LIQUID AUDIO INC
Form 10-K
March 30, 2001

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, 2000
OR
[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number 000-25977

LIQUID AUDIO, INC.
(Exact name of Registrant as specified in its charter)

Delaware	77-0421089
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
2221 Broadway Redwood City, California	94063
(address of principal executive offices)	(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

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 $44,919,341 as of December 31, 2000 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 22,556,554 shares of the Registrant's Common Stock issued and outstanding on March 14, 2001.

DOCUMENTS INCORPORATED BY REFERENCE

Certain sections of Liquid Audio, Inc.'s definitive Proxy Statement for the 2001 Annual Meeting of Stockholders, scheduled to be held on June 1, 2001, are incorporated by reference in Part III of this Form 10-K to the extent stated herein.

TABLE OF CONTENTS

		Page
	PART I	
ITEM 1.	BUSINESS	1
ITEM 1A.	COMPANY RISK FACTORS	12
ITEM 2.	PROPERTIES	22
ITEM 3.	LEGAL PROCEEDINGS	22
ITEM 4.	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	23
	PART II	
ITEM 5.	MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS	24
ITEM 6.	SELECTED FINANCIAL DATA	26
ITEM 7.	MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	27
ITEM 7A.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	35
ITEM 8.	FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA	36
ITEM 9.	CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE	36
	PART III	
ITEM 10.	DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT	37
ITEM 11.	EXECUTIVE COMPENSATION	41
ITEM 12.	SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT	41
ITEM 13.	CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS	41
	PART IV	
ITEM 14.	EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K	42

PART I

ITEM 1. BUSINESS

This Annual Report on Form 10-K and the documents incorporated herein by reference 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," "believes," "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, including those noted in the documents incorporated herein by reference. 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

We provide a leading open platform that enables the digital delivery of music over the Internet. 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 over 1,000 third party music related websites 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, 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 Artemis Records, Avex, Inc., BMG Entertainment, EMI Music Group, Warner Music Group and Zomba Records Group, and artists such as David Bowie, Lenny Kravitz, Aimee Mann, "N SYNC and Britney Spears.

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 up to approximately 20,000 individual music samples per day. Our system hosts digital music files and distributes them through a network of music websites.

- Syndication. Our distribution system syndicates music content to a network of 1,000 affiliates that make up the Liquid Music Network, including music websites and websites operated by music retailers. In addition, our system enables digital music delivery through kiosks located in retail stores.

- 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 or purchase and download digital recorded music. 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 rapidly growing inventory. 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, Windows Media and MP3.

- Security and Compliance. Our digital rights management (DRM) system protects 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, including Liquid Audio, Windows Media and MP3. We also support several leading DRM systems, including Liquid Audio, Windows Media 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 who have limited access to traditional retail distribution channels.

Strategic Relationships and Customers

We plan to continue to build relationships with key third parties engaged in the encoding, hosting, distribution, promotion, syndication and sale 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.

- BMG Entertainment. We entered into a digital music distribution agreement with BMG Entertainment whereby BMG will use our technology and distribution services to promote and sell albums from BMG's recording artists through Liquid Audio kiosks at participating retailers in the United States and Europe.

- edel music. In Europe, we entered into a digital music distribution agreement with edel music whereby edel will use our technology and distribution services to promote and sell albums from edel's recording artists through kiosks at participating retailers.

- 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 and towerrecords.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, Rounder Records, Strictly Rhythm, Sub Pop Records, Twin/Tone Records and Vanguard Records. As of December 31, 2000, record labels have chosen to promote and sell more than 140,000 digital music recordings through our Liquid Music Network. This compares to approximately 50,000 digital music recordings at the beginning of 2000.

Channel Partners. Our distribution channel has grown to 1,000 outlets, including some of the most popular music websites.

- 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 our Retail Integration and Fulfillment System (RIFFS) 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.

- Towerrecords.com. Under an agreement with its parent company MTS, Inc., Tower Records is using RIFFS to promote and sell digital music to consumers through its online retail website, towerrecords.com. The website began offering music content for sale in October 1999.

. Yahoo! Yahoo! Inc. has integrated Liquid Audio music samples using our music clips service on the Yahoo! Shopping and Yahoo! Music websites.

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. We have 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 will be distributed by AOL on the winamp.com website, its other websites and ours.

. ARM. We have entered into an agreement with ARM to create a turnkey platform for the development of secure digital audio devices. We will work together to integrate our Secure Portable Player Platform (SP3) onto the ARM architecture. This integration will make 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.

. Microsoft. To maximize the number of consumers getting music through our distribution network, we added support for the Windows Media format. We encoded and distribute more than 50,000 songs and 1 million music previews in the Windows Media format. We 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 are adding support for Windows Media to Liquid Player.

. RealNetworks Inc. We have developed software "plug-ins" that enable RealNetwork's RealPlayer G2 and RealJukebox software to play music encoded in our format. The plug-ins, which are distributed by RealNetworks, enable music in our Liquid Music Network to be previewed by RealPlayer G2 users and securely downloaded by RealJukebox users.

. 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	PocketPyro Porteson

Digitalw@y Company, Ltd.	RHAS TEL Company, Ltd.
e.Digital Corporation	Saewon Telecom Ltd.
Haitai Electronics Co., Ltd.	Sanyo Corporation
IOData	RHAS TEL Company, Ltd.
Jungmyung Telecom	TDK
Mpuls3	Toshiba Corporation

International Relationships

We believe that relationships with key partners outside the United States are important to establish a complementary international distribution infrastructure. Because personal computers have not achieved high levels of penetration in most international markets, our emphasis in these markets has been and will continue to be on enabling the distribution of digital music through physical kiosks and other consumer-oriented technologies. Our international relationships 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 have adopted RIFFS.

