

LIBERATE TECHNOLOGIES  
Form 10-Q  
October 11, 2005

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

(Mark one)

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

For the quarterly period ended August 31, 2005

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 000-26565

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**LIBERATE TECHNOLOGIES**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or Other Jurisdiction of Incorporation)

**94-3245315**

(I.R.S. Employer Identification No.)

**310 University Avenue, Suite 201**

**Palo Alto, California**

(Address of principal executive office)

**94301**

(Zip Code)

**(650) 330-8960**

(Registrant's telephone number, including area code)

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

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

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

110,938,169 shares of the Registrant's common stock were outstanding as of September 30, 2005.

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**LIBERATE TECHNOLOGIES**

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**Part I. Financial Information****Item 1. Financial Statements****LIBERATE TECHNOLOGIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands)****(Unaudited)**

|   | <b>August 31, 2005</b> | <b>May 31, 2005</b> |
|---|------------------------|---------------------|
| <b>Assets</b>                                 |                        |                     |
| <b>Current assets:</b>                        |                        |                     |
| Cash and cash equivalents                     | \$ 41,817              | \$ 47,124           |
| Accounts receivable, net                      | 2,897                  | 2,836               |
| Prepaid expenses and other current assets     | 319                    | 368                 |
| Other receivables                             | 4,505                  | 4,577               |
| Assets of discontinued operations             |                        | 414                 |
| Total current assets                          | 49,538                 | 55,319              |
| Property and equipment, net                   | 89                     | 61                  |
| Restricted cash                               | 9,809                  | 4,359               |
| Total assets                                  | \$ 59,436              | \$ 59,739           |
| <b>Liabilities and Stockholders Equity</b>    |                        |                     |
| <b>Current liabilities:</b>                   |                        |                     |
| Accounts payable                              | \$ 3,032               | \$ 1,121            |
| Accrued liabilities                           | 13,119                 | 14,261              |
| Accrued payroll and related expenses          | 119                    | 328                 |
| Liabilities of discontinued operations        |                        | 9,502               |
| Total current liabilities                     | 16,270                 | 25,212              |
| Long-term excess facilities charges           | 17,052                 | 18,577              |
| Total liabilities                             | 33,322                 | 43,789              |
| <b>Commitments and contingencies (Note 5)</b> |                        |                     |
| <b>Stockholders equity:</b>                   |                        |                     |
| Common stock                                  | 1,110                  | 1,109               |
| Paid-in-capital                               | 1,258,021              | 1,275,302           |
| Deferred stock-based compensation             |                        | (556)               |
| Accumulated other comprehensive loss          | (2,178)                | (2,178)             |
| Accumulated deficit                           | (1,230,839)            | (1,257,727)         |
| Total stockholders equity                     | 26,114                 | 15,950              |
| Total liabilities and stockholders equity     | \$ 59,436              | \$ 59,739           |

The accompanying notes are an integral part of these condensed consolidated financial statements.



## LIBERATE TECHNOLOGIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
AND COMPREHENSIVE INCOME (LOSS)

(In thousands, except per share data)

(Unaudited)

|   | Three months ended<br>August 31, |             |
|---|----------------------------------|-------------|
|   | 2005                             | 2004        |
| <b>Operating expenses:</b>  |                                  |             |
| Research and development  | \$                               | \$ 494      |
| Sales and marketing   |                                  | 248         |
| General and administrative  | 7,117                            | 3,601       |
| Excess facilities charges and related asset impairment  | (273)                            | 4,415       |
| Total operating expenses  | 6,844                            | 8,758       |
| Loss from continuing operations before non-operating items and income taxes                                   | (6,844)                          | (8,758)     |
| <b>Interest income, net</b>   | 307                              | 548         |
| <b>Other income (expense), net</b>  | 21                               | (110)       |
| Loss from continuing operations before income tax provision   | (6,516)                          | (8,320)     |
| <b>Income tax provision (benefit)</b>   | (2,509)                          | 3           |
| Loss from continuing operations   | (4,007)                          | (8,323)     |
| <b>Income (loss) from discontinued operations (including gain on sale of \$35,138 and \$80, respectively)</b> | 33,458                           | (3,971)     |
| Income tax provision  | 2,563                            | 35          |
| Net income (loss)   | \$ 26,888                        | \$ (12,329) |
| <b>Basic and diluted income (loss) per share:</b>   |                                  |             |
| Continuing operations   | \$ (0.04)                        | \$ (0.08)   |
| Discontinued operations, basic  | \$ 0.28                          | \$ (0.04)   |
| Discontinued operations, diluted  | \$ 0.28                          | \$ (0.04)   |
| Basic net income (loss) per share   | \$ 0.24                          | \$ (0.12)   |
| Diluted net income (loss) per share   | \$ 0.24                          | \$ (0.12)   |
| <b>Shares used in computing basic net income (loss) per share</b>   | 110,925                          | 105,623     |
| <b>Shares used in computing diluted net income (loss) per share</b>   | 111,232                          | 105,623     |
| <b>Comprehensive income (loss):</b>   |                                  |             |
| Net income (loss)   | \$ 26,888                        | \$ (12,329) |
| Foreign currency translation adjustment   |                                  | 220         |
| Unrealized gain on short-term investments, net  |                                  | 5           |
| Comprehensive income (loss)   | \$ 26,888                        | \$ (12,104) |

The accompanying notes are an integral part of these condensed consolidated financial statements.

## LIBERATE TECHNOLOGIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

|  | Three months ended<br>August 31, |             |
|--|----------------------------------|-------------|
|  | 2005                             | 2004        |
| <b>Cash flows from operating activities:</b>   |                                  |             |
| Net income (loss)  | \$ 26,888                        | \$ (12,329) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: |                                  |             |
| Discontinued operations  | (35,138)                         | 2,345       |
| Depreciation and amortization  | 10                               | 11          |
| Non-cash stock based compensation expense  | (28)                             | 225         |
| Non-cash stock based compensation expense from discontinued operations               | (68)                             | 414         |
| Stock units surrendered in consideration of taxes payable                            |                                  | (71)        |
| Loss on disposal of property and equipment   | 25                               | (7)         |
| Provision for doubtful accounts  | 6                                | 44          |
| Changes in operating assets and liabilities:   |                                  |             |
| Accounts receivable  | 2,426                            | (859)       |
| Prepaid expenses and other assets  | 160                              | 12          |
| Accounts payable   | 1,911                            | 65          |
| Accrued liabilities  | (1,176)                          | 2,901       |
| Accrued payroll and related expenses   | (212)                            | (4)         |
| Long-term excess facilities liabilities  | (1,525)                          | 1,777       |
| Net cash used in operating activities  | (6,721)                          | (5,476)     |
| <b>Cash flows from investing activities:</b>   |                                  |             |
| Proceeds from sale of discontinued operations  | 23,555                           |             |
| (Increase) decrease in restricted cash   | (5,450)                          | 3           |
| Purchases of property and equipment, net   | (63)                             | (4)         |
| Proceeds from sale of property and equipment   |                                  | 7           |
| Net cash provided by investing activities  | 18,042                           | 6           |
| <b>Cash flows from financing activities:</b>   |                                  |             |
| Payment on short-term borrowing from bank  |                                  | (608)       |
| Dividends paid   | (16,639)                         |             |
| Proceeds from issuance of common stock   | 11                               | 14          |
| Net cash used in financing activities  | (16,628)                         | (594)       |
| <b>Effect of exchange rate changes on cash</b>                                       |                                  | 158         |
| <b>Net decrease in cash and cash equivalents</b>                                     | (5,307)                          | (5,906)     |
| <b>Cash and cash equivalents, beginning of period</b>                                | 47,124                           | 215,877     |
| <b>Cash and cash equivalents, end of period</b>                                      | \$ 41,817                        | \$ 209,971  |

The accompanying notes are an integral part of these condensed consolidated financial statements.

**LIBERATE TECHNOLOGIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Unaudited**

**Note 1. Description of Business**

Prior to the sales of the North America business and the Non-North America business (collectively the Asset Sales ), Liberate was a provider of software for digital cable television systems. Based on industry standards, Liberate's software enabled cable operators to run multiple services, including high-definition television, interactive programming guide, video on demand, personal video recorders and games, on multiple platforms. As a result of the Asset Sales, Liberate has no significant product offering or services business.

Liberate began operations in late 1995 as a division of Oracle. In April 1996, the company separately incorporated in Delaware as Network Computer, Inc., and on May 11, 1999, it changed its name to Liberate Technologies.

As a result of the sale of the Non-North America business, which closed on July 12, 2005, SeaChange assumed the lease on our San Mateo, California office space. In August 2005, we relocated our headquarters to approximately 2,500 square feet of office space in Palo Alto, California.

**Filing of Going Private Proxy Statement**



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On June 23, 2005, Liberate filed with the Securities and Exchange Commission (the SEC) a preliminary Schedule 13E-3 Transaction Statement with respect to a going private transaction and a preliminary Schedule 14A Proxy Statement soliciting stockholders to vote on a 1-for-250,000 reverse stock split immediately followed by a 250,000-for-1 forward stock split of Liberate's common stock (the Reverse/Forward Stock Split). On August 26, 2005, Liberate filed with the SEC, an amendment to each of the preliminary Schedule 13E-3 Transaction Statement and preliminary Schedule 14A Proxy Statement, relating to the Reverse/Forward Stock Split. If approved, the Reverse/Forward Stock Split should enable Liberate to complete the going private transaction provided there will be fewer than 300 holders of record of common stock. This will permit Liberate to discontinue the obligations of filing annual and periodic reports and make other filings with the SEC.

Once the Schedule 13E-3 Transaction Statement and Schedule 14A Proxy Statement are approved in a definitive form by the SEC, Liberate will mail copies to all of its stockholders, describing all of the material terms of the Reverse/Forward Stock Split. Liberate currently intends to effect the Reverse/Forward Stock Split as soon as possible thereafter.

### **Note 2. Significant Accounting Policies**

#### **Basis of Presentation**

These interim financial statements are unaudited and reflect all adjustments of a normal recurring nature that we believe are necessary to provide a fair statement of the financial position and the results of operations for the interim periods in accordance with the rules of the SEC. These statements have been prepared in accordance with generally accepted accounting principles of the U.S. These statements should be read in conjunction with the audited condensed consolidated financial statements and notes included in our annual report on Form 10-K and our amended annual report on Form 10-K/A for the fiscal year ended May 31, 2005. The results of operations for the interim periods reported do not necessarily indicate the results expected for the full fiscal year or for any future period.

In this report, we sometimes use the words "fiscal" or "FY" followed by a year to refer to our fiscal years, which end on May 31 of the specified year. We also sometimes use "Q1," "Q2," "Q3," and "Q4" to refer to our fiscal quarters, which end on August 31, November 30, the last day of February, and May 31 of each fiscal year.

#### **Principles of Consolidation**

Our consolidated financial statements include the accounts of Liberate and our subsidiaries one located in the U.S. and another one located in the Netherlands. All intercompany accounts and transactions have been eliminated in consolidation.

### **Use of Estimates**

The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions. These estimates affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

### **Foreign Currency Translation and Re-measurement**

The functional currency of Liberate's subsidiary is the U.S. dollar. Liberate's U.K. branch of its Netherlands subsidiary operates in the British Pound and the Euro. Accordingly, the monetary assets and liabilities of these operations are re-measured into U.S. dollars at the exchange rate in effect at the balance sheet date and non-monetary assets and liabilities are re-measured at historical exchange rates. Revenues, expenses, gains or losses are re-measured at the average exchange rate for the period, other than depreciation and amortization, which are re-measured at the same respective historical rates as their related assets. The resulting re-measurement gains and losses of these operations as well as gains and losses from foreign currency transactions are included in the condensed consolidated statements of operations.

Translation gains or losses relating to prior periods have been recorded in Accumulated Other Comprehensive Income (Loss), a component of Stockholders' Equity. As of August 31, 2005 and May 31, 2005, the cumulative translation losses in accumulated other comprehensive loss was \$2.2 million and is related to the re-measurement of the existing U.K. branch of its Netherlands subsidiary.

### **Fair Value of Financial Instruments**

Due to their short maturities, the carrying value of our financial instruments, including cash and cash equivalents, accounts receivable, restricted cash, accounts payable and accrued liabilities approximates their fair market value.

### **Concentration of Credit Risk**

Financial instruments that potentially subject us to concentration of credit risk primarily consist of cash and cash equivalents and accounts receivable. Substantially all of our cash and cash equivalents are invested in high quality money market instruments. While our customers are geographically dispersed, a substantial amount of our revenues has been generated from a few customers, whose receivables are typically unsecured. We mitigate our credit risk associated with accounts receivable by performing ongoing credit evaluations of our customers' financial conditions, and we maintain an allowance for potential credit losses. Historically, we have not experienced significant losses related to accounts receivable.

