LIQUID AUDIO INC
Form 10-K
March 29, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended: December 31, 2001

OR

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

For the transition period from______ to ______

Commission File Number 000-25977

LIQUID AUDIO, INC.

(Exact name of Registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**77-0421089** **(I.R.S. Employer Identification Number)**
800 Chesapeake Drive, Redwood City, California **(address of principal executive offices)**	**94063** **(zip code)**

Registrant s telephone number, including area code: (650) 549-2000

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.001 par value
Preferred Stock Purchase Rights

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) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

The aggregate market value of voting stock held by non-affiliates of the Registrant was approximately $44,632,535 as of December 31, 2001 based on the closing price of the Common Stock as reported on The Nasdaq Stock Market for that date. Shares of Common Stock held by each executive officer and director and by each person who owns 5% or more of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. The determination of affiliate status is not necessarily a conclusive determination for other purposes. There were 22,710,335 shares of the Registrant s Common Stock issued and outstanding on March 13, 2002.

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PART I

ITEM 1. BUSINESS

This Annual Report on Form 10-K contain forward-looking statements that have been made in reliance on the provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on current expectations, estimates and projections about our industry, management s beliefs, and certain assumptions made by management. Words such as anticipates, expects, intends, plans, believ seeks and estimates and similar expressions are intended to identify forward-looking statements. These statements are not guarantees of future performance and actual actions or results may differ materially. These statements are subject to certain risks, uncertainties and assumptions that are difficult to predict. We undertake no obligation to update publicly any forward-looking statements as a result of new information, future events or otherwise, unless required by law. Readers should, however, carefully review the risk factors included herein and in other reports or documents filed by us from time to time with the Securities and Exchange Commission.

The Company

Liquid Audio, Inc. was incorporated in California in January 1996 and reincorporated in Delaware in April 1999. In July 1999, we completed our initial public offering of common stock. Our principal executive offices are located at 800 Chesapeake Drive, Redwood City, California 94063, and our telephone number is (650) 549-2000.

We provide a leading open platform that enables the digital delivery of media over the Internet. Today, our software products and services give artists and record companies the ability to create, syndicate and sell recorded music with copy protection and copyright management through websites and retailers. Through our Liquid Music Network, a network of leading third party music related websites, OEMs, and retailers, we help artists and record companies distribute, promote and sell their recorded music. From the growing catalog of syndicated music which is available through our Liquid Music Network affiliates and online stores using our Retail Integration and Fulfillment System (RIFFS), and Liquid Store, consumers can preview and purchase digital music. Consumers then can transfer downloaded music to recordable compact discs and to digital audio devices manufactured by consumer electronics companies. Our solution is based on an open technical architecture that is designed to support multiple leading digital music formats, including Liquid Audio, MP3 and Microsoft Windows Media. Numerous record companies and recording artists have used our distribution system to sell music, including labels such as Atlantic Records, BMG Entertainment, EMI Music Group, Sup Pop Records, Warner Music Group and Zomba Records Group, and artists such as Backstreet Boys, Enya, Mick Jagger, Jewel, matchbox twenty and N SYNC.

The Liquid Audio Platform

We provide a variety of products and services to enable the publication and distribution, syndication, promotion and sale of downloadable digital music files over the Internet:

> ***Publication and Distribution.*** We offer services to encode content as secure digital music files and have the ability to encode approximately 20,000 individual music samples per day. Our system hosts digital music files and distributes them through a network of music websites, and soon, through a digital music subscription service.
>
> ***Syndication.*** Our distribution system syndicates music content to a network of leading retail, music and original equipment manufacturer (OEM) websites, including Amazon.com, BestBuy, CDNOW, Palm and Sony.
>
> ***Promotion and Sale.*** We offer services to manage the secure promotion, transfer and sale of digital music, including reporting on digital music sales. Our Liquid Player software, a desktop software application, allows the consumer to preview, purchase and download digital recorded music. Soon, our

Liquid Player will include the capability of purchasing digital music through our digital music subscription service. Liquid Player also enables the output of digital music to recordable compact discs and digital audio devices. To enable online sales, we provide a set of e-commerce services, including credit card processing, the remittance of royalty payments and detailed transaction reports. In addition, we provide promotional services that help build market awareness for content available through our network.

Our solution provides the following benefits:

Increased Revenues and Lower Costs. Through our solution, record companies and artists can generate increased revenues by offering their entire catalog of existing music, as well as singles and periodic releases, for sale online. Our products and services provide a cost-effective way to digitally offer entire music catalogs to consumers, thus reducing the costs associated with physical manufacturing, warehousing and shipping.

Superior Consumer Experience. Our solution enables consumers to preview, purchase, download and export a wide variety of near compact disc quality music online. We make it simple to search for, sample and buy selected digital recorded music from a growing inventory. Our Liquid Player will soon have the capability of purchasing digital music through our digital music subscription service. Our Liquid Player also enables digital music to be transferred to a compact disc by means of a recordable compact disc device and output to digital audio devices. We further simplify the user experience by supporting multiple music download formats, including Liquid Audio, Microsoft Windows Media and MP3.

Security and Compliance. Our digital rights management (DRM) system protects copyright owners against piracy by authenticating, limiting and tracking the number of copies made of a digitally delivered sound recording. Our platform also includes patented territory restriction capabilities that enable the sale over the Internet of digital recorded music in compliance with geographic distribution limitations.

Multiple Formats and Digital Rights Management Systems. Our multi-format distribution solution is based on an open architecture and can publish, syndicate and sell content using leading download formats and DRMs, including Liquid Audio, Microsoft Windows Media, MP3 and Sony OpenMG.

Global Reach. Our platform allows the Internet to be used as a global distribution channel for artists, record companies and retailers. This is particularly significant to independent record labels that have limited access to traditional retail distribution channels. Our patented territory restriction technology identifies the approximate geographic location of consumers to enforce content rules worldwide.

Strategic Relationships and Customers

We plan to continue to build relationships with key third parties engaged in the creation and distribution of digital music. We believe that these relationships will enhance our ability to provide a rich variety of music to consumers. Such relationships can be separated into three major areas, the three C s *content, channel and consumer*.

Content Provider Relationships. In the content area, several labels make music available for sale and promotion through our distribution system and network.

EMI Recorded Music. Under an agreement with Virgin Holdings, Inc., an affiliate of EMI Recorded Music, in July 2000 we started to sell EMI songs and albums through designated music destination and retail sites, including CDNOW. Under a separate agreement, we plan to sell music from EMI CMG, the world s largest Christian music company, through our digital music subscription service scheduled to be delivered in spring 2002.

Sony Music. We are encoding, hosting and delivering promotional downloads from Sony Music on Amazon.com s website, through our agreement with Amazon.com.

Universal Music Group. We are encoding, hosting and delivering promotional downloads from Universal Music Group on Amazon.com s website, through our agreement with Amazon.com.

Warner Music Group. Under an agreement with Warner Music Group, in November 2000 we started to sell Warner songs and albums through our Liquid Music Network.

Zomba Records Group. Zomba has made songs and albums from some of the most popular artists available for sale through the Liquid Music Network. These artists include Britney Spears and N SYNC.

Independent Labels. Many independent record labels have chosen to make their catalogs available online using our solution. These labels include Artemis Records, Avex, Beggars Banquet, Del-Fi Records, edel music, Rounder Records, Strictly Rhythm, Sub Pop Records, Twin/Tone Records and Vanguard Records. As of December 31, 2001, record labels have chosen to promote and sell more than 180,000 digital music recordings through our Liquid Music Network. This compares to approximately 140,000 digital music recordings at the beginning of 2001.

Channel Partners. Our distribution channel continues to grow and includes some of the most popular music websites on the Internet today.

Amazon.com. Under our agreement with Amazon.com, we are encoding, hosting and delivering promotional music downloads for the free downloads section of Amazon.com s music website, which is designed to increase compact disc sales.

Best Buy. Leading retailer Best Buy uses the Liquid Store commerce solution and offers a custom branded version of Liquid Player software to sell music from our catalog of content on its bestbuy.com website.

CDNOW. CDNOW uses RIFFS to promote and sell digital music to consumers through its online retail website, cdnow.com. The website began offering music from our catalog of content for sale in February 2000.

