

LIQUID AUDIO INC
Form 10-K
March 31, 2003
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended: December 31, 2002

OR

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

For the transition period from _____ to _____

Commission File Number 000-25977

LIQUID AUDIO, INC.

(Exact name of Registrant as specified in its charter)

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

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

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
None	None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$0.001 par value
Preferred Stock Purchase Rights

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

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

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant as of June 28, 2002 (the last business day of the Registrant's most recently completed second fiscal quarter) was approximately \$38,604,486 based on the closing price of the Common Stock as reported on The Nasdaq Stock Market for that date.

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PART I

ITEM 1. BUSINESS

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

Overview

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

Through January 2003, we provided an open platform that enabled the digital delivery of media over the Internet.

During the first quarter of 2002, we pursued a strategy of maintaining and extending our digital distribution business. This strategy expanded our catalog of digital music recordings available for digital distribution to more than 400,000 digital music recordings.

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

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

On December 6, 2002, we announced a return of capital cash distribution to our stockholders of \$2.50 per share, payable on December 20, 2002 to stockholders of record as of December 10, 2002. Following the cash distribution, our management continued to explore options for disposition or use of our remaining assets. On December 16, 2002, BeMusic, Inc. (BeMusic), a subsidiary of Bertelsmann AG, filed a lawsuit

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against us to stop payment of the \$2.50 per share cash distribution, based on concerns related to our ability to indemnify them in a patent infringement action against BeMusic for its use of technology licensed from us. On January 24, 2003, we reached a settlement with BeMusic whereby we agreed to set aside a cash reserve of \$7.0 million to share in the defense of a lawsuit against BeMusic. We then dismissed our claims against each other. On January 29, 2003, we distributed \$2.50 cash per share as return of capital, for a total of \$57.8 million, to our common stockholders of record as of December 10, 2002.

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

We are reviewing alternatives for the use or disposition of our remaining assets while settling our remaining claims and liabilities. We may ultimately pursue a plan of complete liquidation and dissolution. We also may pursue other business opportunities and investments unrelated to the downloading of digital music. Neither our Board of Directors (Board) nor our stockholders have yet approved any such plan. If a complete liquidation and dissolution is approved, pursuant to Delaware General Corporation Law, we will continue to exist for three years after the dissolution becomes effective or for such longer period as the Delaware Court of Chancery shall direct, for the purpose of prosecuting and defending suits against us and enabling us gradually to close our business, to dispose of our property, to discharge our liabilities and to distribute to our stockholders any remaining assets.

Our common stock continues to be traded on The Nasdaq National Market. The market price per share dropped significantly subsequent to the payment of the \$2.50 per share return of capital cash distribution to our common stockholders. The market price of our common stock as of March 18, 2003 was \$0.35 per share. On March 18, 2003, we were notified by Nasdaq that pursuant to Marketplace Rule 4450(a)(5), we have until September 15, 2003 for our stock to trade above \$1.00 for 10 consecutive trading days to avoid being delisted from The Nasdaq National Market. We may be delisted before that date if we fail to meet other criteria for continued inclusion on The Nasdaq National Market. If we are delisted from The Nasdaq National Market, our stock will only be traded on the OTC Bulletin Board. An investment in an OTC security is speculative and involves a degree of risk. Many OTC securities are relatively illiquid, or thinly traded, which can enhance volatility in the share price and make it difficult for investors to buy or sell without dramatically effecting the quoted price or may be unable to sell a position at a later date. If our stock is delisted from the Nasdaq National Market, then the ability of our stockholders to buy and sell our shares will be materially impaired. Moreover, if we pursue a plan of complete liquidation and dissolution, we will close our stock transfer books, discontinue recording transfers of our common stock, and our common stock will no longer be traded on any exchange, and certificates representing our common stock will no longer be assignable or transferable on our books. Accordingly, the proportionate interests of all of our stockholders will be fixed on the basis of their respective stock holdings at the close of business on the date of dissolution, and any distributions made by us after such date will be made solely to the stockholders of record at the close of business on the date of dissolution.

International Offices

We closed our international offices in 2002.

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

Employees

As of December 31, 2002, we had 29 full-time employees, including 5 in sales and marketing, 10 in research and development, 10 in general and administrative and 4 in operations. We terminated the majority of our employees in 2002. Following the sale of our digital music fulfillment business and related assets in January 2003, we terminated additional employees and as of January 31, 2003, we had 11 employees, including 1

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in sales and marketing, 9 in general and administrative and 1 in operations. We consider our relationships with our remaining employees to be good. None of our employees is covered by collective bargaining agreements.