As of August 31, 2005 and May 31, 2005, two customers accounted for 10% or more of our gross accounts receivable balance. Their respective receivable balances as a percentage of our gross accounts receivable balance were as follows:

|            | August 31, 2005 | May 31, 2005 |
|------------|-----------------|--------------|
| Customer A | 52%             | 53%          |
| Customer B | 35%             | 35%          |

### Property and Equipment

We record property and equipment at cost. We compute depreciation using the straight-line method over the estimated useful lives of the assets of two to five years. We amortize leasehold improvements over the shorter of the remaining lease term or the estimated useful lives of the improvements using the straight-line method.

### Stock-Based Compensation

In December 2002, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 148, Accounting for Stock Based Compensation Transition and Disclosure. SFAS 148 amends SFAS 123, Accounting for Stock Based Compensation, to provide alternate methods of transition for a voluntary change to the fair value based method of accounting for stock based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require more prominent disclosures in both annual and interim financial statements about the method used on reported results. The additional disclosures requirements of SFAS 148 are effective for fiscal years ending after December 15, 2002. We have elected to continue to follow the intrinsic value method of accounting prescribed by Accounting Principles Board

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Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ), to account for employee stock options. Under APB 25, no compensation expense is recognized unless the exercise price of our employee stock option is less than market price of the underlying stock at the date of grant. We have not recorded compensation expenses in the periods presented because stock options were granted at their fair market value on the date of grant.

In December 2004, the FASB issued SFAS 123(R), Share-Based Payment. SFAS 123(R) addresses the accounting for share-based payment transactions with employees and requires companies to expense the value of employee stock options and similar awards. SFAS 123(R) requires stock based compensation of the share-based payment to be measured at fair value on the date that the company grants the awards to employees with the first annual period after June 15, 2005. The expense should be recognized over the vesting period for each option and adjusted for actual forfeitures that occur before vesting. We are required to adopt SFAS 123(R) in Q1 of fiscal 2007.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ). SAB 107 covers key topics related to the implementation of SFAS 123(R ) which include the valuation models, expected volatility, expected option term, income tax effects of SFAS 123(R ), classification of stock-based compensation cost, capitalization of compensation costs and disclosure requirements. Although we do not expect to grant any future options, the Company is currently assessing the impact SFAS 123(R) and SAB 107 will have on our financial statements.

The following information regarding net income (loss) and net income (loss) per share prepared in accordance with SFAS 123 has been determined as if we had accounted for our employee stock options, stock units and shares issued under our 1999 Equity Incentive Plan using the fair value method prescribed by SFAS 123. The resulting effect on net income (loss) and net income (loss) per share pursuant to SFAS 123 is not likely to be representative of the effects on net income (loss) and net income (loss) per share pursuant to SFAS 123 or FAS 123(R) in future periods, because future periods could include additional grants, cancellations and periods of vesting.

The following table illustrates the effect on reported net income (loss) and net income (loss) per share had we applied the fair value recognition provisions of SFAS 123 (in thousands, except per share data):

|  | Three months ended<br>August 31, |             |
|--|----------------------------------|-------------|
|  | 2005                             | 2004        |
| Net income (loss), as reported   | \$ 26,888                        | \$ (12,329) |
| Adjustments:   |                                  |             |
| Stock unit compensation expense (income) included in reported net income (loss), net of related tax effects  | (96)                             | 639         |
| Total stock-based employee compensation expense determined under fair value method for all awards granted since July 1, 1995, net of related tax effects | (29)                             | (1,379)     |
| Pro forma income (loss)  | \$ 26,763                        | \$ (13,069) |
| Basic and diluted net income (loss) per share, as reported   | \$ 0.24                          | \$ (0.12)   |
| Basic and diluted net income (loss) per share, pro forma   | \$ 0.24                          | \$ (0.12)   |

In connection with the granting of stock units in fiscal 2004, we recorded deferred stock-based compensation based on the fair value of the underlying shares of our common stock at the date of grant, and such value is amortized over the vesting period as compensation expense by function. For Q1 FY06 the amortization expense was \$(96,000) due to the reversal of expense related to the cancellation of stock awards during the quarter. For Q1 FY05 the amortization expense was \$639,000. The following table shows the expenses, by functional classification, incurred for the three months ended August 31, 2005 and August 31, 2004 (in thousands):

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|                            | Three months ended |        |
|----------------------------|--------------------|--------|
|                            | August 31,         |        |
|                            | 2005               | 2004   |
| Research and development   | \$                 | \$ 72  |
| Sales and marketing        |                    | 25     |
| General and administrative | (28)               | 128    |
| Discontinued operations    | (68)               | 414    |
| Total                      | \$ (96)            | \$ 639 |

For the three months ended August 31, 2005 we granted no stock units to employees and for the three months ended

August 31, 2004, we granted 75,000 stock units to employees. During each of the three month periods ended August 31, 2005 and 2004, we granted no stock options.

## Revenue Recognition

*License and Royalty Revenues.* Prior to the Asset Sales discussed in Note 3, Liberate licensed its software through its direct sales force located in North America and Europe. License and royalty revenues consisted primarily of fees earned from the licensing of its software, as well as royalty fees earned upon the shipment or activation of products that incorporated its software. In general, license revenues were recognized when a non-cancelable license agreement had been signed and the customer had acknowledged an unconditional obligation to pay, the software product had been delivered, there were no uncertainties surrounding product acceptance, the fees were fixed or determinable and collection was considered probable. Delivery was considered to have occurred when title and risk of loss had been transferred to the customer, which generally occurred when media containing the licensed programs were provided to a common carrier. In the case of electronic delivery, delivery occurred when the customer was given access to the licensed programs. If collectibility was not considered probable, revenue was recognized when the fee was collected.

Liberate recognized revenue from software licensing arrangements using the residual method pursuant to the requirements of Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended by SOP No. 98-9, *Software Revenue Recognition, With Respect to Certain Transactions* and the Securities and Exchange Commission's Staff Accounting Bulletin No. 104, *Revenue Recognition*. Revenues recognized from multiple-element software arrangements were allocated to each element of the arrangement based on the fair values of the elements, such as licenses for software products, maintenance or consulting services. The determination of fair value was based on objective evidence, which was specific to Liberate. We limited our assessment of objective evidence for each element to either the price charged when the same element was sold separately or the price established by management having the relevant authority to do so, for an element not yet sold separately. If evidence of fair value of all undelivered elements existed but evidence did not exist for one or more delivered elements, then revenue was recognized under the residual method. Under the residual method, the fair value of the undelivered elements was deferred and the remaining portion of the arrangement fee was recognized as revenue.

However, if such undelivered elements consisted of services that were essential to the functionality of the software, we recognized license and services revenues using contract accounting, pursuant to SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. If license arrangements included the rights to unspecified future products, revenue was recognized ratably over the contractual or estimated economic term of the arrangement. We recognized royalty revenues when a network operator reported that it had shipped or activated products or its rights to deploy such products expired.

Deferred revenue was primarily comprised of collections from and billings to customers for software arrangements, including subscription arrangements, which did not qualify for revenue recognition under our revenue recognition policy.

We reduced license and royalty revenues by certain expenses as a result of the application of EITF No. 01-09, which generally required that consideration, including warrants, issued to a customer should be classified in a vendor's financial statements not as an expense, but as a reduction to revenues up to the amount of cumulative revenues recognized or likely to be recognized from that customer.

*Service Revenues.* Service revenues consisted of consulting, maintenance, and other services. We generally recognized consulting and other service revenues, including non-recurring engineering and training, as services were performed. Where consulting services were performed under a fixed-price arrangement, we generally recognized revenues on a percentage-of-completion basis. Maintenance services included both updates and technical support. Maintenance revenues were recognized ratably over the term of the maintenance agreement. The fees for maintenance arrangements ranged between 15% and 25% of the cumulative license fees and activation royalties incurred under the contract, depending upon the level of

support being provided.

### Computation of Basic and Diluted Net Income (Loss) Per Share

Basic net income (loss) per share is computed using the weighted average number of shares of common stock outstanding during the periods presented. Calculation of fully diluted shares is required when reporting net income per share and includes the weighted average number of shares of common stock, stock options, stock units and warrants outstanding. As we have recorded a net loss for the three months ended August 31, 2004, the net loss per share on a diluted basis is equivalent to basic net loss per share because the effect of including all outstanding stock options, stock units and warrants in the earnings per share calculation would be anti-dilutive. Accordingly, for the three month period ended August 31, 2005, the dilutive common shares were 307,000 which were related to common stock awards. For the three month period ended August 31, 2004 we excluded from the calculation of net loss per share total potential dilutive common shares of 12,599,000.

The following table illustrates the reconciliation of the numerators and denominators of the basic and diluted earnings per share computations (in thousands, except per share data):

|   | Numerator                             |          | Denominator                           |         | Earnings (loss) per share             |        |
|---|---------------------------------------|----------|---------------------------------------|---------|---------------------------------------|--------|
|   | Three months ended August 31,<br>2005 | 2004     | Three months ended August 31,<br>2005 | 2004    | Three months ended August 31,<br>2005 | 2004   |
| Basic income (loss) per share                               |                                       |          |                                       |         |                                       |        |
| Net income (loss)   | 26,888                                | (12,329) | 110,925                               | 105,623 | 0.24                                  | (0.12) |
| Effect of dilutive common shares<br>related to stock awards |                                       |          | 307                                   |         |                                       |        |
| Diluted net income (loss) per<br>share                      | 26,888                                | (12,329) | 111,232                               | 105,623 | 0.24                                  | (0.12) |

### Reclassifications

Certain reclassifications, primarily resulting from discontinued operations, have been made to previously reported amounts in order to conform to current year's presentation. See Note 3, Discontinued Operations.

### Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS 123(R), Share-Based Payment. SFAS 123 (R) addresses the accounting for share-based payment transactions with employees and requires companies to expense the value of employee stock options and similar awards. SFAS 123(R) requires stock based compensation of the share-based payment to be measured at fair value on the date that the company grants the awards to employees. The expense should be recognized over the vesting period for each option and adjusted for actual forfeitures that occur before vesting. We are required to adopt SFAS 123(R) in Q1 of fiscal 2007.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ). SAB 107 covers key topics related to the implementation of SFAS 123(R) which include the valuation models, expected volatility, expected option term, income tax effects of SFAS 123(R), classification of stock-based compensation cost, capitalization of compensation costs and disclosure requirements. Although we do not expect to grant any future options, the Company is currently assessing the impact SFAS 123(R) and SAB 107 will have on our financial statements.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. This Statement changes the requirements for the accounting for and reporting of a change in accounting principle. It applies to all voluntary changes in accounting principle and to those changes required by an accounting pronouncement when such a pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. We do not expect the adoption of SFAS No. 154 in fiscal 2007 to have a material impact on our financial statements.

### **Note 3. Discontinued Operations**

On July 12, 2005, Liberate Technologies, completed the sale of substantially all of the assets of its Non-North America business to SeaChange International, Inc. ( SeaChange ). SeaChange acquired certain assets and assumed certain limited liabilities relating to the business outside of North America. Liberate received cash consideration of approximately \$23.5 million in connection with the completion of the asset sale to SeaChange. The sale was made pursuant to the Asset Purchase Agreement, dated as of April 15, 2005. We recognized a gain on the sale of the Non-North America business of \$35.1 million in the first quarter of fiscal 2006.

In April 2005, we completed the sale of substantially all of the assets of our North America business to Double C Technologies, LLC, a joint venture majority owned and controlled by Comcast Corporation with a minority investment by

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Cox Communications, Inc. for approximately \$82.0 million. The price included substantially all of the assets, including patents and other intellectual property, and the assumption of certain limited liabilities related to the North America business. We recognized a gain on the sale of the North America business of \$88.9 million in the fourth quarter of fiscal 2005.

Computation of the gain on the sale of the Non-North America business is as follows (in thousands):

|   |    | <b>Non-North<br/>America<br/>business</b> |
|---|----|---|
| Cash proceeds                           | \$ | 23,555                                    |
| Net liabilities assumed by buyer        |    | 11,583                                    |
| Gain on sale of discontinued operations | \$ | 35,138                                    |

Pursuant to the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, amounts in the financial statements and related notes have been reclassified to reflect the discontinued operations of both the North America business and the Non-North America business. Operating results for the discontinued operations are reported under Income (loss) from discontinued operations on the Condensed Consolidated Statement of Operations. Related assets and liabilities are classified as Assets of discontinued operations and Liabilities of discontinued operations, respectively, on the Condensed Consolidated Balance Sheet. As part of the Asset Sales, the accounts receivable were retained by Liberate while the obligation was transferred to the acquirer.