Musicland. Musicland is using RIFFS for its destination sites, SamGoody.com, Suncoast.com, OnCue.com and MediaPlay.com, and started selling music from our catalog of content in August 2000.

Consumer Adoption. We distribute music to millions of consumers in concert with technology companies whose innovative products complement our digital music distribution system. These include the following:

AOL Time Warner. We developed a software plug-in that enables the AOL Nullsoft Winamp player software to purchase and play music encoded in our format. The plug-in is distributed by AOL on the winamp.com website, its other websites and ours.

ARM. We entered into an agreement with ARM, a microprocessor design company, to create a turnkey platform enabling devices supporting secure digital audio devices, using our Secure Portable Player Platform (SP3). This integration has made it easier for consumer electronics and wireless device manufacturers to create new products, using the same chip set platforms they are already using, that support the playback of secure digital downloads distributed by us.

Cirrus Logic, Inc. Cirrus Logic became the first company to integrate the ARM/Liquid Audio SP3 solution into their chipsets. They are using their reference design to enable flash memory-based consumer electronics devices to be compatible with our platform.

Microsoft. To maximize the number of consumers getting music through our distribution network, we added support for the Microsoft Windows Media format. To date, we have encoded and distribute more than 51,000 songs in the Windows Media format. We also deployed Windows Media-based servers in our data centers to host and distribute that content to retailers in our Liquid Music Network. We operate clearinghouse functions for the Windows Media DRM system and added support for Windows Media to our Liquid Player software.

Palm, Inc. We provide Palm handheld users with a solution for accessing digital music. Palm licenses both SP3 and the Liquid Store to create the Palm Music Connection, a new song download website that gives Palm m100 series handheld users immediate access to thousands of secure digital downloads from a wide variety of artists and genres.

Plextor Corp. Plextor delivers a custom-branded version of our Liquid Player software with its compact disc recorder/rewriteable (CD-R/RW) drives. Plextor also uses the Liquid Store to facilitate the secure distribution and sale of audio content on its website.

RealNetworks Inc. We developed software plug-ins that enable users of RealNetwork s RealPlayer G2, RealJukebox and RealOne Player software to playback music encoded in our format using their existing software. To date, more than 9 million users have downloaded the plug-ins.

Sony. Sony delivers a custom-branded version of our Liquid Player software to consumers with certain compact disc recorder (CD-R) devices they sell in the United States and United Kingdom, as well as to customers of its VAIO Music Clip and Memory Stick Walkman devices. Additionally, we enable the distribution of content using Sony s ATRAC3 and OpenMG technologies.

Texas Instruments Inc. We collaborated with Texas Instruments to develop a reference design based on our SP3 specification for secure music delivery. Texas Instruments uses our SP3 reference design in chipsets to enable future flash memory-based consumer electronics devices to be compatible with our platform.

Digital Audio Device Manufacturers. We are also collaborating with the following companies to develop digital audio devices that interoperate with our SP3 specification:

Aiwa	Palm, Inc.
e.Digital Corporation	PocketPyro Porteson
IOData	Sanyo Corporation
Mpuls3	TDK

International Offices

We believe that offices outside the United States are important to establish a complementary international distribution infrastructure. Our international offices include the following:

Liquid Audio Europe. We formed a wholly-owned subsidiary based in London. Liquid Audio Europe is focused on selling our products and services to markets in the United Kingdom, France, German, Italy and other European countries. Several customers in Europe distribute Liquid Player or have adopted Liquid Store.

Japan. We recently established a new office in Tokyo to directly service and build new relationships with label, retail and consumer electronics companies.

Information regarding financial data by geographic area, as well as information regarding operating segments, is set forth in Part II, Item 8 on this Form 10-K in the Notes to Consolidated Financial Statements at Note 1, Segment Information, which information is hereby incorporated by reference.

Customers

We license our software and services to a variety of customers from various market segments. A selected list of our customers includes the following, each of which accounted for more than $10,000 of our revenues in 2001:

ARM	Plextor Corporation
Country Music Hall of Fame	Rhino Records
EMI Music Distribution	Sony Electronics Inc.
Microsoft	Sony UK
Palm, Inc.	Warner Music Group

In 1999, Adaptec, Super Stage and Liquid Audio Korea accounted for 31%, 30% and 12% of our total net revenues, respectively. In 2000, Cyber Music Entertainment, formerly Liquid Audio Japan, and Liquid Audio South East Asia through our strategic partner accounted for 42% and 11% of our total net revenues, respectively. In 2001, Cyber Music Entertainment and Liquid Audio Greater China accounted for 39% and 22% of our total net revenues, respectively.

Promotional Relationships. Numerous record labels and recording artists have used our products and services to promote new releases and create consumer awareness. These mutually beneficial promotional efforts have generated little or no direct revenue for us, individually or in the aggregate. The following table represents a partial list of artists and record labels for whom we have provided promotional services:

Record Labels

American Gramaphone	Arista Records	Artist Direct
Atlantic Records	Blue Note Records	BMG Distribution
Capitol Records	Columbia Records	Dreamworks Records
Elektra Records	EMI Recorded Music	Epic Records
Geffen Records	Hollywood Records	Interscope Records
Island Records/Def Jam	Jive	Matador
Maverick Records	MCA Records	Mercury Nashville
RCA Records	Reprise Records	Rhino Records
Roadrunner	Sony	Sparrow
Tommy Boy Records	TVT Records	Universal Music Group
V2 Records	Verve	Virgin
Warner Music Group	Wind-up Entertainment	Zomba Records Group

Recording Artists

Barenaked Ladies	Basement Jaxx	Bjork
Blink 182	Boz Scaggs	Brad Melhdau
Britney Spears	Bush	Busta Rhymes
Charlie Haden	Custom	Dave Matthews Band
De La Soul	Depeche Mode	Diana Krall
Drowning Pool	Dwight Yokam	Elvis Costello
Enya	Green Day	Ice Cube
Joe	Josh Groban	Lee Greenwood
Mannheim Steamroller	Melissa Etheridge	Mystikal
Natalie Merchant	New Order	Nickelback
No Doubt	Pink Floyd	P.O.D.
Powerman 5000	R. Kelley	Radiohead
Ramones	Randy Travis	REM
Rod Stewart	Steven Curtis Chapman	Sugar Ray
The Grateful Dead	The Strokes	Toby Keith
Uncle Kracker	Willie Nelson	ZOEgirl

Products and Services

Our platform includes software products and services that enable the secure digital delivery and sale of recorded music over the Internet. Our products and services can be separated into three major areas: *publishing and distribution, syndication and consumer delivery.*

Further information regarding products and services may be found in Part II, Item 8 of this Form 10-K in the Notes to Consolidated Financial Statements at Note 1, Segment Information, which information is hereby incorporated by reference.

Publishing and Distribution

Encoding Services. These services prepare music by artists and record companies for publishing. We use software tools to set rules by which the content can be used by consumers. Such software tools use security features, including digital rights management (DRM), encryption and watermarking, to provide copy protection. Our software tools also enable us to attach descriptive text, such as lyrics or album liner notes, graphics such as compact disc cover art, and copyright information to the music file. These are scalable services and we have developed an automated high capacity encoding production service that is currently able to encode approximately 20,000 individual sample sound recordings per day.

Hosting Services. These services can store and serve digital music for recording artists and labels. Content owners can use our services to feature music links on their websites and promote and sell music. Since launching these services in December 1997, more than 16,000 artists have used our hosting services. These artists have made more than 180,000 songs available for downloading either through the Liquid Music Network or their own websites.

Distribution Services. Content owners can leverage our distribution services to deliver music through a network of leading retail and music websites. They can also leverage these services to begin selling their music from their own website.

Subscription Services. We are currently developing a turnkey solution for artists and content owners that wish to sell digital downloads through online subscription services. This service offering leverages our existing publishing and distribution services, player technology and commerce platform. Scheduled to be launched in spring 2002, our initial consumer offering will feature an integrated Liquid Player and exclusive major label content that can be output to recordable compact discs and portable digital audio devices.

Promotion Services. We provide promotional services that leverage the Internet to help build awareness of artists and increase consumer traffic to retail and music sites. Our Promotions Manager is a web-based application that provides record labels and retailers with real-time access to digital music promotions and related customization features and merchandising resources.