- Liquid Audio Japan. In Japan, along with local investors, we established Liquid Audio Japan. Liquid Audio Japan is the exclusive reseller and distributor of our software products, and the exclusive music distribution services provider, in Japan.

- Liquid Audio Korea. In Korea, Liquid Audio and local partners established Liquid Audio Korea in 1998. Liquid Audio Korea is currently focused on kiosk-based retail applications of our technology. These applications allow consumers to preview and purchase custom compact discs and other transportable media from retail entertainment centers. Liquid Audio Korea released these kiosks in the first retail entertainment center in October 1999.

- Liquid Audio Greater China. For the Hong Kong and Taiwan markets, Liquid Audio and local partners established Liquid Audio Greater China in 2000. Liquid Audio Greater China and its subsidiaries have the opportunity to deploy and resell Liquid Audio's secure music delivery services and software products in Hong Kong and Taiwan.

- Liquid Audio South East Asia. In south east Asia, Liquid Audio and a local partner are in the process of establishing Liquid Audio South East Asia. Liquid Audio South East Asia will form affiliates in Singapore, Thailand, the Philippines, Australia and New Zealand. We expect these affiliates to be the exclusive reseller of our software products, and the exclusive music distribution services provider, in those local markets.

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 2000:

BMG North America	Microsoft
Cube	Napster

Duty Free Shops	Random House
EMI Music Distribution	Sony Electronics Inc.
HMV	Sony UK
Launch.com	Tower Records

In 1998, SKM Group accounted for 34% of our total net revenues. In 1999, Adaptec, Super Stage and Liquid Audio Korea accounted for 31%, 30% and 12% of our total net revenues, respectively. In 2000, Liquid Audio Japan and Liquid Audio South East Asia through our strategic partner accounted for 42% and 11% 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

Angel Records	Arista Records Inc.	Atlantic Records
Blue Note Records	Capitol Records	Dreamworks Records
Elektra Records	EMI Recorded Music	Epic Records
Geffen Records	Giant/Revolution	GRP
Hollywood Records	Interscope Records	Island Records/Def Jam
Jive	LaFace Records	Maverick Records
MCA Records	Mercury Nashville	RCA Records
Reprise Records	Rhino Records	Smithsonian Folkways
Tommy Boy Records	TVT Records	V2 Records
Virgin	Warner Music Group	Wind-up Entertainment
Zomba Records Group		

Recording Artists

Aaron Neville	Al Jarreau	Alanis Morissette
A Perfect Circle	Beck	Ben Harper
Brian Setzer Orchestra	Britney Spears	Carlos Santana
Creed	Crosby, Stills, Nash & Young	The Dave Matthews Band
David Bowie	Duran Duran	Elton John
Emmylou Harris	Enya	Everclear
Faith Hill	Hanson	(Hed) Planet Earth
Herbie Hancock	Hole	Jamie O'Neal
Jimi Hendrix	Joni Mitchell	Kenny G
Led Zeppelin	Lee Ann Womack	Lenny Kravitz
Madonna	matchbox twenty	Moby
Natalie Merchant	Nelly Furtado	N'SYNCH
Page/Plant	P.O.D.	Sarah McLachlan
Scorpions	Sinead O'Connor	Snoop Dog
Tori Amos	XTC	

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.

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 up to 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 10,800 artists have used our hosting services. These artists have made more than 140,000 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 more than 1,000 affiliates that offer our music. They can also leverage these services to begin selling their music from their own website.

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. Liquid Promotions include Internet advertisements, promotional Internet events such as Liquid Live performances and featured placement of artists' music on hundreds of websites.

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 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 (R&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 R&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 R&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 more than 1,000 affiliates including music-related and retail websites. We provide these music-related 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.

Digital Music Kiosks. We provide retailers with the ability to digitally deliver music in brick-and-mortar stores using our platform through kiosks located in entertainment centers or other retail locations. These digital music kiosks let consumers preview and purchase custom compilations of songs and transfer them to a personalized compact disc right in the store. The first kiosk installation opened in Korea in October 1999. We have also sold kiosks to customers in the United States, United Kingdom, Austria, Japan and Singapore.

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 hundreds of websites in our Liquid Music Network. An enhanced version of the product, Liquid Player Plus, 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 the first Secure Digital Music Initiative (SDMI) compliant digital music solution for original equipment manufacturers (OEMs) who license the product for a fee to bundle with their products, including digital audio devices, CD-R devices and personal computers. 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.

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 and RealJukebox 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 $4.1 million, $11.7 million and $22.9 million in 1998, 1999 and 2000, 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 and soon, Windows Media, 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 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: Dolby Digital AC-3, AAC, Sony ATRAC3, MS-Audio and MP3. We have developed a version of Dolby Digital technology (AC-3) that is optimized for online music distribution. We have also 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 SDMI and is in use by several leading device manufactures.

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, the Liquid Store and kiosks.

We believe that our technology architecture and our advanced stage of development and deployment provide distinct competitive advantages. We are currently developing the sixth 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 soon, 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. We have also developed technology that allows us to extend our system beyond online applications to include physical locations for sales of music via kiosks, broadening our reach to include both online and traditional consumers.

- 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 soon, 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 and online retailers through a 62-person sales and marketing organization. These employees are located in Redwood City, Los Angeles, New York and London. 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 advertising and sponsorships, press tours, participation in 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 17 patents pending in the United States and four patents pending in other countries relating to our product architecture and technology and hold seven 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. and Intouch Group, Inc. have recently 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. We compete against a number of technology companies that are offering or plan to offer products, services or technologies for the delivery of digital music over the Internet. The number of websites competing for the attention and spending of consumers and advertisers has increased, and we expect it to continue to increase. We may also compete with consumer electronics companies as they begin to market Internet music player devices. 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 Preview Systems, SuperTracks and Loudeye Technologies, and aggregators of digital music content for delivery over the Internet and kiosks such as eMusic, Amplified.com and RedDot.net.

