

LQ CORP INC
Form 10-Q
May 17, 2004
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

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 March 31, 2004

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

LQ CORPORATION, INC.

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of

incorporation or organization)

888 Seventh Ave., 17th Floor, New York, NY
(Address of principal executive offices)

77-0421089
(I.R.S. Employer

Identification No.)

10019
(Zip Code)

(212) 974-5730

(Registrant's telephone number, including area code)

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

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

As of May 11, 2004, there were 23,176,858 shares of registrant's Common Stock outstanding.

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Table of Contents**ITEM 1. FINANCIAL STATEMENTS****LQ CORPORATION, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands; unaudited)**

| | March 31, 2004 | December 31, 2003 |
|---|---------------------------|------------------------------|
| | <u> </u> | <u> </u> |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 7,177 | \$ 9,077 |
| Accounts receivable, net | | 28 |
| Other current assets | 67 | 164 |
| | <u> </u> | <u> </u> |
| Total current assets | \$ 7,244 | \$ 9,269 |
| | <u> </u> | <u> </u> |
| Liabilities and stockholders' equity | | |
| Current liabilities: | | |
| Accrued liabilities | 45 | 1,935 |
| | <u> </u> | <u> </u> |
| Total current liabilities | 45 | 1,935 |
| | <u> </u> | <u> </u> |
| Stockholders' equity: | | |
| Common stock, \$0.001 par value; 50,000,000 shares authorized; 23,176,858 shares issued and outstanding | 23 | 23 |
| Additional paid-in capital | 146,053 | 146,053 |
| Accumulated other comprehensive loss (net) | (80) | (79) |
| Accumulated deficit | (138,797) | (138,663) |
| | <u> </u> | <u> </u> |
| Total stockholders' equity | 7,199 | 7,334 |
| | <u> </u> | <u> </u> |
| Total liabilities and stockholders' equity | \$ 7,244 | \$ 9,269 |
| | <u> </u> | <u> </u> |

See accompanying notes to condensed consolidated financial statements

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

| | Three Months Ended | |
|--|--------------------|------------|
| | March 31, | |
| | 2004 | 2003 |
| Net revenues: | | |
| License | \$ | \$ 4 |
| Services | | 39 |
| Total net revenues | | 43 |
| Cost of net revenues: | | |
| License | | 5 |
| Services | | 2 |
| Total cost of net revenues | | 7 |
| Gross profit (loss) | | 36 |
| Operating expenses: | | |
| Sales and marketing | | 265 |
| Research and development | | 78 |
| General and administrative | 179 | 3,009 |
| Restructuring | | 842 |
| Total operating expenses | 179 | 4,194 |
| Loss from operations | (179) | (4,158) |
| Other income (expense), net | 45 | 105 |
| Gain on sale of digital music fulfillment business | | 2,865 |
| Net loss | \$ (134) | \$ (1,188) |
| Net loss per share: | | |
| Basic and diluted | \$ (.01) | \$ (0.05) |
| Weighted average shares | 23,176 | 23,145 |

See accompanying notes to condensed consolidated financial statements

Table of Contents**LQ CORPORATION, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts; unaudited)

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2004 | 2003 |
| Cash flows from operating activities: | | |
| Net loss | (134) | \$ (1,188) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | | 112 |
| Gain on sale of digital music fulfillment business and related assets | | (2,865) |
| Changes in assets and liabilities: | | |
| Accounts receivable | 28 | 25 |
| Other assets | 97 | 554 |
| Accounts payable | | (623) |
| Accrued liabilities | (1,890) | (1,271) |
| Deferred revenue | | (39) |
| Net cash used in operating activities | (1,899) | (5,295) |
| Cash flows from investing activities: | | |
| Proceeds from sale of digital music fulfillment business and related assets | | 3,200 |
| Net cash provided by investing activities | | 3,200 |
| Cash flows from financing activities: | | |
| Cash distribution to stockholders | | (57,771) |
| Proceeds from issuance of common stock, net of repurchases | | 1 |
| Net cash used in financing activities | | (57,770) |
| Effect of exchange rates on cash and cash equivalents | (1) | (1) |
| Net decrease in cash and cash equivalents | (1,900) | (59,866) |
| Cash and cash equivalents at beginning of period | 9,077 | 73,985 |
| Cash and cash equivalents at end of period | \$ 7,177 | \$ 14,119 |

See accompanying notes to condensed consolidated financial statements

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LQ CORPORATION, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1 - THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

The Company

LQ Corporation, Inc. was incorporated in California as Liquid Audio, Inc. in January 1996 and reincorporated in Delaware in April 1999. In July 1999, we completed our initial public offering of common stock. Our Board of Directors (the Board) received stockholder approval on July 30, 2003 to change our name to LQ Corporation, Inc. Our name was formally changed on January 7, 2004. Our principal executive offices are located at 888 Seventh Avenue, 17th Floor, New York, NY 10019, and our telephone number is (212) 974-5730.