Clearinghouse Services. Through our multi-format clearinghouse, we can clear online financial transactions and manage rights reporting for music downloads that are protected by either the Liquid Audio or Microsoft Windows Media DRM solutions. Our clearinghouse tracks streaming, downloading and purchase information and records it in tamper-resistant logs. This information is used for commerce management and to generate reports and invoices for the appropriate copyright owners.

Music Meeting. Music Meeting is an Internet music auditioning service for radio stations. We have partnered with Radio & Records (Ramp;R) to develop, promote and sell this service, which permits radio stations to retrieve promotional copies of new songs via real-time stream or secure digital download from the Ramp;R ONLINE website. Using our digital music delivery software, Music Meeting allows a radio station program director to audition and download new music, organize new releases and get updates on a record s airplay progress via Ramp;R s various music charts. This service began in January 2001.

Syndication

Liquid Store. The Liquid Music Network, launched in July 1998, is a music distribution network of leading music-related and retail websites and OEM customers. We provide these websites with the Liquid Store, a ready-made online music store, including its own shopping cart, through which consumers can preview, purchase and download digital recorded music from our catalog of content. Liquid Music Network affiliates simply sign up for the service and add hyperlinks to their home page to begin selling digital music.

Retail Integration and Fulfillment System (RIFFS). Liquid Audio s RIFFS solution enables the sale of secure digital music through existing e-commerce websites. RIFFS enables online retailers to seamlessly sell our music catalog right alongside physical goods through their existing shopping carts. Participating retailers can merchandise and offer any of the music downloads we distribute. We host the music and transparently fulfill digital delivery to the consumer. Regular reports let websites track download and sales activity.

Liquid Commerce. For websites that have a search engine but are not e-commerce enabled, we offer a pre-built online shopping cart that websites can use to custom brand and leverage to sell music. Websites can supplement their existing content with music from our catalog of content.

Consumer Delivery

Liquid Player. Our Liquid Player is a consumer desktop software application that enables users to stream, download and purchase digital music. To enhance the consumer experience, our Liquid Player presents lyrics, liner notes and album art with the music. Once content is downloaded, our Liquid Player can be used to organize the content into playlists. Our Liquid Player can be easily customized with faceplates to tie into the logo and branding of our partners websites and is available for both PC and Macintosh platforms. The product can be downloaded free of charge from our website and currently is distributed by the websites in our Liquid Music Network. An enhanced version of the product, Liquid Player Plus, is available to consumers for $19.95 and adds capabilities for transferring digital music to a recordable compact disc or outputting music to digital audio devices for later playback. Delivered in 2000, Liquid Player Plus is distributed through leading consumer device manufacturers and through our Liquid Music Network of retail and music websites. In spring of this year, our Liquid Player will include the capability to purchase digital music through our digital music subscription service.

Plug-ins. To expand our consumer base, we integrate our music delivery system with those from several of our partners. We provide plug-in software for AOL WinAmp, RealNetworks RealPlayer, RealJukebox and RealOne Player to enable consumers using these software products to preview and purchase content we distribute.

Technology

We have developed a technology platform and systems infrastructure that is designed to optimize the digital delivery of music. Our platform is based on four principal technology layers: component technologies, system technologies, network services and content syndication. We have developed and deployed technology in all of these layers to provide specific advantages for our music delivery products and services. We have invested significant amounts toward research and development to date. Our expenses in this area totaled approximately $11.7 million, $22.9 million and $17.0 million in 1999, 2000 and 2001, respectively.

Component Technologies. Our platform begins with component technologies, which include digital rights management, portable device platform, multi-format distribution container, watermarking and audio compression.

> ***Digital Rights Management (DRM).*** Our DRM solution protects content delivered online through a digital identification and rights reporting system. Consumers can use our FastTrack Security technology to enjoy secure music on one computer or use our Liquid Passport to move their music to multiple machines while still providing anti-piracy protections.
>
> ***Consumer Electronics Technology.*** Our Secure Portable Player Platform (SP3) provides content management and protection technology for consumer electronic devices. We have developed specific technologies to enable music to be securely copied to portable digital audio devices. The SP3 system also provides a technology interface that facilitates compatibility with other digital rights management systems.
>
> ***Multi-Format Distribution Container.*** We have developed a master media container that facilitates the delivery of media through our system. This container structure is designed to permit extension to other media types, such as third-party formats or video. The container is optimized for music distribution and includes multiple images that can be used to preview and purchase media content in

multiple formats including Liquid Audio, MP3, Microsoft Windows Media and Sony ATRAC3, and at multiple resolutions. The multi-format nature of the container also facilitates compatibility across systems. This container also facilitates the real-time insertion of information such advertising and promotions.

Watermarking. Watermarking embeds indelible and inaudible digital information into the audio waveform. We have developed our own patented watermarking technology that is specifically designed to operate in conjunction with compression technologies. The embedded information is useful for identifying and tracking audio usage and cannot be removed without destroying the recorded music.

Audio Compression. Audio compression reduces the bandwidth required to stream and download music over network connections. Our format-neutral music distribution system supports the delivery of music using several leading compression technologies: AAC, Sony ATRAC3, MS-Audio and MP3. We have added extensions to the AAC audio compression technology that further improve audio quality. In addition, we have developed an exclusive, proprietary lossless compression algorithm that is useful for professional audio applications.

System Technologies. Our system technologies build on top of the base features provided through our component technologies to enable our digital music delivery services.

Liquid Server. Our Liquid Server software is the heart of our platform and manages and delivers encoded music files for streaming or downloading. We have built transaction, security and copyright management functionality into the Liquid Server. We have integrated this software with a variety of e-commerce and database software applications so that a large volume of digital music and associated information can be securely sold or distributed through the Internet.

Territory Restrictions. We have been awarded a patent by the U.S. Patent Office for the territory restrictions capabilities in our platform. This technology identifies the approximate geographic location of consumers. We use this technology to enforce rules for content access related to territory. This enforcement is necessary since complex worldwide music licensing arrangements often preclude the sale of some content in specific territories.

Open Interfaces. We have developed interfaces to third-party systems for commerce, databases and general purpose media delivery. Our commerce interfaces allow our platform to take advantage of many payment methods from credit cards to micro-payment solutions. The database interfaces allow our system to dynamically update time sensitive information, such as pricing, without requiring expensive re-encoding of content. Our third-party system interfaces permit us to connect and provide compatibility with general purpose media delivery systems such as those provided by RealNetworks and Microsoft Corporation.

Secure Protocols. We have created secure protocols for communication between all parts of the system. Secure communications are necessary to prevent theft of content as it moves through the system. Secure links exist between the Liquid Server and content creation tools for publishing, the server and Liquid Player for consumer downloading, and the server and clearinghouse for transaction reporting.

Device Interfaces. We have developed SP3, which provides a set of security interfaces and techniques for secure digital audio devices. SP3 is an open specification for use by many device manufacturers. SP3 is consistent with the goals of the Secure Digital Music Initiative (SDMI) and is in use by several leading device manufactures. SDMI is sponsored by the Recording Industry Association of America (RIAA) to develop an open standard for the secure digital delivery and use of recorded music.

Network Services and Content Syndication. The implementation of our component and system technologies enables us to provide our network services and content syndication offerings. Our network services are driven out of the Liquid Operations Center, which operates primarily as a processing, security, copyright management and rights reporting center. Our content syndication services encompass RIFFS and the Liquid Store.

We believe that our technology architecture and our advanced stage of development and deployment provide distinct competitive advantages. We are currently developing the seventh generation of our digital music delivery products. The advantages of our technology are summarized below:

Content Distribution Technology. We have developed systems and technology to manage the distribution of content to online merchants such as retailers and service providers. This distribution technology automates and controls the terms for which content is made available to consumers via online retailers and service providers. This system also provides distribution tracking that facilitates customer support for online merchants.

Automated Encoding, Publication and Content Management. We have created technologies that improve the efficiency of online music distribution and reduce operating costs. Our content encoding system allows us to format large amounts of quality audio content for online use in a timely and cost effective manner. We also have developed a content management system that automates the services that are necessary for content creators to publish and manage their content. We have also developed database technology that permits us to manage the large volume of content in our distribution system.