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

- price and cost of products and services;

- quantity and variety of digital recorded music content;

- ease of consumer experience;

- the number and quality of music-related and retail websites;
- brand awareness;
- ability to adapt to changes in component technologies and consumer preferences;
- fidelity and quality of sound of digital recorded music; and
- ability to ensure secure digital delivery of recorded music.

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

- our music catalog features over 10,800 artists and 1,200 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 platform offers better copy protection and copyright management than 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 Napster and MP3.com, may attract consumers who want to 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, some of these music community websites are developing business models that compete directly with us, whereby they will also provide infrastructure technology and aggregate digital music content for delivery over the Internet. To the extent that retailers choose such websites for the distribution technology and aggregated content rather than ours, our business may be harmed. Finally, there are other companies, such as IBM, Microsoft, RealNetworks 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, 2000, we had 218 full-time employees, including 62 in sales and marketing, 86 in research and development, 37 in general and administrative and 33 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, 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, 2000 was approximately $73.9 million. We had net losses of approximately $24.2 million and $33.7 million in 1999 and 2000, 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 2002. Even if we ultimately do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis. If our revenues grow more slowly than we anticipate, or if our operating

expenses exceed our expectations and cannot be adjusted accordingly, our business will be harmed. See "Selected Financial Data" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

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

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

- competition for consumers from traditional retailers as well as providers of online music services;
- the announcement and introduction of new products and services by us and our competitors;
- our ability to increase the number of websites that will use our platform for digital music delivery;
- the timing of our partners' introduction of new products and services for digital music sales; and
- variability and length of the sales cycle associated with our product and service offerings.

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

- market adoption and growth of sales of digitally downloaded recorded music over the Internet;

- our ability to attract significant numbers of music recordings to be syndicated in our format;

- our ability to provide reliable and scalable service, including our ability to avoid potential system failures;

- market acceptance of new and enhanced versions of our products and services; and

- the price and mix of products and services we offer.

Some of these factors are within our control and others are outside of our control.

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

Several of our significant customers, including our international partners Liquid Audio Japan, Liquid Audio Korea, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner, have had limited operating histories and have not achieved profitability. We believe that this will be true of other customers in the future. As of December 31, 2000, 60% and 96% of our trade accounts receivable and receivables from related parties, respectively, or $789,000 and $1.2 million, respectively, were more than 30 days past due. You should evaluate the ability of these companies to meet their payment obligations to us in light of the risks, expenses and difficulties encountered by companies with limited operating histories. If one or more of our customers were unable to pay for our services in the future, or paid more slowly than we anticipate, recognition of revenue might be delayed and our business might be harmed.

If Our Relationships with Our International Partners Terminate, Our Revenues Might Decline

We derive a portion of our revenues from business development fees from relationships with our international partners, including Liquid Audio Korea, Liquid Audio Japan, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner. These relationships vary in size and scope. If one of these relationships does not generate a similar amount of revenue in subsequent periods or if a party is

unable to make its scheduled payments to us, then our business could be harmed. Furthermore, the commercial terms for these relationships could cause our revenues to vary from period-to-period, which might result in unpredictability of our revenues.

Our Revenues Would Be Negatively Effected by the Loss of a Significant Customer

We have derived, and we believe that we will continue to derive, a substantial portion of our net revenues from a limited number of customers and projects. Our ten largest customers for 1999 and 2000 represented approximately 86% and 78%, respectively, of our total net revenues. The loss of any significant customer or any significant reduction of total net revenues generated by significant customers, without an increase in revenues from other sources, would harm our business. The volume of products or services we sell to specific customers is likely to vary year to year, and a major customer in one year may not use our services in a subsequent year. A customer's decision not to use our services in a subsequent year might harm our business.

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

Because other digital recorded music formats, such as MP3, do not contain mechanisms for tracking the source or ownership of digital recordings, users are able to download and distribute unauthorized or "pirated" copies of copyrighted recorded music over the Internet. This piracy is a significant concern to record companies and artists, and is the reason many record companies and artists are reluctant to digitally deliver their recorded music over the Internet. The Secure Digital Music Initiative (SDMI) is a committee formed by the Recording Industry Association of America (RIAA) to propose a standard format for the secure digital delivery and use of recorded music. If a standard format is not adopted, however, unsecure copies of recorded music may continue to be available on the Internet, and record companies and artists might not permit the digital delivery of their music. Additionally, as long as pirated recordings are available, many consumers will choose free pirated recordings rather than paying for legitimate recordings. Accordingly, if a standard format for the secure digital delivery of music is not adopted, our business might be harmed.

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

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

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

- take advantage of opportunities, including more rapid international expansion or 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 "Risk Factors" section. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Our Future Success Depends on Our Key Personnel

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

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

We Depend on Proprietary Rights to Develop and Protect Our Technology

Our success and ability to compete substantially depends on our internally developed technologies and trademarks, which we protect through a combination of patent, copyright, trade secret and trademark laws. Patent applications or trademark registrations may not be approved. Even if they are approved, our patents or trademarks may be successfully challenged by others or invalidated. If our trademark registrations are not approved because third parties own these trademarks, our use of these trademarks would be restricted unless we enter into arrangements with the third-party owners, which might not be possible on commercially reasonable terms or at all.