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ITEM 1A. COMPANY RISK FACTORS

If We Do Not Pursue a Course of Complete Liquidation and Dissolution, the Value of Your Shares May Decrease

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

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

If we pursue a plan of complete liquidation and dissolution, a Certificate of Dissolution will be filed with the State of Delaware after such plan is approved by our stockholders. Pursuant to the Delaware General Corporation Law, we will continue to exist for three years after the dissolution becomes effective or for such longer period as the Delaware Court of Chancery shall direct, for the purpose of prosecuting and defending suits against us and enabling us gradually to close our business, to dispose of our property, to discharge our liabilities and to distribute to our stockholders any remaining assets. Under the Delaware General Corporation Law, in the event we fail to create an adequate contingency reserve for payment of our expenses and liabilities during this three-year period, each stockholder could be held liable for payment to our creditors for such stockholder's pro rata share of amounts owed to creditors in excess of the contingency reserve. The liability of any stockholder would be limited, however, to the amounts previously received by such stockholder from us (and from any liquidating trust or trusts), including the return of capital cash distribution of \$2.50 per share paid to stockholders on January 29, 2003. Accordingly, in such event a stockholder could be required to return all distributions previously made to such stockholder. In such event, a stockholder could receive nothing from us under a plan of complete liquidation and dissolution. Moreover, in the event a stockholder has paid taxes on amounts previously received, a repayment of all or a portion of such amount could result in a stockholder incurring a net tax cost if the stockholder's repayment of an amount previously distributed does not cause a commensurate reduction in taxes payable. There can be no assurance that the contingency reserve maintained by us will be adequate to cover any expenses and liabilities.

Success of a Plan of Complete Liquidation and Dissolution Depends on Qualified Personnel to Execute It

If we pursue a plan of complete liquidation and dissolution, the success of any such plan depends in large part upon our ability to retain the services of qualified personnel to handle the sale of our remaining assets and settlement of remaining liabilities. We may retain the services of a consulting firm specializing in such purpose, however the retention of qualified personnel is particularly difficult under our current circumstances.

If Our Stock Transfer Books Are Closed on a Final Record Date, We Will Not Record Any Trades

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If we pursue a plan of complete liquidation and dissolution, we will close our stock transfer books and discontinue recording transfers of our common stock at the close of business on the date of effectiveness, the final record date, of the filing of the Certificate of Dissolution with the Delaware Secretary of State. Thereafter, certificates representing our common stock will not be assignable or transferable on our books except by will,

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intestate succession or operation of law. The proportionate interests of all of our stockholders will be fixed on the basis of their respective stock holdings at the close of business on the final record date, and any distributions made by us will be made solely to the stockholders of record at the close of business on the final record date, except as may be necessary to reflect subsequent transfers recorded on our books as a result of any assignments by will, intestate succession or operation of law. For any other trades after the final record date, the seller and purchaser of the stock will need to negotiate and rely on due-bill contractual obligations between themselves with respect to the allocation of stockholder proceeds arising from ownership of the shares.

Our Stock May Be Delisted from The Nasdaq National Market, After Which It Will Be Significantly Less Liquid than Before

Our stock may be delisted from trading on The Nasdaq National Market either by not maintaining listing requirements due to the significantly reduced market price of our common stock, or, if we pursue a plan of complete liquidation and dissolution, after we file a Certificate of Dissolution with the State of Delaware. If our common stock is delisted, the ability of stockholders to buy and sell our shares will be materially impaired, and is limited primarily to over-the-counter quotation services, such as the OTC Bulletin Board, that handle high-risk ventures and are not subject to the same degree of regulation as by the Securities and Exchange Commission. Pursuant to Marketplace Rule 4450(a)(5), Nasdaq notified us on March 18, 2003 of potential delisting and provided us until September 15, 2003 to trade above \$1.00 for 10 consecutive trading days to avoid being delisted. We may be delisted before that date if we fail to meet other criteria for continued inclusion on The Nasdaq National Market.