The following table reflects the impact of discontinued operations on certain statements of operations data for the three months ended August 31, 2005 and August 31, 2004 (in thousands except per share information).

|  | <b>Three months ended August 31,</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2005</b>                          | <b>2004</b> |
| Total revenues                                 | \$ 178                               | \$ 1,148    |
| Cost of revenues                               | 155                                  | 1,396       |
| Gross margin                                   | 23                                   | (248)       |
| Operating expenses                             | 1,710                                | 3,851       |
| Operating loss from discontinued operations    | (1,687)                              | (4,099)     |
| Interest and other income (expense)            | 7                                    | 48          |
| Gain on sale of discontinued operations        | 35,138                               | 80          |
| Income tax provision                           | 2,563                                | 35          |
| Net income (loss) from discontinued operations | \$ 30,895                            | \$ (4,006)  |

Additionally, the following table reflects the impact of discontinued operations from the of the Non-North America business on certain balance sheet data (in thousands):

|   | <b>May 31, 2005</b> |     |
|---|---------------------|-----|
| Prepaid expenses and other current assets | \$                  | 53  |
| Property and equipment, net               |                     | 361 |
| Assets of discontinued operations         | \$                  | 414 |
| Accrued payroll and related expenses      | \$                  | 107 |

|  |    |       |
|--|----|-------|
| Deferred revenues                      |    | 9,395 |
| Liabilities of discontinued operations | \$ | 9,502 |

**Note 4. Excess Facilities Charges and Related Asset Impairment**

Excess facilities charges represent remaining lease commitments on vacant facilities, net of expected sublease income. We periodically evaluate our existing needs, the current and estimated future value of our subleases, and other future commitments to determine whether we should record excess facilities charges or adjustments to such charges. Additionally, we periodically evaluate our leasehold improvements for impairment and, if necessary, we reduce the carrying value using

estimates of future cash flows to a level equal to the expected future value at that time. We have an existing commitment to lease office space at our former headquarters in San Carlos, California, in excess of our needs, and we did not anticipate that we will be able to sublease a substantial portion of our excess office space in the near future.

As of August 31, 2005 the total liability for excess facilities was \$23.3 million, including a short term liability of \$6.3 million. At May 31, 2005, the total liability for excess facilities was \$24.9 million, including a short term liability of \$6.3 million.

During Q1 FY06 we recorded a reduction in expenses of \$273,000 primarily due to an increase in expected sublease income with the renewal of a lease with a subtenant.

The liability for excess facilities as of May 31, 2004 did not include additional charges for additional space vacated in Q4 FY04 or potential savings related to the rejection of this lease under the U.S. Bankruptcy Code due to the uncertainty of the outcome of the bankruptcy proceeding. On September 8, 2004, the Bankruptcy Court issued a ruling dismissing our bankruptcy case. Pursuant to the dismissal of the bankruptcy case, which removed the uncertainty that existed at May 31, 2004, we recorded \$4.4 million of excess facilities charges in Q1 FY05 based on revised estimates related to future sublease income and the additional space vacated in Q4 FY04. The \$4.4 million excess facility charge consisted of a \$5.1 million charge related to additional space vacated in Q4 FY04, which was accounted for in accordance with SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, partially offset by an increase in estimates of sublease income of \$640,000 due to revised estimates related to future subleases.

## Note 5. Commitments and Contingencies

### Operating Leases

We currently have various operating leases for our former facilities in San Carlos and the UK that expire at various dates through fiscal 2009 and thereafter. Future minimum lease payments under these operating leases as of August 31, 2005 are as follows (in thousands):

|                             |    |        |
|-----------------------------|----|--------|
| <b>Years ending May 31,</b> |    |        |
| 2006                        | \$ | 6,654  |
| 2007                        |    | 8,760  |
| 2008                        |    | 8,068  |
| 2009 and thereafter         |    | 9,596  |
|                             | \$ | 33,078 |

### Letters of Credit

We maintain an irrevocable letter of credit for \$8.8 million as security deposit for our former headquarters in San Carlos, California. We vacated the San Carlos facility in March 2004 and ceased rent payment effective April 1, 2004. Our former landlord had drawn against the letter of credit for the unpaid rent, net of sublease income from the facility, in the amount of \$6.3 million as of May 31, 2005.

On June 23, 2005, Liberate established a new letter of credit in the amount of \$8.8 million with Circle Star Center Associates named as the beneficiary as a security deposit for our former headquarters in San Carlos, California. In order to secure our obligations with the bank, we established a certificate of deposit of \$8.8 million. This arrangement replaces the original letter of credit with another banking institution, and replenishes the letter of credit to the level required in the lease agreement. The amounts of the certificates of deposit are included in restricted cash on the condensed consolidated balance sheets.

### **Employment Agreements**

In March and April 2003, we entered into employee retention agreements with David Lockwood, Patrick Nguyen, Gregory Wood and Philip Vachon. Under the terms of the retention agreements, in the event of a change of control of Liberate that is followed within one year by the officer's actual or constructive termination, the officer would receive a payment equal to twice his total taxable compensation for the prior fiscal year, with a minimum payment of \$500,000 and a maximum payment of \$750,000. On June 15, 2005, the Board of Directors approved payments in connection with amendments to the retention agreements. Pursuant to the employee retention agreements as so amended, Liberate made such payments in June and July 2005 to Messrs. Lockwood, Vachon, Wood and Nguyen in the amounts of \$625,000, \$750,000, \$625,000 and \$625,000, respectively, at which point the agreements with those executives terminated. We have other retention agreements with a small number of non-executive employees.

As part of our standard compensation package, certain employees and managers may be eligible to participate in discretionary and non-discretionary bonus plans.

### **Indemnification Obligations**

FIN 45 Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee or indemnification. FIN 45 also requires additional disclosure by a guarantor in its interim and annual financial statements about its obligations under certain guarantees and indemnifications. The initial recognition and measurement provisions of FIN 45 are applicable for guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. We adopted the recognition and measurement provisions of FIN 45 prospectively to guarantees issued or modified after December 31, 2002. The adoption of this standard did not have a material impact on our consolidated results of operations or financial position.

Our software license agreements typically provide for indemnification of customers for intellectual property infringement claims. To date, no such claims have been filed against us. We also warrant to customers that software products operate substantially in accordance with specifications. Historically, we have incurred minimal costs related to product warranties, and accordingly, we have not accrued warranty costs for the periods presented. In addition, we are obligated to indemnify our officers and directors under the terms of indemnity agreements entered into with them, as well as pursuant to our certificate of incorporation, bylaws, and applicable Delaware law. We are unable to quantify the charge that could result from officer and director indemnification.

### **Legal Matters**

*Restatement Class-Action Litigation.* On October 20, 2004, a Stipulation and Agreement of Settlement (the *Settlement*) was filed with the United States District Court for the Northern District of California (the *Court*) in connection with the matter *In re Liberate Technologies Securities Litigation* (the *Class Action*). The Class Action is based on the restatement of our financial statements for certain periods of fiscal 2002 and the revision of our preliminary financial results announced for the first quarter of fiscal 2003 (the *Restatement*). The parties to the Settlement are: (i) the lead plaintiff in the Class Action, on behalf of himself and each of the class members; and (ii) defendants Liberate Technologies, Mitchell E. Kertzman, Nancy J. Hilker and Coleman Sisson. Under the terms of the Settlement, Liberate agreed to pay or cause to be paid \$13.8 million in settlement of the claims specified in the Class Action, and the lead plaintiff and each class member agreed to release Liberate and the other defendants from those claims. The Settlement shall in no way be construed or deemed to be evidence of or an admission or concession on the part of Liberate or the other specified defendants with respect to any claim or any fault or liability or wrongdoing or damage whatsoever, or any infirmity in the defenses that the defendants have asserted.

Following a settlement hearing on February 15, 2005, the Court granted final approval of the Settlement and, pursuant to the Settlement, entered judgment dismissing the Class Action with prejudice.

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During Q3 FY05, Liberate paid out the settlement amount of \$13.8 million and recovered \$5.0 million from its insurance carrier. The company expects to recover another \$4.4 million as a rebate of part of the premiums paid for the loss mitigation policy that the Company obtained for the Class Action and Derivative Action, which is included in other receivables at August 31, 2005.

*Restatement Derivative Litigation.* On May 3, 2005, a Stipulation of Settlement re Derivative Claims (the Stipulation ) was filed with the California Superior Court for the County of San Mateo in connection with the matter In re Liberate Technologies Derivative Litigation (the Derivative Action ). As reflected in the Stipulation, Liberate has reached an agreement in principle to settle the Derivative Action on terms that, among other things, provide for Liberate to adopt certain specified corporate governance changes, the dismissal with prejudice of all claims asserted by plaintiffs, and the payment of plaintiffs' counsel's fees and expenses of \$550,000. Following a settlement hearing on August 16, 2005, the Court granted final approval of the settlement and, pursuant to the settlement, entered judgment dismissing the Derivative Action with prejudice, and Liberate paid the settlement amount to plaintiff's counsel.

*SEC Investigation.* On February 13, 2003, the SEC initiated a formal, non-public investigation into the events and circumstances that led to the restatement of Liberate's financial statements. On September 29, 2004, Liberate announced that the SEC's investigation has been terminated as to Liberate. The SEC also advised Liberate that no enforcement action against Liberate has been recommended.

*Lease-Related Litigation* On September 29, 2004, Circle Star Center Associates, L.P., the landlord of Liberate's former offices in San Carlos, California, filed a complaint in the California Superior Court for the County of San Mateo alleging that Liberate had breached the office lease by, among other things, failing to pay rent for certain months of 2004 and applicable late fees, failing to replenish the letter of credit and failing to reimburse the landlord for its attorneys' fees in connection with Liberate's bankruptcy proceeding. The complaint also includes allegations of conversion and defamation. The complaint seeks damages of approximately \$3.9 million for the alleged breach and conversion and unspecified damages for the alleged defamation. In November 2004, Liberate filed motions challenging the legal basis for the landlord's cause of action for defamation and claim for attorneys' fees in connection with Liberate's bankruptcy. On March 24, 2005, the Superior Court granted Liberate's motions and dismissed the landlord's claims for defamation and attorneys' fees. On May 23, 2005, Liberate paid the landlord approximately \$1.2 million for past rent due, late fees and interest in connection with the various lease-related actions, and we have procured a replacement letter of credit.

In addition, on December 16, 2004, the landlord filed a further complaint for breach of lease against Liberate. The complaint seeks damages in the amount of not less than approximately \$1.2 million, plus prejudgment interest, costs of suit and attorneys' fees, alleging that Liberate breached the lease by failing to pay rent in November and December 2004. On February 22, 2005, the landlord filed a motion for summary judgment on the breach of contract claim. On May 10, 2005, Liberate paid the landlord approximately \$1.3 million for the months at issue in this action and on May 13, 2005, the Superior Court granted the landlord's motion for summary judgment.

On May 6, 2005, the landlord filed a third complaint against Liberate alleging that Liberate breached the lease by failing to pay rent for certain months of 2005 and failing to replenish the letter of credit. The landlord seeks approximately \$5.5 million plus pre-judgment interest, costs of suit and attorneys' fees. On May 23, 2005 Liberate paid the landlord approximately \$1.2 million for past rent due, late fees and interest in connection with the various lease-related actions, and we have procured a replacement letter of credit.

On September 22, 2005, pursuant to a stipulation of the parties, the Superior Court referred the first and third lease-related actions to a temporary judge. A trial before the temporary judge on the landlord's claim for interest on the unpaid replenishment amount is currently scheduled for October 31, 2005. The landlord has indicated that (i) it intends to seek an award of attorneys' fees incurred as a result of Liberate's alleged breaches of the lease, and (ii) it intends to pursue an appeal of the dismissal of its defamation cause of action in its claim for attorneys' fees in connection with Liberate's bankruptcy proceeding.

While Liberate intends to defend these lawsuits vigorously, because litigation is by its nature uncertain, we are unable to predict the outcome or estimate the potential liability, if any, of this litigation.

*Underwriting Litigation.* Beginning on May 16, 2001, a number of class-action lawsuits seeking monetary damages were filed in the United States District Court for the Southern District of New York against several of the firms that underwrote our initial public offering, naming Liberate and certain of our former officers and current or former directors as co-defendants. The suits allege that the underwriters received excessive and improper commissions that were not disclosed in our prospectus and that the underwriters artificially increased the price of our stock. The plaintiffs subsequently added allegations regarding our secondary offering, and named additional officers and directors as co-defendants. The suits were consolidated into one action that was coordinated for pretrial purposes with hundreds of virtually identical suits under a case captioned *In re Initial Public Offering Securities Litigation*, Civil Action No. 21-MC-92. On February 19, 2003, the court denied in part and granted in part a motion to dismiss filed on

behalf of the defendants, including Liberate. The court's order did not dismiss any claims against Liberate. As a result, discovery may proceed. The individual defendants have been dismissed without prejudice in this litigation.

While we deny allegations of wrongdoing, we have agreed to enter into a global issuer settlement of plaintiffs' claims. In June 2004, a stipulation of settlement and release of claims against the issuer defendants, including Liberate, was submitted to the court for approval. The terms of the settlement, if approved, would dismiss and release all claims against the participating defendants (including Liberate). In exchange for this dismissal, D&O insurance carriers would agree to guarantee a recovery by the plaintiffs from the underwriter defendants of at least \$1 billion, and the issuer defendants would agree to an assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. The settlement is subject to a number of conditions, including court approval. On August 31, 2005, the Court granted preliminary approval of the stipulation of settlement, and set a hearing for April 24, 2006 for further consideration of the stipulation of settlement and whether the settlement should receive final approval of the Court.