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

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

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

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

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

If We Do Not Increase the Number of Websites that Use Our Platform, Our Business Will Not Grow

In order to grow our business, we need to increase the number of websites, including websites operated by music retailers, that use our technology and our syndicated content to digitally deliver recorded music. To increase the number of websites, we must do the following:

- offer competitive products and services that meet industry standards;
- attract more music content;
- make it easy and cost-effective for music-related websites to sell digital music;
- develop relationships with online retailers, music websites, online communities, broadband providers and Internet broadcasters; and
- develop relationships with international music websites, retailers and broadband providers.

Any failure to achieve one or more of these objectives would harm our business. We may not be successful in achieving any of these objectives.

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

Our success depends on our ability to aggregate a sufficient amount and variety of digital recorded music for syndication. In particular, until a significant number of artists and their record labels adopt a strategy of digitally delivering music over the Internet, the growth of our business might be limited. We currently do not

create our own content; rather, we rely on record companies and artists for digital recorded music to be syndicated using our format. We believe record companies will remain reluctant to distribute their recorded music digitally unless they are satisfied that the digital delivery of their music over the Internet will not result in the unauthorized copying and distribution of that music. If record companies do not believe that recorded music can be securely delivered over the Internet, they will not allow the digital distribution of their recorded music and we might not have sufficient content to attract consumers. If we cannot offer a sufficient amount and variety of digital recorded music for syndication, our business might be harmed.

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

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

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

- the willingness of consumers to invest in computer technology that facilitates the downloading of digital music;

- the cost of time-based Internet access;

- the number, quality and variety of digital recordings available for purchase through our system relative to those available through other online digital delivery companies, digital music websites, music swapping or sharing websites or through traditional physical delivery of recordings;

- the availability of portable devices to which digital recorded music can be transferred;

- the fidelity and quality of the sound of the digital recorded music; and

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

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

Competition among companies in the business of digital delivery of music over the Internet is intense. If we do not compete effectively or if we experience pricing pressures, reduced margins or loss of market share resulting from increased competition, our business might be harmed.

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

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

See "Business--Competition."

New Competitors Could Enter the Industry with Alternative Business Models, Which, if Successful, Could Harm Our Business

New companies may enter our market with alternative business models. For example, companies may provide free music downloading from a website, earning revenues on an advertising or subscription basis. This model could be more attractive to consumers. If we are unable to compete with such companies or adapt our business model, products or services to a more consumer-favorable model, our business could be harmed.

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

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

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

The price of Internet products and services is subject to rapid and frequent change. We may be forced, for competitive or technical reasons, to reduce or eliminate prices for certain of our products or services. If this happens, our business might be harmed.

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

New music sharing technologies allowing users to locate and download copies of digital music stored on the hard drives of other users without payment have been introduced into the market. Because some digital recorded music formats, such as MP3, do not contain mechanisms for tracking the source of ownership of digital recordings, users are able to download copies of copyrighted recorded music over the Internet without being required to compensate the owners of these copyrights. These downloads are a significant concern to record companies and artists. The Recording Industry Association of America has filed a suit seeking a permanent injunction against the use of these file-sharing technologies for exchange of copyrighted works. Several recording artists have also taken 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 free shared copies are available, legally or illegally, consumers may choose not to pay for downloads from retail and other music delivery sites in our Liquid Music Network, which could harm our business.

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

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

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

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

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

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

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

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

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

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

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

Our Products and Services Might Contain Errors

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

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

Because we digitally deliver recorded music to third parties, we might be sued for negligence, copyright or trademark infringement or other reasons. These types of claims have been brought, sometimes successfully,

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

We have taken steps to prevent these claims. For example, we have arrangements with companies that use our hosting services that will allow us to delete potentially infringing or misappropriating materials quickly and securely. We also have put into place indemnification agreements with music content providers, where practicable. Under the Digital 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 is currently experiencing power outages due to a shortage in the supply of power within the state. Although we maintain a comprehensive disaster recovery plan, if the power outages increase in severity, they could disrupt our operations. Interruptions or slowdowns in our services have resulted from the failure of our telecommunications providers to supply the necessary data communications capacity in the time frame we required, as well as from deliberate acts. Despite precautions we have taken, unanticipated problems affecting our systems could in the future cause temporary interruptions or delays in the services we provide. Our customers might become dissatisfied by any system failure or delay that interrupts our ability to provide service to them or slows our response time. Sustained or repeated system failures or delays would affect our reputation, which would harm our business. Slow response time or system failures could also result from straining the capacity of our software or hardware due to an increase in the volume of products and services delivered through our servers. While we carry business interruption insurance, it might not be sufficient to cover any serious or prolonged emergencies, and our business might be harmed.

We Might Be Unable to License or Acquire Technology

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

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

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

. unexpected changes in regulatory requirements;

. export restrictions;

. export controls relating to encryption technology;

. longer payment cycles;

20

. problems in collecting accounts receivable;

. political and economic instability; and

. potentially adverse tax consequences.

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

. difficulties in staffing and managing international operations;

. differences in music rights reporting structures; and

. seasonal reductions in business activity.

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

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

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

Risks Related to Our Industry

Internet Security Concerns Could Hinder E-Commerce

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

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

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

In 1998, Congress passed the Internet Freedom Act, which imposes a three-year moratorium on state and local taxes on Internet-based transactions. We cannot assure you that this moratorium will be extended. Failure to renew this moratorium would allow various states to impose taxes on e-commerce, which might harm our business.