After Our Wind-Up There May Be No Additional Cash to Distribute to Our Stockholders and If There Is Additional Cash to Distribute, the Timing of Any Such Future Distribution is Uncertain

If we pursue a plan of complete liquidation and dissolution, there will be no firm timetable for the distribution of proceeds to our stockholders, because of contingencies inherent in winding up a business. If we pursue a plan of complete liquidation and dissolution, the liquidation should be concluded prior to the third anniversary of the filing of the Certificate of Dissolution in Delaware. If we pursue a plan of complete liquidation and dissolution, the actual nature, amount and timing of all distributions will be determined by our Board, in its sole discretion, and will depend in part upon our ability to resolve our remaining contingencies.

If we pursue this strategy, uncertainties as to the ultimate amount of our liabilities make it impracticable to predict the aggregate net value ultimately distributable to our stockholders. Claims, liabilities and expenses from operations (including costs associated with any retained firm's efforts to sell our remaining assets and settle our remaining liabilities, taxes, legal and accounting fees and miscellaneous office expenses) will continue to be incurred. These expenses will reduce the amount of cash available for ultimate distribution to stockholders. However, no assurances can be given that available cash and amounts received on the sale of assets will be adequate to provide for our obligations, liabilities, expenses and claims and to make cash distributions to stockholders. If such available cash and amounts received from the sale of assets are not adequate to provide for our obligations, liabilities, expenses and claims, we may not be able to distribute meaningful cash, or any cash, to our stockholders.

The Proceeds from a Sale of Our Assets May Be Less than Anticipated

If we pursue a plan of complete liquidation and dissolution, sales of our remaining assets will be made on such terms as are approved by the Board and may be conducted by competitive bidding, public sales or privately negotiated sales. The prices at which we will be able to sell these assets will depend largely on factors beyond our control, including, without limitation, the condition of financial markets, the availability of financing to prospective purchasers of the assets, United States and foreign regulatory approvals, public market perceptions and limitations on

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transferability of certain assets. Because some of our remaining assets may decline in value over time, we may not be able to consummate the sale of these assets in time to generate meaningful value. In addition, we may not obtain as high a price for a particular asset as we might secure if we were not in liquidation.

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

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

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

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

We Will Continue to Incur the Expense of Complying with Public Company Reporting Requirements

We have an obligation to continue to comply with the applicable reporting requirements of the Securities Exchange Act of 1934, as amended, even though compliance with such reporting requirements is economically burdensome. In order to curtail expenses, if we elect to pursue a liquidation and dissolution strategy, after we file our Certificate of Dissolution, we will seek relief from the Securities and Exchange Commission from the reporting requirements under the Exchange Act, which may or may not be granted. Until such relief is granted we will continue to make obligatory Exchange Act filings. We anticipate that even if such relief is granted in the future, we will continue to file current reports on Form 8-K to disclose material events relating to our liquidation and dissolution along with any other reports that the Securities and Exchange Commission may require.

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

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

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

Our Board has approved a shareholders rights plan. The rights will become exercisable the tenth day after a person or group announces acquisition of 10% or more of our common stock or announces commencement of a tender or exchange offer the consummation of which would result in ownership by the person or group of 10% or more of our common stock. If the rights become exercisable, the holders of the rights (other than the person

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acquiring 10% or more of our common stock) will be entitled to acquire, in exchange for the rights exercise price, shares of our common stock or shares of any company in which we are merged, with a value equal to twice the rights exercise price. The rights may have the effect of rendering more difficult or discouraging an acquisition of the Company deemed undesirable by the Board. As a result, the rights could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

ITEM 2. PROPERTIES

Our headquarters are located in 40,795 square feet of leased office space in Redwood City, California. The lease term extends to May 30, 2005. We also lease 1,923 square feet of office space in Los Angeles, California. The lease term extends to April 30, 2005. We are currently attempting to sublease, settle or negotiate an early termination of these leases.