We cannot predict the timing or ultimate outcome of this proposed settlement or estimate the amounts of, or potential range of loss with respect to, this litigation if a settlement is not approved.

*OpenTV Patent Litigation.* On February 7, 2002, OpenTV filed a lawsuit against Liberate in the United States District Court for the Northern District of California, alleging that Liberate is infringing two of OpenTV's patents and seeking monetary damages and injunctive relief. We filed an answer denying OpenTV's allegations. Our counter-claim alleges that OpenTV infringes one of our patents for information retrieval systems. We were seeking to have OpenTV's

patents invalidated, and had requested a finding that our technology does not infringe OpenTV's patents, and had sought monetary damages and injunctive relief against OpenTV. The court issued a claim construction ruling, but a trial date is not currently set. Pursuant to the asset purchase agreement with Double C Technologies LLC that closed on April 7, 2005, Double C has assumed the defense and liabilities associated with this lawsuit.

*Insurance Coverage Litigation.* On December 29, 2004, Federal Insurance Company, one of Liberate's excess insurance carriers, filed a complaint for declaratory judgment, alleging that Liberate and other defendants are not entitled to coverage for defense costs and losses incurred in connection with the Class Action, Derivative Action, SEC investigation or other matters. The complaint, filed in the U.S. District Court for the Northern District of California, named as defendants Liberate and certain former officers and current and former directors. On March 18, 2005, Federal Insurance Company voluntarily dismissed its complaint without prejudice.

On March 1, 2005, Liberate filed a complaint against the London Underwriters, New Hampshire Insurance Company Per: AIG Europe (UK) Limited and Federal Insurance Company (together, the Carriers) for breach of contract, breach of the implied covenant of good faith and fair dealing and declaratory relief. The complaint, filed in the California Superior Court for the County of San Mateo, alleges that the Carriers failed to perform any of their obligations under their respective policies and applicable law on behalf of Liberate or its directors and officers in connection with the Class Action, the Derivative Action and the SEC Investigation. Liberate seeks monetary damages, exemplary or punitive damages, attorneys' fees and declaratory relief.

On April 8, 2005, Federal Insurance Company (Federal) filed a motion challenging the legal basis for Liberate's complaint. On May 2, 2005, New Hampshire Insurance Company and the London Underwriters filed an answer to the complaint. On May 13, 2005, the Superior Court denied Federal's motion. On June 22, 2005, the California Court of Appeal issued a writ of mandate that directed the Superior Court to grant Federal's motion with leave to amend as to Liberate's breach of contract and bad faith claims against Federal. On August 3, 2005, Liberate filed an amended complaint with the Superior Court.

On May 23, 2005, Federal filed a cross-complaint against Liberate and certain of its former officers and directors for breach of contract and declaratory relief. On July 11, 2005, Liberate filed a motion challenging the legal basis for Federal's complaint. On August 9, 2005, the Superior Court granted in part Liberate's motion with leave to amend.

Liberate intends to prosecute its rights under its insurance policies and defend Federal's cross-complaint vigorously. However, litigation is by its nature uncertain and there can be no assurance that Liberate will be successful in securing coverage under the policies.

*Stock Option Litigation.* On March 3, 2005, Mitchell Kertzman, Liberate's former Chairman of the Board and Chief Executive Officer, filed a complaint in the California Superior Court for the County of San Mateo alleging that Liberate breached its Stock Option Agreement with Mr. Kertzman by, among other things, failing to allow him to exercise his stock options after the termination of his employment with Liberate. Liberate believes that it has complied at all times with the terms of the Stock Option Agreement. The complaint alleges claims for breach of contract, breach of the implied covenant of good faith and fair dealing and interference with contract and prospective economic advantage. The complaint seeks monetary damages of at least \$3.0 million, interest and punitive damages in an unspecified amount. On June 16, 2005, Liberate filed an answer to the complaint. A trial date in this action is currently scheduled for January 17, 2006.

*Insight Interactive Litigation.* On June 13, 2005, Liberate filed a complaint against Insight Interactive L.L.C. for breach of contract, specific performance, and open book account. The complaint, filed in the California Superior Court for the County of San Mateo, alleges that under a March 6, 2000 agreement with Liberate, Insight Interactive has failed to pay fees as they become due. Liberate seeks monetary damages, specific performance, and interest and costs as provided by law and/or the March 6, 2000 agreement. On September 1, 2005, Insight Interactive filed an answer generally denying the causes of action set forth in Liberate's complaint and asserting various affirmative defenses, including the contention that Liberate is not entitled to payment under the March 6, 2000 agreement. Liberate intends to prosecute its rights under the agreement vigorously. However, litigation is by its nature uncertain and there can be no assurance that Liberate will be successful in obtaining damages or other relief.

*Reverse Stock Split Litigation.* On September 19, 2005, Leslie J. Lee filed a putative class action complaint in the Court of Chancery of the State of Delaware, alleging, among other things, that Liberate and certain officers and directors breached their fiduciary duties in connection with the Reverse/Forward Stock Split proposed by Liberate. Plaintiff purports to bring the action individually and on behalf of a putative class of all stockholders owning fewer than 250,000 shares of Liberate common stock. The complaint seeks preliminary and permanent injunctive relief against the Reverse/Forward Stock Split, declaratory relief, rescission of the Reverse/Forward Stock Split (if necessary), rescissory and/or compensatory damages and attorneys' fees and expenses. Also on

September 19, 2005, Plaintiff filed a motion for expedited proceedings and a motion for preliminary injunction. On September 27, 2005, Liberate filed a letter in opposition to Plaintiff's motion for expedited proceedings. On October 6, 2005, the court heard oral argument on the motion and, at the conclusion of the argument, denied plaintiff's motion for expedited proceedings and declined to schedule a hearing on plaintiff's motion for a preliminary injunction. Liberate believes the allegations are without merit and intends to defend the complaint vigorously.

We have notified our various insurance carriers of the Class Action, Derivative Action, the Reverse Stock Split litigation and other pending legal matters. Our primary carrier and one of our secondary carriers under our existing policies have disputed whether certain costs incurred in connection with the restatement-related litigation and the SEC investigation are covered under their respective policies. Our insurance may not cover all or portions of our defense costs, any settlement, any judgment rendered against us, or amounts we are required to pay to any indemnified person in connection with the Class Action or Derivative Action or any expenses incurred in connection with the SEC investigation or any other matter.

While Liberate intends to defend and prosecute the above mentioned lawsuits vigorously because legal actions are inherently uncertain, we cannot predict or determine the outcome or resolution of these actions or estimate with any degree of certainty the amounts of loss or recovery with respect to these proceedings. In addition, the timing of the final resolution of these proceedings is uncertain. The actual amount of our liability or recovery in any particular matter could be greater or less than management's estimates, which could result in a net aggregate liability to Liberate outside of the range stated above. The possible resolutions of these proceedings could include judgments against us or settlements that could require substantial payments by us, which could have a material adverse impact on our business, financial position, results of operations and cash flows. The cost of participating and defending against these actions is substantial and will require the continued diversion of management's attention and corporate resources.

In addition to these pending lawsuits, Liberate is considering pursuing claims against its former Chief Operating Officer, Donald Fitzpatrick, to recover money due and owing and damages resulting from his conduct as an officer of Liberate in connection with Liberate's restatement of its financial statements for certain periods of fiscal 2002 and the revision of its preliminary financial results announced for the first quarter of fiscal 2003. However, Liberate has not yet determined whether the potential benefits of pursuing any such claims against Mr. Fitzpatrick would outweigh the costs. In addition, should Liberate decide to pursue any such claims against Mr. Fitzpatrick, we can give you no assurance as to the likelihood that we would prevail, or that even if Liberate prevails, we would be able to actually recover from Mr. Fitzpatrick the amount of any judgment obtained.

#### **Legal Contingencies**

Of the \$13.1 million of accrued liabilities reported within our condensed consolidated balance sheet approximately \$1.7 million has been accrued for resolution of shareholder litigation. We have not accrued any amounts in connection with the Lease-Related Litigation, the OpenTV Litigation, the Stock Option Litigation, the Underwriting Litigation (in the event that the proposed settlement is not approved) or the Reverse Stock Split Litigation. Management believes we have meritorious defenses to these claims and intends to defend these actions vigorously. However, we are unable to predict the outcome or resolution of these actions or estimate the amounts of, or potential range of, loss with respect to these actions.

#### **Note 6. Offerings of Common Stock**

#### **Dividend of \$0.15 per Common Share**



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On June 15, 2005, the Board of Directors of Liberate declared a one-time dividend of \$0.15 per common share. The dividend was payable to the holders of record on June 27, 2005 upon the closing of the sale of Liberate's Non-North America business to SeaChange pursuant to the terms of the Asset Purchase Agreement, dated as of April 15, 2005. The SeaChange transaction closed on July 12, 2005. As required by the NASD rules, the ex-dividend date was set one business day after the payment date. The dividend aggregating \$16.6 million was paid on July 13, 2005 and was recorded against paid-in-capital since Liberate has an accumulated deficit.

### **Common Stock**

In Q1 FY06 we issued 65,302 shares of common stock upon the exercise of stock options, and 10,000 stock units became vested. For these 10,000 vested stock units, the employees received cash in lieu of the units of stock.

In Q1 FY05 we issued 7,332 shares of common stock upon the exercise of stock options, and 313,615 stock units

became vested (of which 103,591 vested units were withheld to satisfy employee withholding taxes, resulting in a net issuance of 210,024 shares to employees and non-employee directors).

#### **Stock-based Compensation   Stock Units**

During fiscal 2004, we implemented a program to grant restricted stock units ( RSUs ) to certain employees and non-employee directors as part of our overall stock-based compensation. Each RSU entitles the holder to receive one share of Liberate common stock on the vesting date of the RSU. The RSUs granted to employees generally vest over a period of four years while those granted to non-employee directors generally vest over 12 months. Stock-based compensation representing the intrinsic value (fair market value) of the underlying shares at the date of grant of the RSUs is recognized evenly over the vesting period. On the vesting dates, the RSUs are settled by the delivery of shares of common stock to the participants. During the three months ended August 31, 2005, there were no RSUs granted to employees. During the quarter ended August 31, 2005, 191,564 RSUs were cancelled primarily due to employee terminations as a result of the sale of the Non-North America business. As of August 31, 2005 the balance of the deferred stock-based compensation related to RSUs was zero in stockholder s equity and there were no unvested RSUs.

During the three months ended August 31, 2004, we granted 75,000 RSUs to employees. During the quarter 84,689 RSUs were cancelled due to employee terminations. As of August 31, 2004 there was a balance of \$7.9 million in deferred stock-based compensation related to RSUs in stockholder s equity and there were 2,229,924 RSUs outstanding and unvested.

#### **Note 7. Subsequent Events**

##### **Reverse Stock Split Litigation**

*Reverse Stock Split Litigation.* On September 19, 2005, Leslie J. Lee filed a putative class action complaint in the Court of

Chancery of the State of Delaware, alleging, among other things, that Liberate and certain officers and directors breached their fiduciary duties in connection with the Reverse/Forward Stock Split proposed by Liberate. Plaintiff purports to bring the action individually and on behalf of a putative class of all stockholders owning fewer than 250,000 shares of Liberate common stock. The complaint seeks preliminary and permanent injunctive relief against the Reverse/Forward Stock Split, declaratory relief, rescission of the Reverse/Forward Stock Split (if necessary), rescissory and/or compensatory damages and attorneys' fees and expenses. Also on September 19, 2005, Plaintiff filed a motion for expedited proceedings and a motion for preliminary injunction. On September 27, 2005, Liberate filed a letter in opposition to Plaintiff's motion for expedited proceedings. On October 6, 2005, the court heard oral argument on the motion and, at the conclusion of the argument, denied plaintiff's motion for expedited proceedings and declined to schedule a hearing on plaintiff's motion for a preliminary injunction. Liberate believes the allegations are without merit and intends to defend the complaint vigorously.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Overview**

Prior to the sales of the North America business and the Non-North America business (collectively the "Asset Sales"), Liberate was a provider of software for digital cable television systems. Based on industry standards, Liberate's software enabled cable operators to run multiple services, including high-definition television, interactive programming guide, video on demand, personal video recorders and games, on multiple platforms. As a result of the Asset Sales, Liberate has no significant product offering or services business.

The following discussion of the financial condition and results of operations of Liberate should be read in conjunction with the condensed consolidated financial statements and the notes there to included elsewhere herein and the discussion contained in Liberate's annual report on Form 10-K and the amended annual report on Form 10-K/A for the fiscal year ended May 31, 2005. The discussion in this report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements in this report, other than statements that are purely historical, are forward-looking statements. Words such as anticipates, expects, believes, intends, plans, estimates and similar expressions also identify forward-looking statements. These forward-looking statements are not guarantees of future performance, and are subject to risks and uncertainties that could cause our actual results to differ materially from the results contemplated in the forward-looking statements. Forward-looking statements in this report include, without limitation, those relating to future revenues, costs, expenses and other financial results, as well as future customer agreements or deployments, disposition of assets, management strategies or the outcome of legal proceedings.