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

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

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

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

Government Regulation of the Internet Might Harm Our Business

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

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

ITEM 2. PROPERTIES

Our headquarters are located in 11,400 square feet of leased office space in Redwood City, California. The lease term extends to April 14, 2002 with a three-year renewal, at our option. We lease an office suite near our headquarters in Redwood City on a month-to-month basis, for additional office space and storage needs. We lease an additional 18,200 square feet of office space near our 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 headquarters. The lease term for this additional space extends to August 31, 2002 with a three-year renewal, at our option.

ITEM 3. LEGAL PROCEEDINGS

In February 2000, Sightsound, Inc. notified one of our customers that it intended to add the customer as a party to a pending patent litigation in the United States District Court for the Eastern District of Pennsylvania (Pittsburgh). The litigation alleges infringement of unspecified claims of three patents (United States Patent Nos. 5,191,573; 5,675,734 and 5,996,440). Damages have not been specified. Our customer has agreed to be added to the case, subject to a revision in the trial schedule. Our customer has requested indemnification, including defense costs, from us, based upon the terms of our contract with them. Based on this request, we are negotiating an agreement with our customer under which we would (i) assume control of the defense, (ii) pay

the expenses of the defense and (iii) reserve certain rights as to indemnification. During negotiation of this agreement we have agreed to assume the costs of the defense for our customer. These costs could be significant. There is no assurance that we will enter into this agreement. If we do not reach an agreement with our customer and the defense is not successful, our customer might seek full indemnification from us for the damages, if any. There can be no assurance regarding the outcome of the litigation. If there is a finding of infringement, we may be required to indemnify our customer as to the full amount of the damages.

On March 31, 2000, Intouch Group, Inc. (Intouch) filed a lawsuit against us in the Northern District of California alleging patent infringement. On April 26, 2000, Intouch filed an amended complaint, which was served on us shortly thereafter. The complaint names us and Amazon.com International, Inc., Listen.com, Inc., Entertaindom LLC, Discovermusic.com, Inc. and Muze, Inc. It alleges that we infringe or induce infringement of, the claims of United States Patent Nos. 5,237,157 and 5,963,916 by operating a website and/or a kiosk that allows interactive previewing of portions of pre-recorded music products. The complaint seeks unspecified damages and injunctive relief. On May 30, 2000, we filed our answer to Intouch's first amended complaint. The action is currently in discovery, and the trial date has been set for January 11, 2002. We believe that we have meritorious defenses to Intouch's claims and we intend to vigorously defend against such claims. However, we cannot assure you that we will be successful in defending these lawsuits. If there is a finding of infringement, we might be required to pay substantial damages to Intouch and could be enjoined from selling any of our products or services that are held to infringe Intouch's patents unless and until we are able to negotiate a license from them.

On August 14, 2000, a former employee filed a charge of discrimination with the California Department of Fair Employment and Housing against us, and several of our employees and former employees. The charge alleges sexual harassment and unlawful retaliation. We believe, after consultation with counsel, that these claims are without merit, and we intend to defend ourselves vigorously. However, should a lawsuit be filed and decided adversely to us, we may have to pay damages.

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 security holders during the quarter ended December 31, 2000.

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

The closing price per share of the common stock at March 15, 2001 was $2.13. As of February 28, 2001, there were approximately 131 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.

Recent Sales of Unregistered Securities

1. In February 2000, we issued 1,426 shares of common stock to a record label upon the exercise of a warrant to purchase common stock. The shares were purchased using the warrant's net exercise provision. Accordingly, we did not receive any cash upon exercise of the warrant; the shares were purchased by the acceptance of a lesser number of shares in exchange for not having to pay the exercise price.

2. In April 2000, we issued 4,072 shares of common stock to a former

consultant in consideration for the purchase of certain intellectual property.

3. In April 2000, we issued 30,000 shares of common stock to another former consultant in connection with a legal settlement.

4. In May 2000, we issued 25,156 shares of common stock to an online retailer upon the exercise of a warrant to purchase common stock. The shares were purchased using the warrant's net exercise provision in the same manner described in item 1 above.

5. In July 2000, we issued 150,000 shares of common stock to a major record label in exchange for a letter agreement to promote the distribution of digital music over the Internet using our technology.

6. In December 2000, we issued 50,000 shares of common stock and a warrant to purchase up to an additional 233,300 shares of common stock to another major record label in connection with an agreement to distribute its music through kiosks.

No underwriters were employed in connection with any of the transactions set forth above.

The issuances of securities described in items 1, 2, 4, 5 and 6 were deemed to be exempt from registration under the Securities Act of 1933, as amended, in reliance on Section 4(2) of the Securities Act, as transactions by an issuer not involving a public offering. The issuance of securities described in item 3 was deemed to be exempt from registration under the Securities Act in reliance on Section 3(a)(10) of the Securities Act, as a transaction involving an exempt security in which the terms and conditions of the issuance were approved, after a hearing upon the fairness of such terms and conditions, by a court. The recipients of securities in each such transaction represented their intention to acquire the securities for investment only and not with a view to or for sale in connection with any distribution thereof and appropriate legends were affixed to the share certificates and other instruments issued in such transactions. All recipients either received adequate information about us or had access, through employment or other relationships, to such information.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data should be read in conjunction with our consolidated financial statements and related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this document.