ITEM 3. LEGAL PROCEEDINGS

On or about April 7, 2000, SightSound, Inc. (SightSound) filed an amended complaint against one of our former customers, BeMusic, in the United States District Court for the Western District of Pennsylvania (Pennsylvania Court). The suit alleges that BeMusic infringes one or more of three patents (United States Patent Nos. 5,191,573; 5,675,734 and 5,996,440). Sightsound claims damages of \$20 million plus an unspecified royalty. We have entered into an agreement with BeMusic agreeing to assume control of the defense and pay the defense costs, while reserving our rights as to indemnification obligations. BeMusic filed an answer to the amended complaint on April 27, 2000, denying the material allegations of the complaint, and asserting counterclaims for declaratory judgment of non-infringement and patent invalidity. Following a claims construction hearing in 2001 and an initial report and recommendation on claim construction by the magistrate judge in February 2002 (which ruling is on appeal to the district judge), we renegotiated our agreement with BeMusic concerning the defense of the case going forward. On December 16, 2002, BeMusic filed a lawsuit against us seeking to enjoin the payment of a \$2.50 per share return of capital cash distribution to our stockholders. On January 24, 2003, we entered into a settlement agreement with BeMusic, whereby we agreed to set aside a cash reserve of \$7.0 million to share in the defense of the patent action brought by SightSound against BeMusic. We have now ceded control of the defense of the case to BeMusic, and are splitting the costs of the defense with BeMusic. We are still reserving our rights as to indemnification issues. The action currently is pending in the United States District Court of the Western District of Pennsylvania. No trial date has been set at this time.

On August 27, 2002, MM Companies, Inc. (MMC formerly musicmaker.com, Inc.) filed a lawsuit against us, Raymond A. Doig, Gerald W. Kearby, Robert G. Flynn, Stephen V. Imbler and Ann Winblad in the Delaware Chancery Court seeking injunctive and other equitable relief to prevent the defendants from appointing two additional directors to our Board. MMC s complaint alleged that the defendants decision to expand our Board was in violation of Delaware law. MMC further alleged that the defendants actions were taken solely to interfere with the vote of our stockholders and to deny MMC and other stockholders a substantial presence on our Board. On October 1, 2002, MMC amended its complaint to add James D. Somes and Judith N. Frank, our newly appointed directors, as named defendants. The amended complaint alleged that the Board s decision to expand the size of the Board and to appoint two additional directors was in violation of Delaware General Corporation Law Section 225. At the trial in this matter held on October 21, 2002, the Delaware Chancery Court denied MMC s application for relief and approved the Board s appointment of two additional directors. On October 30, 2002, MMC filed a notice of appeal and a motion for expedited proceedings in the Supreme Court of Delaware. That Court accepted the appeal and, after briefing and oral argument, on January 7, 2003 the Supreme Court of Delaware reversed the trial court s decision and invalidated the Board s decision to appoint two addition directors. Consequently, James D. Somes and Judith N. Frank were removed from the Board.

On August 21, 2002, we filed a lawsuit against MMC and Steel Partners II, LP (Steel Partners) in U.S. District Court for the Southern District of New York (New York Court). We asked the New York Court to prohibit MMC and Steel Partners from violating the federal securities laws in connection with their campaigns to

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take control of us, and sought compensatory and punitive damages as a result of these alleged violations. Our complaint alleged that MMC failed to register as an investment company under the Investment Company Act of 1940 (ICA) and that its purchase of our shares and subsequent proxy contest to take control of the Board was, therefore, in violation of the ICA. The complaint also alleged that Steel Partners was conducting an illegal proxy contest by failing to make the proper filings with the Securities and Exchange Commission (SEC) and that, in the course of its contest, Steel Partners has distributed false and misleading statements to our stockholders. Shortly after the filing of this complaint, MMC purchased \$4 million in gold bullion in an effort to resolve its possible status as an unregistered investment company under the ICA. In addition, MMC revised its proxy statement to disclose its uncertain status under the ICA. In light of these steps, on September 10, 2002, we informed the New York Court that we were withdrawing our claims for injunctive relief against MMC. In resolution of our claims against Steel Partners, both parties entered into a stipulation, dated September 20, 2002, limiting Steel Partners' ability to issue further press releases referencing us. In light of the stipulated agreement, the New York Court, on September 20, 2002, denied our motion for a preliminary injunction. Pursuant to the Settlement and Reimbursement Agreement entered into on January 2, 2003 (January 2, 2003 Agreement) described below, the parties stipulated, among other things, that this action be dismissed with prejudice. On January 17, 2003, the New York Court entered an order granting the voluntary dismissal, with prejudice, of our claims against Steel Partners in this action.

