retroactive effect has been given to any of the share or earnings per share information in these financial statements as a result of the



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Reverse/Forward Stock Split. Any retroactive effect on the share or earnings per share information will be recorded in the period it takes effect.

As discussed in the Company's Notice of Annual Meeting of Stockholders, dated June 27, 2003 and filed with the Securities and Exchange Commission on July 1, 2003, the capitalization of the Company before and after the Reverse/Forward Stock Split and the Share Reduction is estimated as follows. Note that the exact figures may not be

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the same on the date the amendments to our certificate of incorporation are filed and become effective, due to continued trading by and among existing Company stockholders:

	<b>Before</b>	<b>After</b>
	<b>the Reverse/Forward Stock Split and</b>	<b>the Reverse/Forward Stock Split and</b>
	<b>Share Reduction</b>	<b>Share Reduction</b>
	<hr/>	<hr/>
Issued and outstanding shares of common stock	23,175,036	3,190,810
Authorized reserved for issuance shares of common stock (1)	9,967,000	1,395,380
Authorized but unreserved shares of common stock	16,857,964	25,413,810
Number of Liquid Audio stockholders	6,687	2,369

- (1) Includes options for common stock reserved under the 1996 Equity Incentive Plan (which automatically increases each January 1 by the lesser of 1,500,000 shares (pre-Reverse/Forward Stock Split, or 210,000 shares post-Reverse/Forward Stock Split), 5% of the outstanding shares on such date, or a lesser amount determined by the Board) and the 2000 Nonstatutory Stock Option Plan (no provision for automatic annual increases), and common stock reserved under the 1999 Employee Stock Purchase Plan (which automatically increases each January 1 by the lesser of 750,000 shares (pre-Reverse/Forward Stock Split, or 105,000 post-Reverse/Forward Stock Split), 3% of the outstanding shares on such date, or a lesser amount determined by the Board).

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

## (a) Exhibits

- 3.1 Certificate of Incorporation as currently in effect (1)
- 3.2 Bylaws as currently in effect (2)
- 4.2 Form of Specimen Stock Certificate (1)
- 4.3 Second Amended and Restated Investor Rights Agreement dated July 31, 1998 (1)
- 10.1 Form of Indemnification Agreement entered into between the registrant and each of its directors and executive officers (1)
- 10.2 1996 Equity Incentive Plan (1)
- 10.3 1999 Employee Stock Purchase Plan (1)
- 10.50 2000 Nonstatutory Stock Option Plan (2)
- 10.56 Termination Agreement, dated as of November 8, 2002, by and among Liquid Audio, Inc., April Acquisition Corp. and Alliance Entertainment Corp. (4)
- 10.57 Asset Purchase Agreement with Microsoft Corporation, dated as of September 27, 2002 (5)
- 10.71 Settlement Agreement between Liquid Audio, Inc. and BeMusic, Inc, dated as of January 17, 2003 (7)
- 10.72 Sublease Termination Agreement with Openwave Systems, Inc., dated as of July 14, 2003 (8)
- 10.73 Personal Property Lease Termination Agreement with Openwave Systems, Inc., dated as of July 14, 2003 (8)

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11.1	Statement regarding computation of per share earnings (3)
21.1	Subsidiary of Liquid Audio, Inc. (5)
23.1	Consent of PricewaterhouseCoopers LLP (5)
24.1	Power of Attorney (contained in the signature page to this report)
31.1	Certification of Co-Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002
31.2	Certification of Co-Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002
31.3	Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002

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- 32.1 Certification of Co-Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002
- 32.2 Certification of Co-Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002
- 32.3 Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002

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- + confidential treatment received as to certain portions
  - (1) incorporated by reference to the 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 July 8, 1999
  - (2) incorporated by reference to the Form 10-Q filed with the Securities and Exchange Commission on August 14, 2000
  - (3) this exhibit has been omitted because the information is shown in the financial statements or notes thereto
  - (4) incorporated by reference to Exhibits of the Form 8-K filed with the Securities and Exchange Commission on November 12, 2002
  - (5) incorporated by reference to the Form 10-K filed with the Securities and Exchange Commission on March 31, 2003
  - (6) incorporated by reference to Exhibits of the Form 8-K filed with the Securities and Exchange Commission on January 17, 2003
  - (7) incorporated by reference to Exhibits of the Form 8-K filed with the Securities and Exchange Commission on January 28, 2003
  - (8) incorporated by reference to the Form 10-Q filed with the Securities and Exchange Commission on August 14, 2003

(b) Reports on Form 8-K

On July 22, 2003, we filed a report on Form 8-K, which announced a press release providing details of the members of the Audit Committee, the Compensation Committee and the Nominating Committee.

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**LIQUID AUDIO, INC.**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DATE: November 14, 2003

LIQUID AUDIO, INC.

/s/ James A. Mitarotonda

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James A. Mitarotonda  
Co-Chief Executive Officer (Principal Executive  
Officer)

/s/ Seymour Holtzman

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Seymour Holtzman  
Co-Chief Executive Officer (Principal Executive  
Officer)

/s/ Melvyn Brunt

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Melvyn Brunt  
Chief Financial Officer (Principal Financial and  
Accounting Officer)