	Year Ended December 31,				Period From January 30, 1996 (inception) Through December 31,
	2000	1999	1998	1997	1996
	(in thousands, except share and per share data)				

Statement of Operations Data:					
Net revenues:					
License................	$ 1,284	$ 1,537	$ 1,235	$ 246	$ --
Services...............	2,977	733	268	10	--
Business development (related party).......	7,307	2,137	1,300	--	--
Total net revenues....	11,568	4,407	2,803	256	--
Cost of net revenues:					
License................	290	235	310	302	--
Services...............	2,722	1,122	242	91	--
Business development (related party).......	75	79	2	--	--
Non-cash cost of revenues..............	28	25	36	15	--
Total cost of net revenues.............	3,115	1,461	590	408	--
Gross profit (loss).....	8,453	2,946	2,213	(152)	--
Operating expenses:					
Sales and marketing....	17,114	10,217	4,035	2,820	237
Non-cash sales and marketing............	314	783	741	304	8
Research and development...........	22,917	11,706	4,109	1,880	692
Non-cash research and development...........	80	371	210	127	23
General and administrative........	7,131	2,770	1,642	898	327
Non-cash general and administrative........	13	190	254	88	--
Strategic marketing-equity instruments....	1,935	3,130	--	--	--
Total operating expenses............	49,504	29,167	10,991	6,117	1,287
Loss from operations....	(41,051)	(26,221)	(8,778)	(6,269)	(1,287)
Other income (expense), net....................	8,236	2,015	239	53	23
Equity in net loss of investment............	(870)	--	--	--	--
Net loss................	$ (33,685)	$ (24,206)	$ (8,539)	$ (6,216)	$(1,264)
Net loss per share:					
Basic and diluted......	$ (1.52)	$ (2.28)	$ (3.60)	$ (4.95)	$(14.93)
Weighted average shares...............	22,133,403	10,615,566	2,370,564	1,256,114	84,635

	December 31,				
	2000	1999	1998	1997	1996
	(in thousands)				
Balance Sheet Data:					

Cash and cash equivalents	$ 96,398	$ 138,692	$ 14,143	$ 2,387	$ 864
Short-term investments	27,378	19,157	3,001	--	--
Working capital	119,089	152,030	15,060	858	660
Total assets	138,210	166,109	19,913	3,275	1,086
Long-term debt, less current portion	564	1,321	969	218	103
Mandatorily redeemable convertible preferred stock	--	--	29,801	8,247	2,001
Total stockholders' equity (deficit)	128,674	157,745	(14,133)	(6,879)	(1,228)

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis contains forward-looking statements within the meaning of Federal securities laws. You can identify these statements because they use forward-looking terminology such as "may," "will," "expect," "anticipate," "estimate," "continue," "believe" and "intend" or other similar words. These words, however, are not the exclusive means by which you can identify these statements. You can also identify forward-looking statements because they discuss future expectations, contain projections of results of operations or of financial conditions, characterize future events or circumstances or state other forward-looking information. We have based all forward-looking statements included in Management's Discussion and Analysis on information currently available to us, and we assume no obligation to update any such forward-looking statements. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, actual results could differ materially from those projected in the forward-looking statements. Potential risks and uncertainty include, among others, those set forth in the "Risk Factors" section.

Overview

We are a leading provider of software products and services that enable artists, record companies and retailers to create, syndicate and sell music digitally over the Internet. Our products and services are based on an open technical architecture that is designed to support a variety of digital music formats. From our inception in January 1996 through early 1997, we devoted substantially all of our efforts to product development, raising capital and recruiting personnel. We first generated revenues in the first quarter of 1997 through the licensing of our Liquifier Pro, Liquid Server and Liquid Player software products. In November 1997, we introduced a subscription-based hosting service for digital recorded music using our technology. In July 1998, to enhance consumer access to the music we were hosting, we launched the Liquid Music Network (LMN), a syndicated network that currently links over 1,000 affiliated music-related and music retailer websites.

In early 1999, we began to place greater emphasis on developing and marketing our digital music delivery services. Since that time, we have invested significant resources to increase our distribution reach by expanding the LMN, building our syndicated music catalog available for sale, actively participating in standards initiatives and establishing our international presence. We also have established international initiatives within the Pacific Rim and a subsidiary in Europe to lay the groundwork for offering digital music download services to consumers in these markets. As a provider of digital music delivery services, we expect our revenue sources to expand beyond software license sales to include hosting service fees and sales of digital recorded music. Revenues from digital music sales and transaction fees from our music delivery services represented less than 6% of total net revenues in 2000 and less than 1% of total net revenues in 1999 and 1998. Our Liquid Music Network began offering syndicated music through music retailer websites in the third quarter of 1999.

To date, we have derived our revenues primarily from the licensing of software products and service fees associated with business development contracts. Business development revenues primarily consist of license and maintenance fees from agreements under which we give our strategic related partners the right to license and use our digital recorded music delivery technology. These U.S. dollar-denominated, non-refundable fees are allocated among the various elements of the contract based on vendor specific objective evidence (VSOE) of fair value. When VSOE of fair value exist for the undelivered elements, primarily maintenance, we account for the license portion based on the "residual method" as prescribed by SOP No. 98-9, "Modification of SOP 97-2 with Respect to Certain Transactions." When VSOE of fair value does not exist for the undelivered elements, we recognize the total fee from a business development contract ratably over the term of the contract. We also license our software products to record companies, artists and websites. Software license revenues are recognized when persuasive evidence of an arrangement exists, the fee is fixed and determinable, collection is probable and delivery has occurred. Services revenues from maintenance fees related to our licensed software products and hosting fees from record companies and artists are recognized over the service period, typically one year. We intend to increase our services revenues by significantly expanding our hosting and music

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

Business development revenues as a percentage of total net revenues were 63%, 48% and 46% in 2000, 1999 and 1998, respectively. Liquid Audio Korea (LAK) stopped making its contractual payments as scheduled. LAK is undergoing a recapitalization through the addition of new investment partners so that it can continue making its payments to us. Until such time contractual payments are resumed, we are deferring recognition of revenue from LAK. In late 2000, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner did not make their contractual payments as scheduled. We are pursuing collection for the missed payments. No revenue will be recognized until payments are on schedule.