On July 23, 2002, MMC filed an action in Delaware Chancery Court against us, each member of our Board, and Alliance Entertainment Corp. (Alliance). The complaint alleges that our directors and Alliance violated their fiduciary duties by entering into the merger and approving the Agreement and Plan of Merger dated June 12, 2002 (Merger Agreement) by and among us, April Acquisition Corp and Alliance, and that our directors further violated their fiduciary duties by making certain changes to our shareholders rights plan. Alliance was alleged to have aided and abetted the alleged breaches of fiduciary duty by our directors. MMC sought, among other things, to (i) invalidate the Merger Agreement, (ii) prevent us or Alliance from taking any actions to effectuate or enforce the Merger Agreement, the merger of us or Alliance from 10%, or the self tender-offer, (iii) direct our Board to restore the trigger of our shareholders rights plan to 15%, (iv) prevent enforcement of our shareholders rights plan to the extent it prohibits the plaintiff and other stockholders from cooperating to assist in the solicitation of proxies for our 2002 annual meeting of stockholders (Annual Meeting), (v) damages for incidental injuries, and (vi) costs and expenses, including attorneys' fees and experts' fees. In connection with its complaint, MMC filed a motion for a preliminary injunction and a motion for expedited proceedings. On July 31, 2002, MMC withdrew its motion for a preliminary injunction and for expedited proceedings, and stated that it would file an amended complaint. On December 12, 2002, this action was dismissed without prejudice. On January 2, 2003, MMC, we and the Board, entered into a Settlement and Reimbursement Agreement (January 2, 2003 Agreement) pursuant to which we reimbursed MMC the sum of \$929,000, representing MMC's costs associated with this and other litigations with us and the Board. The \$929,000 is recorded as General and Administrative expense in 2002. This January 2, 2003 Agreement stipulated, among other things, that this action in the Delaware Court be deemed dismissible with prejudice.

On May 3, 2002, MMC filed an action in the Delaware Chancery Court (Delaware Court), pursuant to Title 8 Delaware Code section 211, seeking to compel us to hold an annual meeting of stockholders. We moved to dismiss on the grounds that the Delaware Court lacked subject matter jurisdiction as 13 months had not elapsed since our last annual stockholder meeting, held on June 1, 2001. On May 10, 2002, the Board set July 1, 2002 as the date for the 2002 annual meeting (Annual Meeting) and our motion to dismiss was held in abeyance. On June 13, 2002, we publicly announced the execution of the Merger Agreement and announced that, in light of the merger, the Board had determined to postpone the Annual Meeting. The next day, MMC filed an amended complaint requesting that the Delaware Court order us to hold our Annual Meeting on July 1, 2002. The Delaware Court allowed the parties to take expedited discovery and scheduled a hearing for July 15, 2002. At the hearing, the Delaware Court granted our request that the Annual Meeting be scheduled for September 26, 2002.

In October 2001, two lawsuits were filed in Delaware Chancery Court naming us and certain of our officers and directors as defendants. Both actions related to our response to recent acquisition offers and purported to be

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class actions brought on behalf of our stockholders. On February 1, 2002, the two complaints were consolidated into a single action, titled *In Re Liquid Audio, Inc., Shareholders Litigation*, Consolidated Civil Action No. 19212-NC. That action was brought against Gerald W. Kearby, Silvia Kessel, Ann L. Winblad and Liquid Audio itself. The complaint alleged that defendants had breached their fiduciary duties owed to our stockholders in connection with our response to acquisition offers from Steel Partners II, LLP and an investor group formed by MMC. The complaint sought, among other things, a court order barring us from adopting or maintaining measures that would make us less attractive as a takeover candidate or, alternatively, awarding compensatory damages to the purported plaintiff class. The January 2, 2003 Agreement stipulated, among other things, that this action in the Delaware Court be deemed dismissible with prejudice.

On or about September 27, 2001, Network Commerce, Inc. (NCI) filed a Complaint against us in the United States District Court for the Western District of Washington (Seattle) (Washington Court). The suit alleged that we infringed the claims of United States Patent No. 6,073,124. NCI requested that we be enjoined from our allegedly infringing activities and seeks unspecified damages. We were served with the Complaint on November 2, 2001 and subsequently submitted our answer and included counterclaims. We also filed a motion for summary judgment in November 2001. In March 2002, our motion for summary judgment was denied and in August 2002, we filed an amended motion for summary judgment. On October 30, 2002, the motion for summary judgment of non-infringement was denied, but the Washington Court did adopt our claim construction of a key term of the patent. In addition, NCI filed for Chapter 11 bankruptcy protection. On January 21, 2003, we entered into a settlement agreement with NCI under which NCI agreed to dismiss their Complaint against us with prejudice and we agreed to pay NCI \$150,000. The \$150,000 is recorded as General and Administrative expense in 2002. Under the terms of the settlement, both parties provided a mutual release of claims against each other.