Open Technical Architecture. An open system design is important because standard formats are not yet available for online music distribution. Our technology has been designed to provide an open and flexible solution that can adapt to many competing compression technologies and formats, including Sony ATRAC3, MP3 and Microsoft Windows Media, as well as future changes that may occur in digital music distribution. Our open system design allows the integration of new technologies while maintaining compatibility with existing content. In addition, our flexible architecture allows us to continue to integrate technologies such as audio compression and audio watermarking as they continue to improve in the future.

Robust and Scalable System Architecture. A comprehensive and robust system architecture is important to meet the demands that may result from large scale consumer adoption. We have developed a broad range of technologies that enables efficient music distribution services. We have developed specific technologies that permit our system to scale across multiple systems and locations. This technology provides unique advantages for efficiently delivering music and other media to a global audience.

Superior Audio Quality. We believe consumers will pay for quality music, and we believe that we have consistently provided superior audio quality for digital music. We employ specific techniques and optimize industry algorithms to improve sound quality. We believe that our use of standardized compression algorithms such as AAC, MP3 and Microsoft Windows Media, provides greater compatibility than proprietary audio compression solutions.

Sales and Marketing

Our sales and marketing efforts are principally concentrated on selling our products and services, developing complementary business opportunities, aggregating digital music recordings for syndication and sale, and broadening our content syndication reach by expanding the number and geographic reach of music and retail websites in our Liquid Music Network. We sell our products and services to artists, record companies, websites, OEMs and online retailers through a 24-person sales and marketing organization. These employees are located in Redwood City, Los Angeles, New York, London and Tokyo. Our software products and services are also bundled and distributed by third-party manufacturers of various computer hardware and software products.

We use a variety of marketing programs to create market awareness and generate demand for our products and services. Our marketing activities include event-based promotions with popular recording artists and record labels, web-based consumer outreach including a weekly music e-mail, press tours, participation in key trade events and conferences and other public relations activities.

In addition to maintaining relationships with worldwide rights societies and expanding the distribution opportunities for our products and services, our business development group works to develop new international markets and business opportunities for our products and services. We believe that establishing strategic relationships in each of the major international markets will accelerate the international deployment of our products and services.

Intellectual Property

Our success will depend in part on our ability to protect our proprietary software and other intellectual property. To protect our proprietary rights we rely generally on patent, copyright, trademark and trade secret laws, confidentiality agreements with employees and third parties, and license agreements with consultants, vendors and customers. Despite these protections a third party could, without authorization, copy or otherwise obtain and use our products or technology to develop similar technology independently.

Our agreements with employees, consultants and others who participate in product and service development activities may be breached, we may not have adequate remedies for any breach, and our trade secrets may become known or independently developed by competitors.

We currently have nine patents pending in the United States and eight patents pending in other countries relating to our product architecture and technology and hold fourteen patents. Those patents expire between October 2015 and October 2018. We have had claims allowed on two of our patent applications. Any pending or future patent applications may not be granted, existing or future patents may be challenged, invalidated or circumvented, and the rights granted under a patent that has issued or any patent that may issue may not provide competitive advantages to us. Many of our current and potential competitors dedicate substantially greater resources to protection and enforcement of intellectual property rights, especially patents. If a blocking patent has issued or issues in the future, we would need either to obtain a license or to design around the patent. We may not be able to obtain a required license on acceptable terms, if at all, or to design around the patent. See Legal Proceedings.

We pursue the registration of our trademarks and service marks in the United States and in other countries, although we have not secured registration of all our marks. A significant portion of our marks begin with the word Liquid. We are aware of other companies that use Liquid in their marks, alone or in combination with other words, and we do not expect to be able to prevent all third-party uses of the word Liquid. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the U.S., and effective patent, copyright, trademark and trade secret protection may not be available in these jurisdictions. We license our proprietary rights to third parties, and these licensees may fail to abide by compliance and quality control guidelines with respect to our proprietary rights or take actions that would harm our business.

To license many of our products, we rely in part on shrinkwrap and clickwrap licenses that are not signed by the end user and, therefore, may be unenforceable under the laws of certain jurisdictions. As with other software products, our products are susceptible to unauthorized copying and uses that may go undetected. Policing unauthorized use is difficult.

We attempt to avoid infringing known proprietary rights of third parties in our product and service development efforts. We have not, however, conducted, and do not conduct comprehensive patent searches to determine whether the technology used in our products infringes patents held by third parties. In addition, it is difficult to proceed with certainty in a rapidly evolving technological environment in which there may be numerous patent applications pending, many of which are confidential when filed, with regard to similar technologies. If we were to discover that our products violate third-party proprietary rights, we might not be able to obtain licenses to continue offering these products without substantial reengineering. Effort to undertake this reengineering might not be successful, licenses might be unavailable on commercially reasonable terms, if at all, and litigation might not be avoided or settled without substantial expense and damage awards.

Any claims relating to the infringement of third-party proprietary rights, even if not meritorious, could result in the expenditure of significant financial and managerial resources and could result in injunctions preventing us from distributing certain products and services. These claims could harm our business. We also rely on technology that we license from third parties, including software that is integrated with internally developed software and used in our products and services, to perform key functions. Third-party technology licenses may not continue to be available to us on commercially reasonable terms. The loss of any of these technologies could harm our business. Moreover, although we are generally indemnified against claims that third-party technology infringes the proprietary rights of others, this indemnification may be unavailable for all types of intellectual property rights, for example, patents may be excluded, and in some cases the scope of indemnification is limited. Even if we receive broad indemnification, third-party indemnitors are not always well capitalized and may not be able to indemnify us in the event of infringement, resulting in substantial exposure to us. Infringement or invalidity claims may arise from the incorporation of third-party technology, and our customers may make claims for indemnification. These claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources in addition to potential product and service redevelopment costs and delays, all of which could harm our business. Sightsound, Inc., Intouch Group, Inc. and Network Commerce, Inc. have claimed that our products infringe their patent rights. See Legal Proceedings.

Competition

Competition among companies in the business of delivering digital music over the Internet is intense. New or current competitors may emerge that are more successful than us. See Company Risk Factors The Market for Digital Delivery of Music Over the Internet is Highly Competitive, and if We Cannot Compete Effectively, Our Revenues Might Decline.

We compete with providers of infrastructure technology, products and services such as Full Audio, RioPort and Loudeye Technologies, providers of digital music subscription services such as Listen.com, MusicNet and pressplay and providers of music player software such as MusicMatch, RealOne or Microsoft Windows Media Player.

We believe that the primary competitive factors in our market are the following:

- quantity and variety of digital recorded music content;
- copyright licenses associated with digital recorded music;
- the number and quality of music-related and retail websites;
- ease of consumer experience;
- number of music players distributed;
- price and cost of products and services;
- ability to ensure secure digital delivery of recorded music;
- ability to adapt to changes in component technologies and consumer preferences;
- brand awareness; and
- fidelity and quality of sound of digital recorded music.

We believe our products and services offer significant advantages over those of our competitors:

- our music catalog features over 16,000 artists and 1,600 individual record labels. We believe that we offer more artists and more labels than most digital music distribution services;

through our Liquid Music Network, we believe we have the potential to reach more music consumers than other digital music delivery solutions;

our Liquid Player can be customized by our OEM customers to match their own branding initiatives. This customization enables our OEM customers to maintain and extend their relationships with their customers and provide both a branded Liquid Store and the ability to feature their own product offerings within the Liquid Player. Currently, no other company offering a digital music player or jukebox provides these features and instead redirect users to their own website;

our platform offers better copy protection and copyright management than Microsoft Windows Media or MP3-based solutions;

our open architecture will allow us to adapt to changing component technologies; and

the fidelity and sound quality of music encoded by our products and services are superior to competitive systems due to optimizations we perform on audio compression technologies used in our products and services.

Additionally, music community websites, such as Morpheus/Music City, WinMX and others, may attract consumers who want to share or download music from the Internet. These websites compete directly with our affiliates. To the extent that consumers download digital music from these websites rather than from our affiliates, our business may be harmed. Additionally, there are other companies, such as IBM, Microsoft, RealNetworks, RioPort and InterTrust Technologies Corporation, that provide component software technologies that facilitate the digital delivery of goods over the Internet, including music. To the extent that the market standardizes on these technologies and we are unable to incorporate these components into our music delivery services, our business may be harmed.

Employees

As of December 31, 2001, we had 105 full-time employees, including 24 in sales and marketing, 52 in research and development, 17 in general and administrative and 12 in operations. We consider our relationships with employees to be good. None of our employees is covered by collective bargaining agreements.