Risks and uncertainties that could cause actual results to differ materially include risks associated with the Reverse/Forward Stock Split, the emerging nature of our market, unknown revenue potential, a limited number of potential customers and the risks associated with legal proceedings, in addition to other risks identified below in "Risk Factors." Other factors and assumptions not identified above were also involved in the derivation of these forward-looking statements, and the failure of such other assumptions to be realized as well as other factors may also cause actual results to differ materially. Most of these factors are difficult to predict accurately and are generally beyond our control. We assume no obligation to update any forward-looking statements, and we encourage you not to place undue reliance on forward-looking statements, which speak only as of the date of this report. You are also encouraged to consider forward-looking statements in light of our condensed consolidated financial statements, related notes, and the cautionary statements and risk factors listed from time to time in our reports on Form 10-K, Form 10-Q and Form 8-K filed with the SEC.

**Filing of Going Private Proxy Statement**



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On June 23, 2005, Liberate filed with the SEC a preliminary Schedule 13E-3 Transaction Statement with respect to a going private transaction and a preliminary Schedule 14A Proxy Statement soliciting stockholders to vote on the Reverse/Forward Stock Split. On August 26, 2005, Liberate filed with the SEC, an amendment to each of the preliminary Schedule 13E-3 Transaction Statement and preliminary Schedule 14A Proxy Statement, relating to the Reverse/Forward Stock Split. If approved, the Reverse/Forward Stock Split should enable Liberate to complete the going private transaction provided there will be fewer than 300 holders of record of common stock. This will permit Liberate to discontinue the obligations of filing annual and periodic reports and make other filings with the SEC.

Once the Schedule 13E-3 Transaction Statement and Schedule 14A Proxy Statement are approved in a definitive form by the SEC, Liberate will mail copies to all of its stockholders, describing all of the material terms of the Reverse/Forward Stock Split. Liberate currently intends to effect the Reverse/Forward Stock Split as soon as possible thereafter.

### **Reverse Stock Split Litigation**

On September 19, 2005, Leslie J. Lee filed a putative class action complaint in the Court of Chancery of the State of Delaware, alleging, among other things, that Liberate and certain officers and directors breached their fiduciary duties in connection with a 1-for-250,000 reverse stock split proposed by Liberate (the "Stock Split"). Plaintiff purports to bring the action individually and on behalf of a putative class of all stockholders owning fewer than 250,000 shares of Liberate common stock. The complaint seeks preliminary and permanent injunctive relief against the Stock Split, declaratory relief, rescission of the Stock Split, rescissory and/or compensatory damages and attorneys' fees and expenses. Also on September 19, 2005, Plaintiff filed a motion for expedited proceedings and a motion for preliminary injunction. On September 27, 2005, Liberate filed a letter in opposition to Plaintiff's motion for expedited proceedings. On October 6, 2005, the court heard oral argument on the motion and, at the conclusion of the argument, denied plaintiff's motion for expedited proceedings and declined to schedule a hearing on plaintiff's motion for a preliminary injunction. Liberate believes the allegations are without merit and intends to defend the complaint vigorously.

### **Subscription-based License Agreements**

Beginning in fiscal 2004, we entered into agreements with several cable operators. These agreements provided for monthly subscription fees based on deployments of our software with cable customers. In some cases, we received up-front fees at the inception of the license agreement. In addition, the completed agreements had provided for minimum periodic license fees for minimum subscriber levels. Pursuant to these agreements, we invoiced our customers and amounts due had been paid and were non-refundable.

We had not recognized revenues under the agreements. We had concluded, that based on current contract provisions, that because the agreements provide for future delivery of products and specified annual updates of the product during the term of the agreements we were unable to recognize revenue under our revenue recognition policy. While future annual product updates were contemplated and identified at the inception of the agreement, the details of the product releases would be discussed and agreed between us and the customers at future dates. During the quarter ended August 31, 2005, we collected \$2.5 million non-refundable up-front fees and non-refundable monthly subscription fees from customers under these subscription license arrangements. As a result of the Asset Sales, all deferred revenue amounts were transferred to discontinued operations as part of the net liabilities assumed by the buyers.

### **Critical Accounting Policies Update**

There have been no material changes to our critical accounting policies as disclosed on our annual report on Form 10-K for the fiscal year ended May 31, 2005.

## Revenues and Cost of Revenues

Pursuant to the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, amounts in our unaudited consolidated financial statements and the related notes, included in Item 1, have been reclassified to reflect the discontinued operations of our North America business and Non-North America business. Operating results for the discontinued operations are reported, net of tax, under *Income (loss) from discontinued operations* on the consolidated statement of operations. We classified \$178,000 and \$1.1 million of revenue as part of discontinued operations for the three months ended August 31, 2005 and August 31, 2004, respectively, relating to the Asset Sales. For the cost of revenues we reclassified \$155,000 and \$1.4 million as part of discontinued operations for the three months ended August 31, 2005 and August 31, 2004, respectively, relating to the Asset Sales. See Note 3 in the Notes to Condensed Consolidated Financial Statements.

Prior to our Asset Sales, we generated license and royalty revenues by licensing our client and server software products, applications, and tools, primarily to network operators that provide television services, and, in a small number of cases, to set-top box manufacturers. We generated service revenues from consulting, maintenance, and other services provided in connection with those licenses. The cost of revenues consisted primarily of salary and other related costs for employees, costs incurred for licenses and support of third-party technologies that are incorporated in our products and external contractors.

As a result of the Asset Sales, we have no significant product offering or services business thus we do not expect that our revenues or cost of revenues will equal or exceed historical levels.

**Operating Expenses**

The operating expenses described below have all been adjusted for discontinued operations for the periods shown. Since all of the revenues have been reclassified to discontinued operations, the operating expenses of Liberate are not shown as a percentage of revenue. As a result of the Asset Sales, we expect operating expenses to decrease.

*Research and Development.* Research and development expenses consist primarily of salary, employee-related expenses, and costs for external contractors, as well as costs related to outsourced development projects necessary to support product development. Research and development expenses were as follows (in thousands):

|                                     | <b>Three months ended August 31,</b> |             |
|-------------------------------------|--------------------------------------|-------------|
|                                     | <b>2005</b>                          | <b>2004</b> |
| Research and development            | \$                                   | \$ 494      |
| Decrease, year over year            | \$                                   | (494)       |
| Percentage decrease, year over year |                                      | (100)%      |

Research and development expenses for Q1 FY05 consists primarily of salary and employee related expenses of \$302,000 for research and development that were not part of the Asset Sales. In addition, \$175,000 was the allocation of shared corporate expenses which consisted primarily of management costs, insurance and benefits. For Q1FY06 research and development expenses totaling \$1.6 million related to discontinued operations.

*Sales and Marketing.* Sales and marketing expenses consist primarily of salaries and other employee-related expenses for sales and marketing personnel, sales commissions, travel, marketing communications and regional sales offices. Sales and marketing expenses were as follows (in thousands):

|                                     | <b>Three months ended August 31,</b> |             |
|-------------------------------------|--------------------------------------|-------------|
|                                     | <b>2005</b>                          | <b>2004</b> |
| Sales and marketing                 | \$                                   | \$ 248      |
| Decrease, year over year            | \$                                   | (248)       |
| Percentage decrease, year over year |                                      | (100)%      |

Sales and marketing expenses for Q1 FY05 consists of an allocation of Liberate's centrally managed sales and marketing costs. The allocation was based on even sharing of the total costs. For Q1 FY06 sales and marketing expenses of \$50,000 related to discontinued operations.

*General and Administrative.* General and administrative expenses consist primarily of salaries and other employee-related expenses for corporate development, finance, human resources, and legal employees; outside legal and other professional fees; and non-income-based taxes. General and administrative expenses were as follows (in thousands):

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|                                     | Three months ended August 31, |          |
|-------------------------------------|-------------------------------|----------|
|                                     | 2005                          | 2004     |
| General and administrative          | \$ 7,117                      | \$ 3,601 |
| Increase, year over year            | \$ 3,516                      |          |
| Percentage increase, year over year | 98%                           |          |

The increase in general and administrative expenses from Q1 FY05 to Q1 FY06 was due to an increase in employee related expenses of \$4.7 million primarily related to payments made in Q1 FY06 pursuant to the amendment of employee retention agreements for executive officers in June 2005 and other discretionary employee bonuses. This increase was partially offset by a decrease in facilities expenses of \$643,000, a decrease in professional fees of \$436,000 and a decrease in other expenses of \$116,000, which includes primarily computer supplies of \$43,000, depreciation of \$24,000 and external contractors of \$39,000.

*Excess Facilities Charges and Related Asset Impairment.* Our excess facilities charges consist primarily of costs associated with permanently vacating our facilities and the related asset impairments. In determining the charges for excess facilities, we are required to estimate future sublease income, future net operating expenses of the facilities, and other expenses. The most significant of these estimates relates to the timing and extent of future sublease income which reduces our lease obligations. We based our estimates of sublease income on current market conditions and rental rates provided by an independent real estate consultant, an assessment of the time period over which reasonable estimates could be made, the status of negotiations with potential subtenants, and the location of the facility, among other factors. Adjustments to the facilities accrual will be required if actual lease exit costs or sublease income differ from amounts currently expected. We review the status of activities on a quarterly basis and, if appropriate, record changes to our excess facilities obligations in current operations based on management's most current estimates. If current market conditions for the commercial real estate market remain the same or worsen, or we conclude that we are not likely to use additional space, we may be required to record additional charges in future periods.

The liability for excess facilities as of May 31, 2004 did not include charges for additional space vacated in Q4 FY04 or potential savings related to the anticipated rejection of this lease under the U.S. Bankruptcy Code due to the uncertainty of the outcome of the bankruptcy proceeding. On September 8, 2004, the Bankruptcy Court issued a ruling dismissing our bankruptcy case. In connection with the dismissal of the bankruptcy case, which removed the uncertainty that had existed at May 31, 2004, we recorded \$4.4 million of excess facilities charges in Q1 FY05 based on revised estimates related to future sublease income and the additional space vacated in Q4 FY04. The \$4.4 million excess facility charge consists of a \$5.1 million charge related to additional space vacated in Q4 FY04 partially offset by an increase in estimates of sublease income of \$640,000. During Q1 FY06 we recorded a reduction in expenses of \$273,000 primarily due to an increase in sublease income with the renewal of a lease with a subtenant.

As of August 31, 2005 the total liability for excess facilities was \$23.3 million, including a short term liability of \$6.3 million. At May 31, 2005, the total liability for excess facilities was \$24.9 million, including a short term liability of \$6.3 million.

#### Interest Income, Net

Interest income, net consists of interest earned on our cash and cash equivalents and short-term investments, and is netted against interest expense primarily related to an operating lease. Interest income, net was as follows (in thousands):

|                                     | Three months ended August 31, |       |    |     |
|-------------------------------------|-------------------------------|-------|----|-----|
|                                     | 2005                          | 2004  |    |     |
| Interest income, net                | \$                            | 307   | \$ | 548 |
| Decrease, year over year            | \$                            | (241) |    |     |
| Percentage decrease, year over year |                               | (44)% |    |     |

Interest income, net decreased from Q1 FY05 to Q1 FY06 primarily due to lower cash balances. Interest income could continue to decline in future periods because of lower cash balances and lower interest rates.

#### Other Income (Expense), Net

Other income (expense), net consists of re-measurement gains and losses from the operations of our foreign subsidiaries and foreign currency exchange gains and losses and other non-operating income and expenses. For the three months ended August 31, 2005 and August 31, 2004, other income (expense), net was \$21,000 and \$(110,000), respectively. The increase was primarily due to lower re-measurement and foreign currency exchange losses.

**Income Tax Provision (Benefit)**

The income tax provision consists of foreign withholding tax expense, foreign and state income taxes and taxes related to discontinued operations. For the three months ended August 31, 2005, the income tax benefit related to continuing operations was \$2.5 million and the provision related to discontinued operations was \$2.6 million. For the three months ended August 31, 2004, the income tax provision relating to continuing operations was \$3,000 and the provision related to discontinued operations was \$35,000.

**Income (loss) from Discontinued Operations**

Pursuant to the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, amounts in the financial statements and related notes have been reclassified to reflect the discontinued operations of both the North America business and the Non-North America business. Operating results for the discontinued operations are reported, net of tax, under Income (loss) from discontinued operations on the Condensed Consolidated Statement of Operations.