We, certain of our officers and directors, and various of the underwriters in our initial public offering (IPO) and secondary offering, were named as defendants in a consolidated action filed in the United States District Court for the Southern District of New York, *In re Liquid Audio, Inc. Initial Public Offering Securities Litigation*, CV-6611. The consolidated amended complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in our IPO and secondary offering of securities. The plaintiffs brought claims for violation of several provisions of the federal securities laws against those underwriters, and also against us and certain of our directors and officers, seeking unspecified damages on behalf of a purported class of purchasers of our common stock between July 8, 1999 and December 6, 2000. Various plaintiffs filed similar actions asserting virtually identical allegations against more than 40 investment banks and 250 other companies. All of these IPO allocation securities class actions currently pending in the Southern District of New York have been assigned to Judge Shira A. Scheindlin for coordinated pretrial proceedings as *In re Liquid Audio, Inc. Initial Public Offering Securities Litigation*, 21 MC 92. Defendants have filed motions to dismiss the actions. In October 2002, the directors and officers were dismissed without prejudice. We believe that we have meritorious defenses to the claims against us and intend to defend ourselves vigorously.

From time to time we receive letters from corporations or other business entities notifying us of alleged infringement of patents held by them or suggesting that we review patents to which they claim rights. These corporations or entities often indicate a willingness to discuss licenses to their patent rights.

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

There were no submissions of matters to a vote of securities holders during the quarter ended December 31, 2002.

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS****Market Price of Common Stock**

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

	<u>High</u>	<u>Low</u>
Year Ended December 31, 2001		
First Quarter	3.88	2.00
Second Quarter	2.95	1.81
Third Quarter	2.95	2.03
Fourth Quarter	2.72	2.10
Year Ended December 31, 2002		
First Quarter	2.47	2.25
Second Quarter	2.60	2.27
Third Quarter	2.60	2.36
Fourth Quarter	2.79	2.44

The closing price per share of the common stock at March 18, 2003 was \$0.35. As of March 18, 2003, there were approximately 114 holders of record of our common stock. Because many shares of our common stock are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders.

Dividend Policy

On December 6, 2002, we declared a non-dividend, return of capital cash distribution of \$2.50 per share to shareholders of record as of December 10, 2002 to be paid on December 20, 2002. We paid this cash distribution on January 29, 2003, for a total of \$57.8 million. We have not declared any other distributions since January 1, 2001.

We continue to explore various ways of using and/or disposing of our remaining assets and settling our final claims and liabilities. Depending on the alternatives chosen, and the success of maximizing the return on assets and minimizing the cost of settling claims and liabilities, we may or may not declare future cash distributions to stockholders. If we choose to adopt a plan of complete liquidation and dissolution, we intend to make a final cash distribution to our stockholders in connection with this dissolution once all our assets have been sold and obligations satisfied, in approximately three to four years.

Preferred Stock Rights Agreement

On August 7, 2001, our Board adopted a Preferred Stock Rights Agreement, as amended on July 14, 2002, under which we declared a dividend of one right to purchase one one-thousandth share of our Series A participating preferred stock for each outstanding share of common stock. The rights will separate from the common stock and become exercisable following (i) the tenth day (or such later date as may be determined by our Board) after a person or group of affiliated or associated persons has acquired, or obtained the right to acquire, beneficial ownership of 10% or more of the common stock then outstanding or (ii) the tenth business day (or such later date as may be determined by our Board) after a person or group announces a tender of exchange offer, the consummation of which would result in ownership by a person or group of 10% or more of our then outstanding common stock. Each right will entitle the holder to purchase for \$17.00 one one-thousandth of a share of Series A preferred stock with economic terms similar to that of one share of our common stock.

Table of Contents**ITEM 6. SELECTED FINANCIAL DATA**

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

	Year Ended December 31,				
	2002	2001	2000	1999	1998
(in thousands, except per share data)					
Statement of Operations Data:					
Net revenues:					
License	\$ 108	\$ 682	\$ 1,284	\$ 1,537	\$ 1,235
Services	374	1,173	2,977	733	268
Business development (related party)		2,873	7,307	2,137	1,300
Total net revenues	482	4,728	11,568	4,407	2,803
Cost of net revenues:					
License	388	491	290	235	310
Services	654	1,503	2,722	1,122	242
Business development (related party)			75	79	2
Non-cash cost of revenues	82	349	28	25	36
Total cost of net revenues	1,124				