ITEM 1A. COMPANY RISK FACTORS

Our Limited Operating History in the New Market of Digital Delivery of Music over the Internet Increases the Possibility that the Value of Your Investment Will Decline

We incorporated in January 1996. We did not start generating revenues until the first quarter of 1997. In early 1999 we began to place greater emphasis on developing and marketing our digital music delivery services. Accordingly, we are still in the early stages of development and have only a limited operating history upon which you can evaluate our business. You should evaluate our chances of financial and operational success in light of the risks, uncertainties, expenses, delays and difficulties associated with starting a new business in the new market of digital delivery of music, many of which may be beyond our control.

We Have a History of Losses, We Expect Losses to Continue and We Might Not Achieve or Maintain Profitability

Our accumulated deficit as of December 31, 2001 was approximately $111.1 million. We had net losses of approximately $24.2 million, $33.7 million and $37.2 million in 1999, 2000 and 2001, respectively. Given the level of our planned operating and capital expenditures, we expect to continue to incur losses and negative cash flows through at least mid-2003. Even if we ultimately do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis. If our revenues grow more slowly than we anticipate, or if our operating expenses exceed our expectations and cannot be adjusted accordingly, our business and operating results will be harmed.

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

Several of our significant customers have had limited operating histories and have not achieved profitability. We believe that this will be true of other customers in the future. As of December 31, 2001, 69% or $315,000 of our accounts receivable from third parties and 100% or $1.6 million of our account receivables from related parties, were more than 30 days past due. You should evaluate the ability of these companies to meet their payment obligations to us in light of the risks, expenses and difficulties encountered by companies with limited operating histories. If one or more of our customers were unable to pay for our services in the future, or paid more slowly than we anticipate, recognition of revenue might be delayed and our operating results will be harmed.

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

We have recently decided to focus on providing a subscription-based service offering and a licensing-based offering for our customers. We have limited experience in pricing such new models, and failure to properly price and adjust these new pricing models may result in a loss of customers which would have an adverse effect on our business and operating results. Moreover, the price of Internet products and services is subject to rapid and frequent change. We may be forced, for competitive or technical reasons, to reduce or eliminate prices for certain of our products or services. If we are forced to reduce or eliminate prices, it would diminish our revenues and impact our margins, which will harm our business.

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

In the past, we derived a significant portion of our revenues from business development fees from relationships with our international partners, including Liquid Audio Korea, Liquid Audio Japan, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner. We recently terminated our relationships with these partners. Consequently, we do not expect additional revenue will be generated from them. If we are unable to establish additional relationships with international partners, and if such additional relationships do not generate a significant amount of revenue in future periods, then our future revenues could be lower than we anticipate and our business and operating results could be harmed. Furthermore, the commercial terms for these new relationships could cause our revenues to vary from period-to-period, which might result in unpredictability of our revenues.

We Might Not Be Successful in the Development and Introduction of New Products and Services

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

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

We Depend on Proprietary Rights to Develop and Protect Our Technology

Our success and ability to compete substantially depends on our internally developed technologies and trademarks, which we protect through a combination of patent, copyright, trade secret and trademark laws. We hold fourteen existing patents and currently have nine patents pending in the United States and eight patents pending in other countries. Our patents expire between October 2015 and October 2018. We have had claims allowed on two of our patent applications. We are presently pursuing the registration of our trademarks. Our patent applications or trademark registrations in the United States may not be approved. Even if they are approved, our patents or trademarks may be successfully challenged by others or invalidated. If our trademark registrations in the United States are not approved because third parties own these trademarks, our use of these trademarks would be restricted unless we enter into arrangements with the third-party owners, which might not be possible on commercially reasonable terms or at all.

The primary forms of intellectual property protection for our products and services internationally are patents and copyrights. Patent protection throughout the world is generally established on a country-by-country basis. To date, we have applied for eight patents outside the United States. Copyrights throughout the world are protected by several international treaties, including the Berne Convention for the Protection of Literary and Artistic Works. Despite these international laws, the level of practical protection for intellectual property varies among countries. In particular, United States government officials have criticized countries such as China and Brazil, two countries in which we do business, for inadequate intellectual property protection. If our intellectual property is infringed in any country in which we do business without a high level of intellectual property protection, our business and operating results could be harmed.

We generally enter into confidentiality or license agreements with our employees, consultants and corporate partners, and generally control access to and distribution of our technologies, documentation and other proprietary information. Despite our efforts to protect our proprietary rights from unauthorized use or disclosure, parties may attempt to disclose, obtain or use our solutions or technologies. The steps we have taken may not prevent misappropriation of our solutions or technologies, particularly in foreign countries where laws or law enforcement practices may not protect our proprietary rights as fully as in the United States.

We have licensed, and we may license in the future, certain proprietary rights to third parties. While we attempt to ensure that the quality of our brand is maintained by our business partners, they may take actions that could impair the value of our proprietary rights or our reputation. In addition, these business partners may not take the same steps we have taken to prevent misappropriation of our solutions or technologies.

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

From time to time, we receive letters from corporations and other entities suggesting that we review patents to which they claim rights or claiming that we infringe on their intellectual property rights. Such claims may result in our being involved in litigation. Although we do not believe we infringe the proprietary rights of any party, we cannot assure you that parties will not assert additional claims in the future or that any claims will not be successful. We could incur substantial costs and diversion of management resources to defend any claims relating to proprietary rights, which could harm our business. In addition, we are obligated under certain agreements to indemnify the other party for claims that we infringe on the proprietary rights of third parties. If we are required to indemnify parties under these agreements, our business could be harmed. If someone asserts a claim against us relating to proprietary technology or information, we might seek licenses to this intellectual property. We might not be able to obtain licenses on commercially reasonable terms, or at all. The failure to obtain the necessary licenses or other rights might harm our business and operating results. See   Legal Proceedings.

If Standards for the Secure, Digital Delivery of Recorded Music Are Not Adopted, the Piracy Concerns of Record Companies and Artists Might Not Be Satisfied, and They Might Not Use Our Platform for Digital Delivery of Their Music

Because other digital recorded music formats, such as MP3, do not contain mechanisms for tracking the source or ownership of digital recordings, record companies and artists are unable to prevent users from downloading and distributing unauthorized or pirated copies of copyrighted recorded music in these formats over the Internet. This piracy is a significant concern to record companies and artists, and is the primary reason many record companies and artists are reluctant to digitally deliver their recorded music over the Internet. If record companies and artists do not adopt a standard format, however, it may permit unsecure copies of recorded music to continue to be available on the Internet, and as a result record companies and artists might not permit the digital delivery of their music. Additionally, as long as pirated recordings are available, many consumers will choose free pirated recordings rather than paying for legitimate recordings. Accordingly, if a standard format for the secure digital delivery of music is not adopted, our business and operating results might be harmed.

We have designed our current products to be adaptable to different music industry and technology standards. Numerous standards in the marketplace, however, could cause confusion as to whether our products and services are compatible. If a competitor were to establish the dominant industry standard, our business would be harmed. It is too soon to determine whether our standard will be adopted as the dominant industry standard, if a standard is so adopted.

If Our Platform Does Not Provide Sufficient Rights Reporting Information, Record Companies and Artists Are Unlikely to Digitally Deliver Their Recorded Music Using Our Platform

Record companies and artists must be able to track the number of times their recorded music is downloaded so that they can make appropriate payments to music rights organizations, such as the American Society of Composers, Authors and Publishers, Broadcast Music Incorporated and SESAC, Inc. If our products and services do not accurately or completely provide this rights reporting information, record companies and artists might not use our platform to digitally deliver their recorded music, and our business might be harmed.

If Artists and Record Labels Are Not Satisfied that They Can Securely, Digitally Deliver Their Music Over the Internet, We Might Not Have Sufficient Content to Attract Consumers

Our success depends on our ability to aggregate a sufficient amount and variety of digital recorded music for syndication. In particular, until a significant number of artists and their record labels adopt a strategy of digitally delivering and selling music over the Internet, the growth of our business might be limited. We currently do not create our own content; rather, we rely on record companies and artists for digital recorded music to be syndicated using our format. We believe record companies will remain reluctant to distribute their recorded music digitally unless they are satisfied that the digital delivery of their music over the Internet will not result in the unauthorized copying and distribution of that music. If record companies do not believe that recorded music can be securely delivered over the Internet, they may not allow the digital distribution of their recorded music and we might not have sufficient content to attract consumers. If we cannot offer a sufficient amount and variety of digital recorded music for syndication, our business will be harmed.