On July 12, 2005, Liberate Technologies, completed the sale of substantially all of the assets of its Non-North America business to SeaChange International, Inc. ( SeaChange ). SeaChange acquired certain assets and assumed certain limited liabilities relating to the business outside of North America. Liberate received cash consideration of approximately \$23.5 million in connection with the completion of the asset sale to SeaChange. The sale was made pursuant to the Asset Purchase Agreement, dated as of April 15, 2005. We recognized a gain on the sale of the Non-North America business of \$35.1 million in the first quarter of fiscal 2006.

Computation of the gain on the sale of the Non-North America business is as follows (in thousands):

|   | <b>Non-North<br/>America<br/>business</b> |
|---|---|
| Cash proceeds                           | \$ 23,555                                 |
| Net liabilities assumed by buyer        | 11,583                                    |
| Gain on sale of discontinued operations | \$ 35,138                                 |

For the three months ended August 31, 2004 we recorded a gain on the sale of discontinued operations of \$80,000 from unanticipated cash receipts from a third party relating to the sale of discontinued operations.

The following table reflects the impact of discontinued operations on certain statements of operations data for the three months ended August 31, 2005 and August 31, 2004 (in thousands except per share information).

|  | <b>Three months ended August 31,</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2005</b>                          | <b>2004</b> |
| Total revenues                                 | \$ 178                               | \$ 1,148    |
| Cost of revenues                               | 155                                  | 1,396       |
| Gross margin                                   | 23                                   | (248)       |
| Operating expenses                             | 1,710                                | 3,851       |
| Operating loss from discontinued operations    | (1,687)                              | (4,099)     |
| Interest and other income (expense)            | 7                                    | 48          |
| Gain on sale of discontinued operations        | 35,138                               | 80          |
| Income tax provision                           | 2,563                                | 35          |
| Net income (loss) from discontinued operations | \$ 30,895                            | \$ (4,006)  |

*Liquidity and Capital Resources*

**Cash Flows**

Our principal source of liquidity at August 31, 2005 was cash and cash equivalents and liquid investments of \$41.8 million. In addition, we had \$9.8 million of restricted cash that primarily secures obligations under two office leases.

*Cash Flows from Operating Activities.* For the three months ended August 31, 2005, net cash used in operating activities was \$6.7 million. This amount consisted primarily of net income of \$26.9 million, adjusted for \$35.2 million of non-cash adjustments to reconcile net income to net cash used in operating activities and a \$1.6 million net increase in operating assets and liabilities. The non-cash adjustments consisted primarily of \$35.2 million related to discontinued operations. The net decrease in operating assets and liabilities was primarily due to an increase in accounts payable of \$1.9 million, partially offset by a decrease in accrued liabilities of \$1.2 million, a decrease in accrued payroll and related expenses of \$212,000, a decrease in long-term excess facilities of \$1.5 million a decrease in accounts receivable of \$2.4 million and a decrease in prepaid expenses and other current assets of \$160,000.

For the three months ended August 31, 2004, net cash used in operating activities was \$5.5 million. This amount consisted primarily of net loss of \$12.3 million, adjusted for \$3.0 million of non-cash adjustments to reconcile net loss to net cash used in operating activities and a \$5.2 million net increase in operating assets and liabilities. The non-cash adjustments consisted primarily of \$2.8 million related to discontinued operations and \$225,000 of stock-based compensation expense offset by \$71,000 of non-cash compensation expense for restricted stock grants. The net increase in operating assets and liabilities was primarily due to an increase in accrued liabilities of \$2.9 million and an increase in long-term excess facilities liabilities of \$1.8 million offset by an increase in accounts receivable of \$859,000

*Cash Flows from Investing Activities.* For the three months ended August 31, 2005, net cash provided by investing activities of \$18.0 million which consisted primarily of the net proceeds from the sale of discontinued operations of \$23.6 million offset by an increase in restricted cash of \$5.5 million. See Note 5 in the Notes to Condensed and Consolidated Financial Statements for a discussion of the letters of credit.

For the three months ended August 31, 2004, net cash used in investing activities was \$1,000 which consisted primarily from the proceeds from the purchase of property and equipment offset by a decrease in restricted cash.

*Cash Flows from Financing Activities.* For the three months ended August 31, 2005, net cash used in financing activities of \$16.6 million was related to the dividends paid.

For the three months ended August 31, 2004, net cash used in financing activities of \$594,000 was primarily attributed to the payment on short-term borrowing from the bank of \$608,000 offset by \$14,000 of proceeds from the issuance of common stock.

### **Cash Requirements**

On June 15, 2005, the Board of Directors of Liberate declared a one-time dividend of \$0.15 per common share. The dividend was payable to the holders of record on June 27, 2005 upon the closing of the sale of Liberate's Non-North America business to SeaChange International, Inc. pursuant to the terms of the Asset Purchase Agreement, dated as of April 15, 2005. The SeaChange transaction closed on July 12, 2005. Liberate received cash consideration of approximately \$23.5 million in connection with the sale to SeaChange. The special dividend, totaling \$16.6 million, was paid on July 13, 2005. In addition to funding normal operating expenses, we anticipate requiring cash to pay outstanding commitments. We expect to fund our short-term working capital and operating resource expenditure requirements, for at least the next twelve months, from our existing cash and cash equivalents resources. However, we could experience unforeseen circumstances, such as a worsening economic downturn, lease obligations and litigation settlements that may increase our use of available cash or our need to obtain additional financing.

### **Contractual Obligations**

Our contractual obligations, including the lease on our former offices in San Carlos and the UK, as of August 31, 2005, are as follows (in thousands):

|                               | Total     | Payments due by period |           |           |               |
|-------------------------------|-----------|------------------------|-----------|-----------|---------------|
|                               |           | Less than one year     | 1-3 years | 4-5 years | After 5 years |
| Operating leases and expenses | \$ 33,078 | \$ 8,799               | \$ 16,013 | \$ 8,266  | \$            |

As a result of the dismissal of the bankruptcy case, Liberate continues to be liable for the lease payments on its former offices in San Carlos, California in accordance with the terms of the lease, which over the life of the lease could be up to approximately \$32.8 million, including common area maintenance expenses. See Notes 4 and 5 in the Notes to Condensed Consolidated Financial Statements for a discussion of excess facilities charges related to the San Carlos lease.

#### Off Balance Sheet Arrangements

As of August 31, 2005, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

**Risk Factors**



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*In evaluating Liberate and our business, you should consider the following factors in addition to the other information in this quarterly report on Form 10-Q. Forward-looking statements in this report are subject to risks and uncertainties that could cause our actual results to differ materially from the results contemplated. Any of the following risks could seriously harm our business, financial condition, and results of operations, causing the price of our stock to decline. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations.*

**We now have no current product or services business.**



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On July 12, 2005, we completed the sale of substantially all of the assets relating to our business outside of North America to SeaChange International, Inc. Following the transaction, we have no current product offering or services business. We will continue to operate Liberate to resolve existing liabilities, prosecute and defend pending litigation and pursue other claims as appropriate that we may have against third parties, and dispose of non-operating assets to maximize shareholder interests. Although our board of directors has not yet made any determination, we also will continue from time to time to evaluate and potentially explore all available alternatives including a dissolution and liquidation of Liberate, a share repurchase, an extraordinary dividend or other transactions to maximize stockholder value. We believe that our cash, together with proceeds from the Asset Sales, will be sufficient to meet our working capital requirements for the next twelve months. In fiscal 2006, we expect to continue to use cash to fund our remaining activities.

**Our efforts to manage outstanding liabilities and non-operating assets may not have favorable results.**



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Although we will strive to resolve outstanding liabilities, prosecute and defend pending litigations and claims, and dispose of non-operating assets to achieve favorable results in the best interests of shareholders, the actual resolution of such liabilities, litigations and assets are uncertain and we may not be able to achieve favorable results.

**If the stockholders do not approve, or we fail to complete, the Reverse/Forward Stock Split as part of a going private transaction, we will be unable to eliminate the costs associated with being a public company and the market price of our common stock may decrease.**



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On June 16, 2005, Liberate's Board of Directors approved a reverse 1-for-250,000 split of Liberate common stock to be followed immediately by a forward 250,000-for-1 split, subject to stockholder approval at an upcoming special meeting of stockholders, as part of a going private transaction. If the transaction is approved by Liberate's stockholders and implemented, Liberate expects to have fewer than 300 stockholders of record, which would enable Liberate to voluntarily terminate the registration of its common stock under the Securities Exchange Act of 1934, as amended, and become a non-reporting company. As a private company, Liberate would no longer be required to file periodic reports and other information with the SEC. The proposed transaction is subject to the approval of Liberate's stockholders at a special meeting of shareholders. We cannot predict whether we will succeed in obtaining the approval of our stockholders and we cannot assure that the Reverse/Forward Stock Split will be completed. On September 19, 2005, Leslie J. Lee filed a putative class action complaint in the Court of the Chancery of the State of Delaware seeking to enjoin the Reverse/Forward Stock Split and to recover damages. Liberate believes the allegations are without merit and intends to defend the complaint vigorously. However, we cannot assure you that we will be successful. If we are unable to complete the Reverse/Forward Stock Split, we will not save significant costs and expenses associated with being a public company and the market price of our common stock may decline.

**We are unable to compete with the North America business for five years from the date of the closing.**



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In connection with the asset sale to Double C, we have agreed that we and our affiliates will not develop, market, license, grant forbearances not to sue or grant any rights to or authorize the use of any Non-North America intellectual property for commercial use or deployment in the United States, Canada and Mexico for a period of five years from the date of the closing of the asset sale to Double C. We have agreed that this covenant not to compete will be binding on any purchaser of our Non-North America business (such as SeaChange) or other successor to that business and its affiliates. We have further agreed that we will require any such purchaser to agree to be bound by this covenant for the remainder of the five year period and that the covenant not to compete may be enforced by Double C. In Connection with the asset sale to SeaChange, we agreed not to induce any customer of the Non-North America business to refrain from or discontinue its relationship with SeaChange for a period of five years from the date of the closing of the asset sale to SeaChange.

**If Liberate becomes a privately held company, stockholders will own shares in a private company and may not have the ability to sell their shares in the public market.**



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Should Liberate consummate the Reverse/Forward Stock Split, some stockholders may have shares in Liberate for which there would be no public market and their ability to sell the shares would be impeded. Furthermore, Liberate would not file current, quarterly or annual reports or be subject to the proxy requirements of the federal securities laws. Stockholders may therefore find it more difficult to obtain information about Liberate and its financial performance. Liberate expects to incur substantial expenses in connection with the going private transaction and may not be able to realize sufficient cost savings to recover those expenses.

**Litigation related to the restatement of our financial statements could continue to generate substantial costs and harm our financial condition.**



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While the SEC staff has terminated its investigation into the events and circumstances that led to the restatement and has recommended no enforcement action against Liberate at this time, the SEC is not precluded from any future action.

We have agreed to indemnify our directors and officers to the fullest extent allowed by Delaware law. As a consequence, we are advancing expenses (including reasonable attorneys' fees) incurred by directors and officers in connection with the securities class action, shareholder derivative action and the SEC investigation, although these payments are subject to reimbursement if such expenses are ultimately found to be non-indemnifiable. Additionally, we may ultimately be obligated to pay indemnifiable judgments, penalties, fines, and amounts paid in settlement in connection with these proceedings.

We have notified our various insurance carriers of the litigations and the SEC investigation. Our primary carrier and one of our excess carriers have disputed whether certain costs incurred in connection with the restatement-related litigations and the SEC investigation, are covered under their respective policies. On March 1, 2005, Liberate filed a complaint against the primary carrier and one of the excess carriers alleging that the carriers failed to perform any of their obligations under

their respective policies and applicable law on behalf of Liberate or its directors and officers in connection with the securities class action, the shareholder derivative action, and the SEC investigation. Liberate intends to prosecute its rights under its insurance policies vigorously. However, litigation is by its nature uncertain and there can be no assurance that Liberate will be successful in securing coverage under the policies. Our insurance may not cover all or portions of our defense costs, any settlement, judgment rendered against us, or amounts we are required to pay to any indemnified person in connection with the litigations, the SEC investigation, or any other matter. These costs and liabilities, if not covered by insurance, could harm our financial condition, results of operations, and cash flows.

**Litigation related to the lease of our former offices could generate substantial costs, divert management attention and resources and harm our financial condition.**



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In September and December 2004 and in May 2005, Circle Star Center Associates, L.P., the landlord of our former offices in San Carlos, California, filed complaints in California state court alleging, among other things, that Liberate had breached the office lease. The cost of participating and defending against these actions could be substantial and will require management's attention and corporate resources. The possible resolution of these proceedings could include a judgment against Liberate or settlement that could require substantial payments, which could harm our financial condition, results of operations, or cash flows.

**If we are unable to terminate leases on excess facilities or sublease excess office space, our net loss could increase and our financial condition could be harmed.**

Liberate is a party to real property leases in San Carlos, California and London, England that include space significantly in excess of our needs for the foreseeable future. We have vacated these premises and have sought to sublease the excess space or, alternatively, to terminate these leases upon acceptable terms. If we are unable to terminate or settle these leases on favorable terms, we may remain liable for the full amounts due under the leases. In the past, we have recorded significant excess facilities charges in our statements of operations, and we anticipate that we may record additional charges in the future if actual lease exit costs or sublease income differ from amounts currently expected. Our inability to sublease significant portions of our excess office space or to terminate or otherwise settle these leases upon favorable terms could cause our net losses to increase and could harm our financial condition or results of operations.