In 2000, approximately 53% of total net revenues came from sales to two customers, Liquid Audio Japan and Liquid Audio South East Asia through our strategic partner. In 1999, approximately 73% of total net revenues came from sales to three customers, Adaptec, Inc., Super Stage, Inc. and Liquid Audio Korea. In 1998, approximately 34% of total net revenues came from sales to one customer, SKM Group. International revenues represented approximately 69%, 49% and 65% of total net revenues in 2000, 1999 and 1998, respectively. We expect international revenues will continue to represent a significant portion of our total net revenues.

We have a limited operating history upon which investors may evaluate our business and prospects. Since inception we have incurred significant losses, and as of December 31, 2000 we had an accumulated deficit of approximately $73.9 million. We expect to incur additional losses and continued negative cash flow from operations through at least 2002. Our revenues may not increase or even continue at their current levels or we may not achieve or maintain profitability or generate cash from operations in future periods. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stages of development, particularly companies in new and rapidly evolving markets such as the digital delivery of recorded music. We may not be successful in addressing these risks, and our failure to do so would harm our business.

28

Results of Operations

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

	Year Ended December 31,		
	2000	1999	1998
Net revenues:			
License	11 %	35 %	44 %
Services	26	17	10
Business development (related party)	63	48	46
Total net revenues	100	100	100
Cost of net revenues:			
License	3	5	11
Services	23	25	9
Business development (related party)	1	2	--
Non-cash cost of revenues	--	1	1
Total cost of net revenues	27	33	21
Gross profit	73	67	79
Operating expenses:			
Sales and marketing	148	232	144
Non-cash sales and marketing	2	18	26
Research and development	198	266	146
Non-cash research and development	1	8	8
General and administrative	62	63	59
Non-cash general and administrative	--	4	9
Strategic marketing-equity instruments	17	71	--
Total operating expenses	428	662	392
Loss from operations	(355)	(596)	(313)
Other income (expense), net	72	47	8
Equity in net loss of investment	(8)	--	--

Net loss	(291)%	(549)%	(305)%

Years Ended December 30, 2000, 1999 and 1998

Total Net Revenues

Total net revenues increased 162% to $11.6 million in 2000 from $4.4 million in 1999. Total net revenues increased 57% in 1999 from $2.8 million in 1998.

License. License revenues decreased 16% to $1.3 million in 2000 from $1.5 million in 1999. License revenues increased 24% in 1999 from $1.2 million in 1998. The decrease in 2000 and increase in 1999 relates principally to Liquid Player license fees received under an agreement with a customer. Under this agreement, we received $1.5 million in license fees over a 14-month period. These fees were recognized as license revenue over the license period, which ended on December 31, 1999. The decrease in 2000 from Liquid Player license fees were partially offset by an increase in license fees related to digital music kiosk sales. Due to our shift in marketing emphasis from software licensing to digital music delivery services, however, revenues from licensing of our Liquifier Pro and Liquid Server software decreased in 1999 from 1998, which partially offset the increase in Liquid Player revenues described above.

Services. Services revenues increased 306% to $3.0 million in 2000 from $733,000 in 1999. Services revenues increased 174% in 1999 from $268,000 in 1998. The increase in 2000 was due to increases in encoding services, kiosk-related equipment and services, digital music and transaction fees from our music delivery services and promotion and advertising services. The increase in 1999 was due to increased maintenance and hosting fees and the addition to revenues from promotion and advertising services, sample music clips service and music sales.

Business Development (Related Party). Business development revenues increased 242% to $7.3 million in 2000 from $2.1 million in 1999. Business development revenues increased 64% in 1999 from $1.3 million in 1998. Total business development revenues are summarized as follows (in thousands):

	Year Ended December 31,		
	2000	1999	1998
Liquid Audio Japan and strategic partner	$5,047	$1,105	$ 250
Liquid Audio South East Asia and strategic partner	1,261	--	--
Liquid Audio Greater China and strategic partner	705	500	--
Liquid Audio Korea and strategic partner	294	532	1,050
	$7,307	$2,137	$1,300

Of the total fees earned from Liquid Audio Japan and strategic partner, $4.9 million and $272,000 were earned from Liquid Audio Japan and relate to software licensing and maintenance fees in 2000 and 1999, respectively, and $167,000 and

$833,000 were earned from our strategic partner in Liquid Audio Japan in 2000 and 1999, respectively, and relate to a non-refundable service fee of $1.0 million received in March 1999 and recognized ratably over the one-year term of the service agreement. The fee of $250,000 earned from our strategic partner in Liquid Audio Japan in 1998 relates to consulting services. The total fee of $1.3 million and $705,000 earned in 2000 from Liquid Audio South East Asia through our strategic partner and Liquid Audio Greater China, respectively, consist of software licensing and maintenance fees. The total fee of $500,000 earned from our strategic partner in Liquid Audio Greater China in 1999 relates to a service fee to develop a local business in Taiwan and Hong Kong. The total fee of $294,000 and $532,000 earned from Liquid Audio Korea in 2000 and 1999, respectively, consist primarily of software licensing and maintenance fees. Of the $1.1 million earned from our strategic partner in Liquid Audio Korea in 1998, $950,000 relates to service fees earned under two separate agreements and $100,000 relates to software licensing fees. In 1998, we recognized our proportionate share (40%) of losses recorded by Liquid Audio Korea. Our share of the equity losses amounted to $400,000, which equaled our total investment in Liquid Audio Korea. These equity losses were offset against the revenue earned in 1998 from our strategic partner in Korea to more clearly reflect the substance of the business development transactions with our strategic partner.