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

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

- the availability of sufficient bandwidth on the Internet to enable consumers to download digital recorded music rapidly and easily;

- the willingness of consumers to invest in computer technology that facilitates the downloading of digital music;
- the cost of time-based Internet access;
- the number, quality and variety of digital recordings available for purchase through our system relative to those available through other online digital delivery companies, digital music websites, music swapping or sharing websites or through traditional physical delivery of recordings;
- the availability of portable devices to which digital recorded music can be transferred;
- the fidelity and quality of the sound of the digital recorded music; and
- the level of consumer comfort with the process of downloading and paying for digital music over the Internet, including ease of use and lack of concern about transaction security.

It is too soon to determine whether consumers will accept our platform as their primary application to download, manage and play digital music. A lack of customer acceptance would harm our business and operating results.

Companies Might Not Develop or Consumers Might Not Adopt Devices That Will Play Digitally Downloaded Music

We believe that the market for digitally recorded music delivered over the Internet will not develop significantly until consumers are able to enjoy this music other than solely through the use of a personal computer. Several consumer electronics companies have introduced or announced plans to introduce devices that will allow digital music delivered over the Internet to be played away from the personal computer. If companies fail to introduce additional devices, consumers do not adopt these devices or our products and services are incompatible with these devices, our business would be harmed. In addition, digital music can be transferred to a compact disc, but that transfer requires a compact disc recorder (CD-R). Many desktop computer manufacturers offer CD-Rs in their computers. If companies do not continue to offer CD-Rs in their computers, consumers do not adopt CD-Rs, or our products and services are incompatible with CD-Rs, our business might be harmed.

We Might Experience Delays in the Development of New Products and Services

We must continue to innovate and develop new versions of our software to remain competitive in the market for digital delivery of recorded music solutions. Our software products and services development efforts are inherently difficult to manage and keep on schedule. Our failure to manage and keep those development projects on schedule might harm our business.

The Market for Digital Delivery of Music Over the Internet is Highly Competitive, and if We Cannot Compete Effectively, Our Ability to Generate Meaningful Revenues Would Suffer Dramatically

Competition among companies in the business of digital delivery of music over the Internet is intense. We expect that present competitors will increase competitive pressure in the market for digital delivery of music.

Competition is likely to increase further as new companies enter the market and current competitors expand their products and services or merge with other competitors. Many of these potential competitors are likely to enjoy substantial competitive advantages, including the following:

- larger audiences;
- larger technical, production and editorial staffs;
- greater brand recognition;

- access to more recorded music content;
- a more established Internet presence;
- a larger advertiser base; and
- substantially greater financial, marketing, technical and other resources.

If we do not compete effectively or if we experience pricing pressures, reduced margins or loss of market share resulting from increased competition, our business and operating results would be harmed.

If MusicNet and pressplay License its Services to Our Competitors, and We Are Unable to License Similar Content, Our Business Could be Harmed

The major U.S. record companies have recently formed ventures for the licensing of their digital music subscription services to online music service providers. BMG Entertainment, EMI, Real Networks and Warner Music Group have formed a venture called MusicNet. Also, Universal Music Group (an unit of Vivendi Universal) and Sony Music Entertainment have formed a venture called pressplay. Musicnet and pressplay have recently launched their services, and may license their services to other third party online music service providers.

pressplay has reported that it has entered into distribution agreements with affiliates, including Yahoo!, Microsoft Network and MP3.com, and that is has entered into licensing agreements with six independent record labels including Madacy, Navarre, OWIE, Razor & Tie, Roadrunner and Rounder. The press has reported that MusicNet has licensed its service to America Online, Real Networks and Napster and that MusicNet has entered into a licensing agreement with Zomba Label Group which encompasses seven record labels: flagship Jive Records, Jive Electro, Silvertone, Verity, Brentwood, Reunion, and Volcano. If our competitors obtain licenses for digital music subscription services from MusicNet and pressplay and we are unable to obtain similar content provided by those services on commercially reasonable terms, these competitors may be able to develop a more compelling consumer product and our business could be harmed.

We Might Be Unable to License or Acquire Technology

We rely on certain technologies that we license or acquire from third parties, including Dolby Laboratories Licensing Corporation, Fraunhofer Institut, RSA Data Security, Inc. and Thomson Consumer Electronics Sales GmbH. These technologies are integrated with our internally developed software and used in our products, to perform key functions and to enhance the value of our platform. These third-party licenses or acquisitions may not continue to be available to us on commercially reasonable terms or at all. Any inability to acquire these licenses or software on commercially reasonable terms might harm our business.

Our Business Might Be Harmed if Challenges Against Intellectual Property Laws by New Digital Music Delivery Technologies Are Successful

New music sharing technologies allowing users to locate and download copies of digital music stored on the hard drives of other users without payment have been introduced into the market. Because some digital recorded music formats, such as MP3, do not contain mechanisms for tracking the source of ownership of digital recordings, users are able to download copies of copyrighted recorded music over the Internet without being required to compensate the owners of these copyrights. These downloads are a significant concern to record companies and artists. The Recording Industry Association of America has filed a suit seeking a permanent injunction against the use of these file-sharing technologies for exchange of copyrighted works. Several recording artists have also taken legal action against companies providing music sharing technology. If the injunction is denied, and it is determined that this file sharing technology is non-infringing, record companies and artists may limit their use of the Internet to sell and distribute their copyrighted materials. Even if the technology is determined to be infringing, it may be difficult to prevent this type of file sharing because of the non-centralized character of these technologies. As long as digital music copies are available through file sharing without payment, legally or illegally, consumers may choose not to pay for downloads from retail and other music delivery sites in our Liquid Music Network, which could harm our business.

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

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

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

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

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

We may not be successful in effectively using new technologies, developing new products or services or enhancing our existing products or services on a timely basis. These new technologies or enhancements may not achieve market acceptance. Our pursuit of necessary technological advances may require substantial time and expense. Finally, we may not succeed in adapting our services to new technologies as they emerge.

Our Products and Services Might Contain Errors

We offer complex products and services. They may contain undetected errors when first introduced or when new versions are released. If we market products and services that have errors or that do not function properly, then we may experience negative publicity, loss of or delay in market acceptance, or claims against us by customers, any of which might harm our business.

We Might Have Liability for the Content of the Recorded Music That We Digitally Deliver

Because we digitally deliver recorded music to third parties, we might be sued for negligence, copyright or trademark infringement or other reasons. These types of claims have been brought, sometimes successfully, against providers of online products and services in the past. Others could also sue us for the content that is accessible from our website through links to other websites. These claims might include, among others, claims that by hosting, directly or indirectly, the websites of third parties, we are liable for copyright or trademark infringement or other wrongful actions by these third parties through these websites. Our insurance may not adequately protect us against these types of claims and, even if these claims do not result in liability, we could incur significant costs in investigating and defending against these claims.

We have taken steps to prevent these claims. For example, we have arrangements with companies that use our hosting services that will allow us to delete potentially infringing or misappropriating materials quickly and securely. We also have put into place indemnification agreements with music content providers, where practicable. Under the Digital Millennium Copyright Act of 1999, Internet service providers are insulated from several types of these claims, upon compliance with the requirement that they appoint an agent to receive claims relating to their service, and we have appointed an agent.

System Failures or Delays Might Harm Our Business

Our operations depend on our ability to protect our computer systems against damage from fire, water, power loss, telecommunications failures, computer viruses, vandalism and other malicious acts, and similar unexpected adverse events. Our corporate headquarters are located in northern California. California had recently experienced power outages due to a shortage in the supply of power within the state. Although we maintain a comprehensive disaster recovery plan, if the power outages recur or increase in severity, they could disrupt our operations. Interruptions or slowdowns in our services have resulted from the failure of our telecommunications providers to supply the necessary data communications capacity in the time frame we required, as well as from deliberate acts. Despite precautions we have taken, unanticipated problems affecting our systems could in the future cause temporary interruptions or delays in the services we provide. Our customers might become dissatisfied by any system failure or delay that interrupts our ability to provide service to them or slows our response time. Sustained or repeated system failures or delays would affect our reputation, which would harm our business. Slow response time or system failures could also result from straining the capacity of our software or hardware due to an increase in the volume of products and services delivered through our servers. While we carry business interruption insurance, it might not be sufficient to cover any serious or prolonged emergencies, and our business might be harmed.