**We have been named in securities class-action litigation involving the underwriters to our public offerings, which may result in substantial costs and occupy management attention and resources.**



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Beginning on May 16, 2001, a number of class-action lawsuits seeking monetary damages were filed in federal court in New York against several of the firms that underwrote our initial public offering, naming Liberate and certain of our former officers and current or former directors as co-defendants. The plaintiffs subsequently added allegations regarding our secondary offering. While we deny allegations of wrongdoing, we have agreed to enter into a global issuer settlement of plaintiffs' claims, which involves our insurers providing a guaranteed recovery to the plaintiffs. The settlement is subject to a number of conditions, including court approval, and failure to resolve this litigation on favorable terms could result in substantial costs or otherwise harm our business.

**A small group of stockholders owns a majority of our outstanding shares and can exercise significant control over Liberate.**



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As of August 19, 2005, to our knowledge, six stockholders, who are not affiliated with one another, beneficially owned a total of approximately 59% of our outstanding common stock. As a result, these stockholders will be able to exercise control over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. The concentration of ownership may have the effect of delaying or preventing a change in control of Liberate.

**Expenses related to equity awards for our employees increase our net loss.**



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As a result of our introduction, in fiscal year 2004 of restricted stock units as a form of equity compensation for employees and non-employee directors, we recorded an expense of approximately \$2.5 million in FY05, and we expect to record expenses in future periods related to stock units. The continuation of granting of restricted stock units or other similar equity awards will increase our loss.

In addition, with the issuance of SFAS 123(R), when adopted may require us to record the value of stock options or other equity awards granted to all or certain of our employees using a higher fair value. If we begin recording these amounts, our net loss would increase over the vesting period.

**Our compliance with the new regulatory requirements of Sarbanes-Oxley is untested and will likely be costly and time-consuming.**



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We are now subject to the ongoing internal control provisions of Section 404 of the Sarbanes-Oxley Act of 2002 and identification of material weaknesses in the internal control over financial reporting, if identified in future periods, could indicate a lack of proper controls to generate accurate financial statements. We may identify a material weakness in current and future periods, and our controls necessary for continued compliance may not continue to operate effectively at all times. We also may not be able to retain sufficient skilled financial accounting personnel, especially in light of increased demand for such personnel among publicly traded companies.

**If we require additional capital and cannot raise it, we may not be able to fund our operations.**

We believe that our existing cash balances will be sufficient to meet our working capital and capital expenditure needs for at least the next twelve months. However if in the future, we require additional capital we cannot be certain that we will be able to obtain additional financing on favorable terms, or at all. If we need additional capital and cannot raise it on acceptable terms, we may not be able to develop our products and services, acquire complementary technologies or businesses, hire and retain employees, or respond to competitive pressures or new business requirements. Our inability to obtain additional financing on favorable terms could have a material adverse effect on our company.

**Provisions of our corporate documents and Delaware law could deter takeovers and prevent stockholders from receiving a premium for their shares.**



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Certain provisions of our certificate of incorporation and bylaws may discourage, delay, or prevent a change in control of our company that a stockholder may consider favorable. These include provisions that:

Authorize the issuance of blank check preferred stock to increase the number of outstanding shares and thwart a takeover attempt;

Require super-majority voting to make certain amendments to our certificate of incorporation;

Limit who may call special meetings of stockholders;

Prohibit stockholder action by written consent, which means that all stockholder action must be taken at a meeting of the stockholders; and

Establish advance notice requirements for nominations of candidates for election to the board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law and provisions in our stock incentive plans may discourage, delay, or prevent a change in control of our company.

Our board of directors has adopted a stockholder rights plan, which is designed to give the board flexibility in responding to unsolicited acquisition proposals and discourage coercive takeover offers. In general, the stockholder rights plan would provide our existing stockholders (other than an existing stockholder who becomes an acquiring person) with rights to acquire additional shares of our common stock at 50% of its trading price if a person or entity acquires 15% or more of the outstanding shares of our common stock, unless our board of directors elects to redeem these rights.

**Our executive officers** and key employees are critical to our business, and they may not remain with us in the future.



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Our business substantially depends on the performance of our executive officers and key employees. The loss of the services of any of our executive officers or key employees could impact the resolution of liabilities, the outcome of pending litigation and other claims that we may have against third parties, and the disposal of non-operating assets to maximize shareholder interests. We do not carry key person life insurance policies on any of our employees. Our future success also depends on our continuing ability to retain, identify and hire highly qualified personnel.

**If we do not manage our remaining activities effectively, our stock price could decline.**



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Since our inception, we have incurred significant losses, and we may never sustain profitability. We may continue to incur significant losses and negative cash flows in the future. If we cannot achieve favorable resolution and disposition of liabilities, litigation and non-operating assets, our financial condition and results of operations will suffer and our stock price is likely to decline.

**Acquisitions or dispositions of businesses or product lines could be difficult to implement or integrate and could disrupt our business and dilute stockholder value.**



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We have acquired and disposed of businesses and assets in an effort to increase stockholder value, and we may do so in the future. With any acquisitions or dispositions, it may be difficult to integrate or separate product lines, technologies, personnel, customers and widely dispersed operations. These efforts have in some cases proven more difficult than anticipated and may not succeed or may distract our management from operating our business. Our failure to successfully manage acquisitions or could seriously harm our operating results. In addition, our stockholders would be diluted if we were to finance acquisitions by incurring convertible debt or issuing equity securities, and our liquidity may be adversely affected if we were to use our cash to make acquisitions.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

#### Interest Rate Risk

As of August 31, 2005, our investment portfolio consisted primarily of U.S. government obligations, with original maturities at time of purchase of 90 days or less, classified as cash and cash equivalents which may increase or decrease in value if interest rates change prior to maturity. We do not maintain any derivative financial instruments in our investment portfolio. We are averse to principal loss and seek to preserve our invested funds by limiting the default risk, market risk, and reinvestment risk. We currently maintain sufficient cash and cash equivalent balances to hold our investments to maturity. An immediate 10% change in interest rates would be immaterial to our financial condition or results of operations.

#### Foreign Currency Risk

We transact business in various foreign currencies, primarily in the U.K, the Netherlands and Austria, and, accordingly, are subject to adverse movements in foreign currency exchange rates. The effect of changes in foreign currency exchange rates on revenues has not been material as we generally conduct our revenue transactions in U.S. dollars. Our foreign subsidiary located in the Netherlands with a U.K. branch is a fully integrated entity, which operates in the British Pound and the Euro, whose functional currency is the U.S. dollar. Monetary items are re-measured at rates prevailing at the balance sheet date and non-monetary items are re-measured at historical rates. The revenue and expenses are re-measured at average exchange rates throughout the period, other than depreciation and amortization, which are re-measured at the respective historical rates as their related assets. We report the unrealized foreign currency re-measurement gains and losses as well as the gains and losses from foreign currency transactions in the condensed consolidated statement of operations under Other income (expense), net. Translation gains or losses for prior periods have been recorded in Accumulated other comprehensive loss, a separate component of stockholders' equity. See Note 2 in the Notes to Condensed Consolidated Financial Statements. We do not currently use financial instruments to hedge these operating expenses.

### Item 4. Controls and Procedures

#### Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in reports we file or submit under the Securities Exchange Act of 1934, as amended (the Exchange Act) is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures are also designed to reasonably ensure that this information is accumulated and communicated to our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), to allow timely decisions regarding required disclosure. We also maintain internal controls over financial reporting that are designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of our financial statements in accordance with generally accepted accounting principles in the U.S.

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As of August 31, 2005, our CEO and CFO have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) were sufficiently effective to ensure that the information disclosed by us in this quarterly report on Form 10-Q was

recorded, processed, summarized and reported within the time periods specified in the SEC's rules and instructions for Form 10-Q.

There were no changes in our internal controls over financial reporting during the quarter ended August 31, 2005 (as defined in Rules 13a-15 and 15d-15 under the Exchange Act) that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

Our management, including our CEO and CFO, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. Attached as exhibits to this quarterly report on Form 10-Q are certifications of the CEO and CFO that are required by Rule 13a-14 of the Exchange Act.

## **Part II. Other Information**

### **Item 1. Legal Proceedings**

*Restatement Class-Action Litigation.* On October 20, 2004, a Stipulation and Agreement of Settlement (the "Settlement") was filed with the United States District Court for the Northern District of California (the "Court") in connection with the matter *In re Liberate Technologies Securities Litigation* (the "Class Action"). The Class Action is based on the restatement of our financial statements for certain periods of fiscal 2002 and the revision of our preliminary financial results announced for the first quarter of fiscal 2003 (the "Restatement"). The parties to the Settlement are: (i) the lead plaintiff in the Class Action, on behalf of himself and each of the class members; and (ii) defendants Liberate Technologies, Mitchell E. Kertzman, Nancy J. Hilker and Coleman Sisson. Under the terms of the Settlement, Liberate agreed to pay or cause to be paid \$13.8 million in settlement of the claims specified in the Class Action, and the lead plaintiff and each class member agreed to release Liberate and the other defendants from those claims. The Settlement shall in no way be construed or deemed to be evidence of or an admission or concession on the part of Liberate or the other specified defendants with respect to any claim or any fault or liability or wrongdoing or damage whatsoever, or any infirmity in the defenses that the defendants have asserted.

Following a settlement hearing on February 15, 2005, the Court granted final approval of the Settlement and, pursuant to the Settlement, entered judgment dismissing the Class Action with prejudice.

During Q3 FY05, Liberate paid out the settlement amount of \$13.8 million and recovered \$5.0 million from its insurance carrier. The company expects to recover another \$4.4 million as a rebate of part of the premiums paid for the loss mitigation policy that the company obtained for the Class Action and Derivative Action, which is included in other receivables at August 31, 2005.

*Restatement Derivative Litigation.* On May 3, 2005, a Stipulation of Settlement re Derivative Claims (the Stipulation ) was filed with the California Superior Court for the County of San Mateo in connection with the matter In re Liberate Technologies Derivative Litigation (the Derivative Action ). As reflected in the Stipulation, Liberate has reached an agreement in principle to settle the Derivative Action on terms that, among other things, provide for Liberate to adopt certain specified corporate governance changes, the dismissal with prejudice of all claims asserted by plaintiffs, and the payment of plaintiffs counsel s fees and expenses of \$550,000. Following a settlement hearing on August 16, 2005, the Court granted final approval of the settlement and, pursuant to the settlement, entered judgment dismissing the Derivative Action with prejudice, and Liberate paid the settlement amount to plaintiff s counsel.

*SEC Investigation.* On February 13, 2003, the SEC initiated a formal, non-public investigation into the events and circumstances that led to the restatement of Liberate s financial statements. On September 29, 2004, Liberate announced that the SEC s investigation has been terminated as to Liberate. The SEC also advised Liberate that no enforcement action against Liberate has been recommended.

*Lease-Related Litigation* On September 29, 2004, Circle Star Center Associates, L.P., the landlord of Liberate s former offices in San Carlos, California, filed a complaint in the California Superior Court for the County of San Mateo alleging that Liberate had breached the office lease by, among other things, failing to pay rent for certain months of 2004 and applicable late fees, failing to replenish the letter of credit and failing to reimburse the landlord for its attorneys fees in

connection with Liberate's bankruptcy proceeding. The complaint also includes allegations of conversion and defamation. The complaint seeks damages of approximately \$3.9 million for the alleged breach and conversion and unspecified damages for the alleged defamation. In November 2004, Liberate filed motions challenging the legal basis for the landlord's cause of action for defamation and claim for attorneys' fees in connection with Liberate's bankruptcy. On March 24, 2005, the Superior Court granted Liberate's motions and dismissed the landlord's claims for defamation and attorneys' fees. On May 23, 2005, Liberate paid the landlord approximately \$1.2 million for past rent due, late fees and interest in connection with the various lease-related actions, and we have procured a replacement letter of credit.

In addition, on December 16, 2004, the landlord filed a further complaint for breach of lease against Liberate. The complaint seeks damages in the amount of not less than approximately \$1.2 million, plus prejudgment interest, costs of suit and attorneys' fees, alleging that Liberate breached the lease by failing to pay rent in November and December 2004. On February 22, 2005, the landlord filed a motion for summary judgment on the breach of contract claim. On May 10, 2005, Liberate paid the landlord approximately \$1.3 million for the months at issue in this action and on May 13, 2005, the Superior Court granted the landlord's motion for summary judgment.

On May 6, 2005, the landlord filed a third complaint against Liberate alleging that Liberate breached the lease by failing to pay rent for certain months of 2005 and failing to replenish the letter of credit. The landlord seeks approximately \$5.5 million plus pre-judgment interest, costs of suit and attorneys' fees. On May 23, 2005 Liberate paid the landlord approximately \$1.2 million for past rent due, late fees and interest in connection with the various lease-related actions, and we have procured a replacement letter of credit.