Total Cost of Net Revenues

Our gross profit increased to approximately 73% of total net revenues in 2000 from 67% in 1999. Our gross profit decreased to approximately 67% of total net revenues in 1999 from 79% in 1998. Total cost of net revenues increased 113% to $3.1 million in 2000 from $1.5 million in 1999. Total cost of net revenues increased 148% in 1999 from $590,000 in 1998.

License. Cost of license revenues primarily consists of royalties paid to third-party technology vendors and costs of documentation, duplication and packaging. Cost of license revenues increased 23% to $290,000 in 2000 from $235,000 in 1999. Cost of license revenues decreased 24% in 1999 from $310,000 in 1998. Cost of license revenues increased in 2000 due to the addition of certain technology licenses. Cost of license revenues decreased in 1999 due to product mix differences and the cancellation of certain technology licenses.

Services. Cost of services revenues primarily consists of compensation for customer service, encoding and professional services personnel, kiosk-related equipment and an allocation of our occupancy costs and

other overhead attributable to our services revenues. Cost of services revenues increased 143% to $2.7 million in 2000 from $1.1 million in 1999. Cost of services revenues increased 364% in 1999 from $242,000 in 1998. The increases in cost of services revenues were due primarily to the addition of encoding and customer service personnel. Additionally, 2000 included the addition of professional services personnel and kiosk-related equipment.

Business Development (Related Party). Cost of business development revenues primarily consists of kiosk-related equipment and royalties paid to third-party technology vendors. Cost of business development revenues were $75,000, $79,000 and $2,000 in 2000, 1999 and 1998, respectively.

Non-Cash Cost of Revenues. Non-cash cost of revenues consist of expenses associated with the value of common stock and warrants issued to partners as part of our content acquisition agreements and stock-based employee compensation arrangements. Common stock expense is based on the fair value of the stock at the time it was issued. Warrant expense is based on the estimated fair value of the warrants based on the Black-Scholes option pricing model and the provisions of EITF 96-18. In December 2000, we signed an agreement with BMG Entertainment to obtain the right to distribute BMG sound recordings and related artwork through kiosks. In connection with this agreement, we issued 50,000 shares of common stock to BMG, valued at $195,000 and are being recognized ratably over the initial one-year term of the agreement; as a result, $14,000 was recognized as non-cash cost of revenues. Also in connection with this agreement, we granted a warrant for a total of 233,300 shares of common stock. Of the total, 77,768 shares vest in December 2001, and the cost will be remeasured each quarter until a commitment for performance has been reached or the warrant vests, based on current market data. At December 31, 2000, the 77,768 shares under this warrant were valued at $156,000, of which $12,000 was recognized as non-cash cost of revenues. The unamortized portion will be remeasured at each balance sheet date through the vesting date and amortized over the remaining vesting period. If BMG renews the agreement after December 2001, the remaining shares will vest at 6,481 shares per month commencing January 2002 for one year and 6,480 shares per month commencing January 2003 for one year. Such shares will be valued at the fair market value of our common stock upon BMG renewing the agreement at each renewal date. Stock compensation expense for customer service, encoding and professional services personnel were $2,000, $25,000 and $36,000 in 2000, 1999 and 1998, respectively. We expect quarterly amortization related to these options to be less than $1,000 per quarter during 2001 and annual amortization to be approximately $1,000 in 2002. These future compensation charges would be reduced if any customer service, encoding or professional services employee terminates employment prior to the expiration of the employee's option vesting period.

Operating Expenses

Sales and Marketing. Sales and marketing expenses consist primarily of compensation for our sales, marketing and business development personnel, compensation for customer service and professional services personnel attributable to sales and marketing activities, advertising, trade show and other promotional costs, design and creation expenses for marketing literature and our website and an allocation of our occupancy costs and other overhead. Sales and marketing expenses increased 68% to $17.1 million in 2000 from $10.2 million in 1999. Sales and marketing expenses increased 153% in 1999 from $4.0 million in 1998. These increases were primarily due to increases in the number of sales and marketing personnel and advertising and promotional programs. We expect that sales and marketing expenses will remain at or decline from levels of the fourth quarter of 2000.

Research and Development. Research and development expenses consist primarily of compensation for our research and development, network operations and product management personnel, payments to outside contractors and, to a lesser extent, depreciation on equipment used for research and development and an allocation of our occupancy costs and other overhead. Research and development expenses increased 96% to $22.9 million in 2000 from $11.7 million in 1999. Research and development expenses increased 185% in 1999 from $4.1 million in 1998. These increases were primarily due to increases in the number of personnel and outside contractors needed to enhance our existing software products, develop and enhance our online services, develop new products and

services and build our external network and computer data center infrastructure. We expect that research and development expenses will remain at or decline from levels of the fourth quarter of 2000.

General and Administrative. General and administrative expenses consist primarily of compensation for personnel and payments to outside contractors for general corporate functions, including finance, information systems, human resources, facilities, legal and general management, fees for professional services, bad debt expense and an allocation of our occupancy costs and other overhead. General and administrative expenses increased 157% to $7.1 million in 2000 from $2.8 million in 1999. General and administrative expenses increased 69% in 1999 from $1.6 million in 1998. These increases were primarily due to increases in the number of personnel and outside contractors needed to support the growth of our business and professional fees. The 2000 period includes legal fees related to patent infringement claims against us and a non-cash charge of $354,000 related to the issuance of common stock in the settlement of a lawsuit with a former consultant. General and administrative expenses declined as a percentage of total net revenues. We expect that general and administrative expenses will remain at or decline from levels of the fourth quarter of 2000.

Strategic Marketing-Equity Instruments. Strategic marketing-equity instruments consist of expenses associated with the value of common stock and warra