Our Future Success Depends on Our Key Personnel

Our future success depends to a significant extent on the continued service of our key technical, sales and senior management personnel and their ability to execute our growth strategy. The loss of the services of any of our senior level management, or other key employees, could harm our business. Our future performance will depend, in part, on the ability of our executive officers to work together effectively. Our executive officers may not be successful in carrying out their duties or running our company. Any dissent among executive officers could impair our ability to make strategic decisions quickly in a rapidly changing market.

Our future success also depends on our ability to attract, retain and motivate highly skilled employees. Competition for employees in our industry is intense. Although we provide compensation packages that include incentive stock options, cash incentives and other employee benefits, the volatility and current market price of our common stock may make it difficult for us to attract and retain highly qualified employees in the future. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications.

Fluctuations in Our Quarterly Revenues and Operating Results Might Lead to Reduced Prices for Our Stock

Our quarterly results of operations have varied in the past, and you should not rely on quarter-to-quarter comparisons of our results of operations as an indication of our future performance. In some future periods, our results of operations are likely to be below the expectations of public market analysts and investors. In this event, the price of our common stock would likely decline. Factors that have caused our results to fluctuate in the past and that are likely to affect us in the future include the following:

- the timing of individual software licenses to customers;
- competition for consumers from traditional retailers as well as providers of online music services;

- the announcement and introduction of new products and services by us and our competitors;
- distribution of the player through OEM and retail partners;
- the upgrade percentage of our promotional player to the paid Player Plus version;
- our ability to increase the number of websites that will use our platform for digital music delivery;
- the timing of our partners introduction of new products and services for digital music sales; and
- variability and length of the sales cycle associated with our product and service offerings.

In addition, other factors may also affect us, including:

- market adoption and growth of sales of digitally downloaded recorded music over the Internet;
- legal developments with respect to copyright law and downloadable music;
- our ability to attract significant numbers of music recordings to be syndicated in our format;
- our ability to provide reliable and scalable service, including our ability to avoid potential system failures;
- market acceptance of new and enhanced versions of our products and services; and
- the price and mix of products and services we offer.

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

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

- take advantage of opportunities, including acquisitions of complementary businesses or technologies;
- develop new products or services; or
- respond to competitive pressures.

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

Difficulties Presented by International Economic, Political, Legal, Accounting and Business Factors Could Harm Our Business in International Markets

A key component of our strategy is to expand into international markets. The following risks are inherent in doing business on an international level and we have little or no control over them:

- unexpected changes in regulatory requirements;
- export restrictions;
- export controls relating to encryption technology;
- longer payment cycles;

- problems in collecting accounts receivable;
- political and economic instability; and
- potentially adverse tax consequences.

In addition, other factors that may also affect us and over which we have some control include the following:

- difficulties in staffing and managing international operations;
- differences in music rights reporting structures; and
- seasonal reductions in business activity.

We recently terminated our individual agreements in Japan, Korea, greater China and south east Asia. We may enter into similar arrangements in the future in these and other countries. We also established a wholly-owned subsidiary in the United Kingdom and an office in Tokyo. One or more of the factors listed above may harm our present or future international operations and, consequently, our business.

Our Management and Internal Systems Might Be Inadequate to Handle the Potential Growth of Our Personnel

To manage future growth, our management must continue to improve our operational and financial systems and expand, train, retain and manage our employee base. Our management may not be able to manage our growth effectively. If our systems, procedures and controls are inadequate to support our operations, our expansion would be halted and we could lose our opportunity to gain significant market share. Any inability to manage growth effectively may harm our business.

Our Charter Documents and Delaware Law May Impede Or Discourage A Takeover, Which Could Lower Our Stock Price

Provisions of our restated certificate of incorporation and bylaws, and provisions of Delaware law, may have the effect of making it more difficult for a third party to acquire, or of discouraging a third party from attempting to acquire, control of us. For example, we have a classified board of directors which may tend to discourage a third party from making a tender offer or otherwise attempting to obtain control of us and may maintain the incumbency of our board of directors, as the classification of the board of directors increases the difficulty of replacing a majority of the directors. These provisions may have the effect of deferring hostile takeovers, delaying changes in our control or management, or may make it more difficult for stockholders to take certain corporate actions. Consequently, these provisions could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

Our Rights Plan May Impede Or Discourage a Takeover, Which Could Lower Our Stock Price

Our board of directors has approved a shareholders rights plan. The rights will become exercisable the tenth day after a person or group announces acquisition of 15% or more of our common stock or announces commencement of a tender or exchange offer the consummation of which would result in ownership by the person or group of 15% or more of our common stock. If the rights become exercisable, the holders of the rights (other than the person acquiring 15% or more of our common stock) will be entitled to acquire, in exchange for the rights exercise price, shares of our common stock or shares of any company in which we are merged, with a value equal to twice the rights exercise price. The rights may have the effect of rendering more difficult or discouraging an acquisition of the Company deemed undesirable by the board of directors. As a result, the rights could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

Risks Related to Our Industry

Internet Security Concerns Could Hinder E-Commerce

A significant barrier to e-commerce and communications over the Internet has been the need for secure transmission of confidential information. Internet usage may not increase at the rate we expect unless some of those concerns are adequately addressed and found acceptable by the market. Internet usage could also decline if any well-publicized compromise of security occurs. We may incur significant costs to protect against the threat of security breaches or to alleviate problems caused by these breaches. Protections may not be available at a reasonable price or at all. If a third person were able to misappropriate a user s personal information, users could bring claims against us.

Imposition of Sales and Other Taxes On E-Commerce Transactions Might Hinder E-Commerce

We do not collect sales and other taxes when we sell our products and services over the Internet. State or local governments may seek to impose sales tax collection obligations on out-of-state companies, such as ours, which engage in or facilitate e-commerce. A number of proposals have been made at the state and local level that would impose additional taxes on the sale of products and services through the Internet. These proposals, if adopted, could substantially impair the growth of e-commerce and could reduce our opportunity to derive profits from e-commerce. Moreover, if any state or local government or foreign country were to successfully assert that we should collect sales or other taxes on the exchange of products and services on our system, our business might be harmed.

In 1998, Congress passed the Internet Tax Freedom Act, which imposed a three-year moratorium on state and local taxes on Internet-based transactions. The moratorium was scheduled to expire in October 2001. Recently, Congress extended the Internet Tax Freedom Act until November 1, 2003. We cannot assure you that this moratorium will be extended beyond November 1, 2003. Failure to extend this moratorium beyond that date would allow various states to impose taxes on e-commerce, which might harm our business.

In February 2002, European Finance Ministers announced that beginning July 2003 Value Added Tax (VAT) will be imposed on services delivered electronically over the Internet from suppliers outside the European Union (EU). The tax may substantially impair the growth of e-commerce in the EU and may reduce our opportunity to derive e-commerce in the EU, and our business could be harmed.

Demand for Our Products and Services Might Decrease if Growth in the Use of the Internet Declines

Our future success substantially depends upon the continued growth in the use of the Internet. The number of users on the Internet may not increase and commerce over the Internet may not become more accepted and widespread for a number of reasons, including the following, over which we have little or no control:

- actual or perceived lack of security of information, such as credit card numbers;
- lack of access and ease of use;
- inconsistent quality of service and lack of availability of cost-effective, high speed service;
- possible outages due to damage to the Internet;
- excessive governmental regulation; and
- uncertainty regarding intellectual property rights.

If the necessary infrastructure, products, services or facilities are not developed, or if the Internet does not grow as a commercial medium, our business would be harmed.

Government Regulation of the Internet Might Harm Our Business

The applicability to the Internet of existing laws governing issues such as property ownership, libel and personal privacy is uncertain. In addition, governmental authorities may seek to further regulate the Internet with respect to issues such as user privacy, pornography, acceptable content, e-commerce, taxation, and the pricing, characteristics and quality of products and services. Finally, the global nature of the Internet could subject us to the laws of a foreign jurisdiction in an unpredictable manner. Any new legislation regulating the Internet could inhibit the growth of the Internet and decrease the acceptance of the Internet as a communications and commercial medium, which might harm our business.