On September 22, 2005, pursuant to a stipulation of the parties, the Superior Court referred the first and third lease-related actions to a temporary judge. A trial before the temporary judge on the landlord's claim for interest on the unpaid replenishment amount is currently scheduled for October 31, 2005. The landlord has indicated that (i) it intends to seek an award of attorneys' fees incurred as a result of Liberate's alleged breaches of the lease, and (ii) it intends to pursue an appeal of the dismissal of its defamation cause of action in its claim for attorneys' fees in connection with Liberate's bankruptcy proceeding.

While Liberate intends to defend these lawsuits vigorously, because litigation is by its nature uncertain, we are unable to predict the outcome or estimate the potential liability, if any, of this litigation.

*Underwriting Litigation.* Beginning on May 16, 2001, a number of class-action lawsuits seeking monetary damages were filed in the United States District Court for the Southern District of New York against several of the firms that underwrote our initial public offering, naming Liberate and certain of our former officers and current or former directors as co-defendants. The suits allege that the underwriters received excessive and improper commissions that were not disclosed in our prospectus and that the underwriters artificially increased the price of our stock. The plaintiffs subsequently added allegations regarding our secondary offering, and named additional officers and directors as co-defendants. The suits were consolidated into one action that was coordinated for pretrial purposes with hundreds of virtually identical suits under a case captioned *In re Initial Public Offering Securities Litigation*, Civil Action No. 21-MC-92. On February 19, 2003, the court denied in part and granted in part a motion to dismiss filed on behalf of the defendants, including Liberate. The court's order did not dismiss any claims against Liberate. As a result, discovery may proceed. The individual defendants have been dismissed without prejudice in this litigation.

While we deny allegations of wrongdoing, we have agreed to enter into a global issuer settlement of plaintiffs' claims. In June 2004, a stipulation of settlement and release of claims against the issuer defendants, including Liberate, was submitted to the court for approval. The terms of the settlement, if approved, would dismiss and release all claims against the participating defendants (including Liberate). In exchange

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for this dismissal, D&O insurance carriers would agree to guarantee a recovery by the plaintiffs from the underwriter defendants of at least \$1 billion, and the issuer defendants would agree to an assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. The settlement is subject to a number of conditions, including court approval. On August 31, 2005, the Court granted preliminary approval of the stipulation of settlement, and set a hearing for April 24, 2006 for further consideration of the stipulation of settlement and whether the settlement should receive final approval of the Court.

We cannot predict the timing or ultimate outcome of this proposed settlement or estimate the amounts of, or potential range of loss with respect to, this litigation if a settlement is not approved.

*OpenTV Patent Litigation.* On February 7, 2002, OpenTV filed a lawsuit against Liberate in the United States District Court for the Northern District of California, alleging that Liberate is infringing two of OpenTV's patents and seeking monetary damages and injunctive relief. We filed an answer denying OpenTV's allegations. Our counter-claim alleges that OpenTV infringes one of our patents for information retrieval systems. We were seeking to have OpenTV's patents invalidated, and had requested a finding that our technology does not infringe OpenTV's patents, and had sought monetary damages and injunctive relief against OpenTV. The court issued a claim construction ruling, but a trial date is not currently set. Pursuant to the asset purchase agreement with Double C Technologies LLC that closed on April 7, 2005, Double C has assumed the defense and liabilities associated with this lawsuit.

*Insurance Coverage Litigation.* On December 29, 2004, Federal Insurance Company, one of Liberate's excess insurance carriers, filed a complaint for declaratory judgment, alleging that Liberate and other defendants are not entitled to coverage for defense costs and losses incurred in connection with the Class Action, Derivative Action, SEC investigation or other matters. The complaint, filed in the U.S. District Court for the Northern District of California, named as defendants Liberate and certain former officers and current and former directors. On March 18, 2005, Federal Insurance Company voluntarily dismissed its complaint without prejudice.

On March 1, 2005, Liberate filed a complaint against the London Underwriters, New Hampshire Insurance Company Per: AIG Europe (UK) Limited and Federal Insurance Company (together, the Carriers) for breach of contract, breach of the implied covenant of good faith and fair dealing and declaratory relief. The complaint, filed in the California Superior Court for the County of San Mateo, alleges that the Carriers failed to perform any of their obligations under their respective policies and applicable law on behalf of Liberate or its directors and officers in connection with the Class Action, the Derivative Action and the SEC Investigation. Liberate seeks monetary damages, exemplary or punitive damages, attorneys' fees and declaratory relief.

On April 8, 2005, Federal Insurance Company (Federal) filed a motion challenging the legal basis for Liberate's complaint. On May 2, 2005, New Hampshire Insurance Company and the London Underwriters filed an answer to the complaint. On May 13, 2005, the Superior Court denied Federal's motion. On June 22, 2005, the California Court of Appeal issued a writ of mandate that directed the Superior Court to grant Federal's motion with leave to amend as to Liberate's breach of contract and bad faith claims against Federal. On August 3, 2005, Liberate filed an amended complaint with the Superior Court.

On May 23, 2005, Federal filed a cross-complaint against Liberate and certain of its former officers and directors for breach of contract and declaratory relief. On July 11, 2005, Liberate filed a motion challenging the legal basis for Federal's complaint. On August 9, 2005, the Superior Court granted in part Liberate's motion with leave to amend.

Liberate intends to prosecute its rights under its insurance policies and defend Federal's cross-complaint vigorously. However, litigation is by its nature uncertain and there can be no assurance that Liberate will be successful in securing coverage under the policies.

*Stock Option Litigation.* On March 3, 2005, Mitchell Kertzman, Liberate's former Chairman of the Board and Chief Executive Officer, filed a complaint in the California Superior Court for the County of San Mateo alleging that Liberate breached its Stock Option Agreement with Mr. Kertzman by, among other things, failing to allow him to exercise his stock options after the termination of his employment with Liberate. Liberate believes that it has complied at all times with the terms of the Stock Option Agreement. The complaint alleges claims for breach of contract, breach of the implied covenant of good faith and fair dealing and interference with contract and prospective economic advantage. The complaint seeks monetary damages of at least \$3.0 million, interest and punitive damages in an unspecified amount. On June 16, 2005, Liberate filed an answer to the complaint. A trial date in this action is currently scheduled for January 17, 2006.

*Insight Interactive Litigation.* On June 13, 2005, Liberate filed a complaint against Insight Interactive L.L.C. for breach of contract, specific performance, and open book account. The complaint, filed in the California Superior Court for the County of San Mateo, alleges that under a March 6, 2000 agreement with Liberate, Insight Interactive has failed to

pay fees as they become due. Liberate seeks monetary damages, specific performance, and interest and costs as provided by law and/or the March 6, 2000 agreement. We expect that Insight Interactive may assert defenses and claims contending that Liberate is not entitled to payment under the March 6, 2000 agreement. On September 1, 2005, Insight Interactive filed an answer generally denying the causes of action set forth in Liberate's complaint and asserting various affirmative defenses, including the contention that Liberate is not entitled to payment under the March 6, 2000 agreement. Liberate intends to prosecute its rights under the agreement vigorously. However, litigation is by its nature uncertain and there can be no assurance that Liberate will be successful in obtaining damages or other relief.

*Reverse Stock Split Litigation.* On September 19, 2005, Leslie J. Lee filed a putative class action complaint in the Court of Chancery of the State of Delaware, alleging, among other things, that Liberate and certain officers and directors breached their fiduciary duties in connection with the proposed Reverse/Forward Stock Split. Plaintiff purports to bring the action individually and on behalf of a putative class of all stockholders owning fewer than 250,000 shares of Liberate common stock. The complaint seeks preliminary and permanent injunctive relief against the Stock Split, declaratory relief, rescission of the Reverse/Forward Stock Split (if necessary), rescissory and/or compensatory damages and attorneys' fees and expenses. Also on September 19, 2005, Plaintiff filed a motion for expedited proceedings. On October 6, 2005, the court heard oral argument on the motion and, at the conclusion of the argument, denied plaintiff's motion for expedited proceedings and declined to schedule a hearing on plaintiff's motion for a preliminary injunction. Liberate believes the allegations are without merit and intends to defend the complaint vigorously.

We have notified our various insurance carriers of the Class Action, Derivative Action, the Reverse Stock Split Litigation and other pending legal

matters. Our primary carrier and one of our secondary carriers under our existing policies have disputed whether certain costs incurred in connection with the restatement-related litigation and the SEC investigation are covered under their respective policies. Our insurance may not cover all or portions of our defense costs, any settlement, any judgment rendered against us, or amounts we are required to pay to any indemnified person in connection with the Class Action or Derivative Action or any expenses incurred in connection with the SEC investigation or any other matter.

While Liberate intends to defend and prosecute the above mentioned lawsuits vigorously because legal actions are inherently uncertain, we cannot predict or determine the outcome or resolution of these actions or estimate with any degree of certainty the amounts of loss or recovery with respect to these proceedings. In addition, the timing of the final resolution of these proceedings is uncertain. The actual amount of our liability or recovery in any particular matter could be greater or less than management's estimates, which could result in a net aggregate liability to Liberate outside of the range stated above. The possible resolutions of these proceedings could include judgments against us or settlements that could require substantial payments by us, which could have a material adverse impact on our business, financial position, results of operations and cash flows. The cost of participating and defending against these actions is substantial and will require the continued diversion of management's attention and corporate resources.

In addition to these pending lawsuits, Liberate is considering pursuing claims against its former Chief Operating Officer, Donald Fitzpatrick, to recover money due and owing and damages resulting from his conduct as an officer of Liberate in connection with Liberate's restatement of its financial statements for certain periods of fiscal 2002 and the revision of its preliminary financial results announced for the first quarter of fiscal 2003. However, Liberate has not yet determined whether the potential benefits of pursuing any such claims against Mr. Fitzpatrick would outweigh the costs. In addition, should Liberate decide to pursue any such claims against Mr. Fitzpatrick, we can give you no assurance as to the likelihood that we would prevail, or that even if Liberate prevails, we would be able to actually recover from Mr. Fitzpatrick the amount of any judgment obtained.

## **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Not applicable.

## **Item 3. Defaults Upon Senior Securities**

Not applicable.

## **Item 4. Submission of Matters to a Vote of Securities Holders**

On July 6, 2005, a special meeting of stockholders was held in Redwood City, California to approve and adopt the Asset Purchase Agreement, dated as of April 15, 2005, by and among Liberate, SeaChange International, Inc., a Delaware corporation and Liberate Technologies B.V., a corporation organized under the laws of the Netherlands. The asset sale closed on July 12, 2005.

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At the July 6 special meeting, 76,988,393 votes were cast for approval and adoption of the Asset Purchase Agreement, 82,269 votes were cast against approval and adoption of the Asset Purchase Agreement and there were 10,871 abstentions and broker non-votes. The other information required by this Item is incorporated by reference to the information set forth in the Definitive Proxy Statement on Schedule 14A related to the sale of the Non-North America business filed with the SEC on June 10, 2005.

### Item 5. Other Information

#### Filing of Amendment No. 1 on Form 10-K/A

On September 28, 2005, Liberate filed with the Securities and Exchange Commission an amended Form 10-K/A for fiscal year ended May 31, 2005. On August 15, 2005, Liberate filed with the SEC its Annual Report on Form 10-K for the fiscal year ended May 31, 2005 (the Initial Form 10-K ). In accordance with the SEC rules, the Company incorporated by reference Part III of the Initial Form 10-K from the Proxy Statement to be filed by the Company in connection with its 2005 Annual Stockholders Meeting, which the Company anticipated filing on or before September 28, 2005. Since filing the Initial Form 10-K, the Company has determined that it would not file its Proxy Statement prior to the September 28 deadline and, in accordance with SEC rules, filed an amendment to its Initial Form 10-K on September 28, 2005, to include the disclosures required by Part III of Form 10-K. Amendment No. 1 on Form 10-K/A amended and supplemented Part III of the Initial Form 10-K in order to include those disclosures required by Part III of Form 10-K.

### Item 6. Exhibits

| Exhibit No. | Exhibit  |
|-------------|--|
| 31.1        | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2        | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1        | Section 1350 Certification of Liberate's Chief Executive Officer and Chief Financial Officer       |

**LIBERATE TECHNOLOGIES**

**Signatures**

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

Liberate Technologies

Date: October 11, 2005

By: /s/ David Lockwood  
David Lockwood  
*Chief Executive Officer*

Date: October 11, 2005

By: /s/ Gregory S. Wood  
Gregory S. Wood  
*Executive Vice President and  
Chief Financial Officer*

**Exhibit Index**

| <b>Exhibit No.</b> | <b>Exhibit</b>   |
|--------------------|--|
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| 31.2               | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1               | Section 1350 Certification of Liberate s Chief Executive Officer and Chief Financial Officer       |