In addition, the growing use of the Internet has burdened the existing telecommunications infrastructure and has caused interruptions in telephone service. Telephone carriers have petitioned the government to regulate the Internet and impose usage fees on Internet service providers. Any regulations of this type could increase the costs of using the Internet and impede its growth, which could in turn decrease the demand for our services or otherwise harm our business.

ITEM 2. PROPERTIES

Our headquarters are located in 40,795 square feet of leased office space in Redwood City, California. The lease term extends to May 30, 2005. We lease an office suite near the former headquarters in Redwood City, California on a month-to-month basis, for additional storage needs. In connection with our restructuring in May 2001, we consolidated our then three Redwood City, California offices into the aforementioned headquarters. We continue to lease these three offices until the expiration of their terms, and have subleased one of the offices. We lease 11,400 square feet of leased office space in Redwood City at our former headquarters location. The lease term extends to April 14, 2002 with a three-year renewal, at our option. We lease an additional 18,200 square feet of office space near our former headquarters. The lease term for this additional space extends to November 15, 2002 with two five-year renewals, at our option. We lease an additional 26,800 square feet of office space near our former headquarters. The lease term for this additional space extends to August 31, 2002 with a three-year renewal, at our option. We have subleased this space to a tenant through July 31, 2002.

ITEM 3. LEGAL PROCEEDINGS

In November 2001, two lawsuits were filed in Delaware Chancery Court naming us and certain of our officers and directors as defendants. Both actions related to our response to recent acquisition offers and purported to be class actions brought on behalf of our shareholders. On February 1, 2002, the two complaints were consolidated into a single action, titled *In Re Liquid Audio, Inc. Shareholders Litigation*, Consolidated Civil Action No. 19212-NC. That action was brought against Gerald W. Kearby, Silvia Kessel, Ann L. Winblad and us. The complaint alleges that defendants had breached their fiduciary duties owed to our shareholders in connection with our response to acquisition offers from Steel Partners II, LLP and an investor group formed by musicmaker.com, Inc. The complaint seeks, among other things, a court order barring us from adopting or maintaining measures that would make us less attractive as a takeover candidate or, alternatively, awarding compensatory damages to the purported plaintiff class. To date, we have not responded to the complaint, nor has the court set a date for discovery cutoff or trial. We intend to vigorously defend the action. There is no assurance concerning the outcome of either action, or whether either action would have a material effect on our financial condition or business operations.

On or about September 27, 2001, Network Commerce, Inc. (NCI) filed a Complaint against us in the United States District Court for the Western District of Washington (Seattle). The suit alleges that we infringe the claims of United States Patent No. 6,073,124. NCI requests that we be enjoined from our allegedly infringing activities and seeks unspecified damages. We were served with the Complaint on November 2, 2001 and subsequently submitted an answer to the Complaint that included counterclaims. In February 2002, we entered into settlement negotiations but have yet to reach a settlement.

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

On July 20, 2001, a putative securities class action, captioned *Murowa Financial v. Liquid Audio, Inc. et al.*, Civil Action No. 01-CV-6661, was filed against us, certain of our officers and directors (the Individual Defendants) and three underwriters in our initial public offering (the IPO), in the United States District Court for the Southern District of New York. The Complaint seeks unspecified damages on behalf of a purported class of purchasers of our common stock between July 8, 1999 and December 6, 2000. Several complaints substantially identical to *Murowa* were later filed against us, the Individual Defendants, and several of the IPO underwriters in the Southern District of New York. These cases have been consolidated under Civil Action No. 01-CV-6661. These complaints generally allege that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in our initial public offering and secondary offering of securities. The complaints bring claims for violation of several provisions of the federal securities laws against those underwriters, and also against us and certain of our directors and officers. Various plaintiffs have filed similar actions asserting virtually identical allegations against more than 300 other companies. The lawsuit and all other 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. We believe that we have meritorious defenses to the claims and intend to vigorously defend against such claims.

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

On March 31, 2000, Intouch Group, Inc. (Intouch) filed a lawsuit against us in the United States District Court for the Northern District of California alleging patent infringement. The Complaint names us, Amazon.com, Inc., Listen.com, Inc., Entertaindom LLC, DiscoverMusic.com, Inc. and Muze, Inc. It alleges that these parties infringe, or induce infringement of, the claims of United States Patent Nos. 5,237,157 (the 157 patent) and 5,963,916 (the 916 patent) by operating a web site and/or a kiosk that allows interactive previewing of pre-recorded music products. The Complaint seeks unspecified damages and injunctive relief. We answered Intouch s first amended complaint, denying the material allegations of the amended complaint, and asserting counterclaims for declaratory judgment of non-infringement, patent invalidity and inequitable conduct. In May 2001, the parties reached an agreement in principle to settle Intouch s claims on the 157 patent. On February 6, 2002, the parties executed a final settlement regarding the 916 patent. Pursuant to the settlement, the terms of which are confidential, Intouch has dismissed its suit with prejudice as to us and granted us a nonexclusive license on the 916 patent. The settlement did not have a material impact on our financial position or results of operations.

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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no submissions of matters to a vote of securities holders during the quarter ended December 31, 2001.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Price of Common Stock

Our common stock has been quoted on the Nasdaq National Market under the symbol LQID since July 8, 1999. The following table presents, for the periods indicated, the high and low closing prices per share of the common stock as reported on the Nasdaq National Market.

	High	Low
Year Ended December 31, 1999		
Third Quarter (since July 8, 1999)	$ 40.44	$ 20.88
Fourth Quarter	45.13	26.25
Year Ended December 31, 2000		
First Quarter	34.06	13.25
Second Quarter	19.00	6.69
Third Quarter	14.50	4.25
Fourth Quarter	6.00	2.16
Year Ended December 31, 2001		
First Quarter	3.88	2.00
Second Quarter	2.95	1.81
Third Quarter	2.95	2.03
Fourth Quarter	2.72	2.10

The closing price per share of the common stock at March 13, 2002 was $2.27. As of March 13, 2002, there were approximately 126 holders of record of our common stock. Because many shares of our common stock are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders.

Dividend Policy

We have never declared or paid any dividends on our common stock. We do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain future earnings, if any, to finance operations and the expansion of our business. Any future determination to pay cash dividends will be at the discretion of the board of directors and will depend upon our financial condition, operating results, capital requirements and other factors the board of directors deems relevant.

Preferred Stock Rights Agreement

On August 7, 2001, our Board of Directors adopted a Preferred Stock Rights Agreement under which we declared a dividend of one right to purchase one one-thousandth share of our Series A participating preferred stock for each outstanding share of common stock. The rights will separate from the common stock and become exercisable following (i) the tenth day (or such later date as may be determined by our Board of Directors) after a person or group of affiliated or associated persons has acquired, or obtained the right to acquire, beneficial ownership of 15% or more of the common stock then outstanding or (ii) the tenth business day (or such later date as may be determined by our Board of Directors) after a person or group announces a tender of exchange offer, the consummation of which would result in ownership by a person or group of 15% or more of our then outstanding common stock. Each right will entitle the holder to purchase for $17.00 one one-thousandth of a share of Series A preferred stock with economic terms similar to that of one share of our common stock.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data should be read in conjunction with Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and related notes thereto included in Item 8 included elsewhere in this document to fully understand factors that may affect the comparability of the information presented below.

	Year Ended December 31,				
	2001	2000	1999	1998	1997
	(in thousands, except per share data)				
Statement of Operations Data:					
Net revenues:					
License	$ 682	$ 1,284	$ 1,537	$ 1,235	$ 246
Services	1,173	2,977	733	268	10
Business development (related party)	2,873	7,307	2,137	1,300	
Total net revenues	4,728	11,568	4,407	2,803	256
Cost of net revenues:					
License	491	290	235	310	302
Services	1,503	2,722	1,122	242	91
Business development (related party)		75	79	2	
Non-cash cost of revenues	349	28	25	36	15
Total cost of net revenues	2,343	3,115	1,461	590	408
Gross profit (loss)	2,385	8,453	2,946	2,213	(152)
Operating expenses:					
Sales and marketing	11,404	17,114	10,217	4,035	2,820
Non-cash sales and marketing	(43)	314	783	741	304
Research and development	16,957	22,917	11,706		