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

Through 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 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.

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 transferred ownership of certain Liquid Audio related

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trademarks to Geneva and the Microsoft License. As a result of the sale, we are currently not operating any business and are exploring options for the use of our remaining assets.

We are reviewing alternatives for the use or disposition of our remaining assets while settling our remaining claims and liabilities. We intend to pursue other business opportunities and investments unrelated to the downloading of digital music. Neither our Board nor our stockholders have yet approved any such opportunities. If we are unable to find any suitable business opportunities and/or investments, we may pursue a plan of complete liquidation and dissolution. 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.

We traded shares of an available-for-sale security in August and September of 2003. Although we liquidated our entire remained position in this security as of November 12, 2003 and do not intend to make any additional purchases of available-for-sale securities, we may inadvertently have become, or may become in the future, an investment company under the Investment Company Act of 1940 as a result of our lack of an operating business, our significant cash balance as a percentage of our total assets and our recent trading activities. Registration as an investment company would be very expensive, further depleting our cash reserves and would also subject us to restrictions that may be inconsistent with any future business strategy we may decide upon.

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LQ CORPORATION, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

We entered into a Settlement Agreement and Mutual Release on February 12, 2004 with BeMusic which finally resolved all matters between BeMusic and us with respect to the litigation matter with SightSound, Inc. Under the terms of this Agreement, we paid approximately \$1,452,000 to BeMusic as settlement expenses and approximately \$314,000 in legal fees relating to the SightSound litigation. These payments were in addition to \$335,827 previously paid by us for our share of attorney fees incurred in connection with this matter.

Our common stock currently trades over the counter on The Nasdaq OTC Bulletin Board. Our common stock was traded on The Nasdaq National Market, but was delisted on June 5, 2003. The market price per share of our stock dropped significantly 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 May 13, 2004 was \$0.271 per share. 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. 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.

At our September 29, 2003 meeting of our stockholders, our stockholders approved amendments to our certificate of incorporation to effect a 1-for-250 reverse stock split, to be followed immediately by a 35-for-1 forward stock split (collectively, the Reverse/Forward Stock Split), as well as a reduction in the number of common shares authorized for issuance from 50,000,000 shares to 30,000,000 shares (the Share Reduction).

Although our Board has received stockholder approval to implement the Reverse/Forward Stock Split and the Share Reduction, we have not yet consummated these corporate actions. We intend to file the amendments necessary to implement the Reverse/Forward Stock Split and the Share Reduction within the next few months. In the case of the Reverse/Forward Stock Split, we will issue a press release announcing the Reverse/Forward Stock Split prior to its effectiveness. For a more detailed discussion of the effect of the Reverse/Forward Stock Split and the Share Reduction on the capitalization of the Company, see Part II Item 5: Other Information No retroactive effect has been given to any of the share or earnings per share information in these financial statements as a result of the Reverse/Forward Stock Split or the Share Reduction. Any retroactive effect on the share or earnings per share information will be recorded in the period it takes effect.

Basis of presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by us and reflect all adjustments which are, in the opinion of management, necessary for a fair presentation of the interim periods presented. The results of operations for the three months ended March 31, 2004 are not necessarily indicative of the results to be expected for any subsequent quarter or for the year ending December 31, 2004. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the Securities and Exchange Commission's (SEC) rules and regulations.

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These unaudited condensed consolidated interim financial statements and notes included herein should be read in conjunction with our audited consolidated financial statements and notes as included in our Annual Report on Form 10-K for the year ended December 31, 2003 as filed with the SEC on March 30, 2004.

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LQ CORPORATION, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Going concern consideration

The accompanying financial statements have been prepared assuming that we will continue as a going concern, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. We incurred losses and negative cash flows from operations for every year since inception. For the three months ended March 31, 2004, we incurred a net loss of approximately \$134,000 and negative cash flows from operations of approximately \$1.9 million. As of March 31, 2004, we had an accumulated deficit of approximately \$138.8 million. We have not yet settled on an operating plan, and can give no assurance that our existing cash and cash equivalents are sufficient to fund the current operations and satisfy our obligations. We believe these obligations will primarily relate to costs associated with the operation as a public company (legal, accounting, insurance, etc.), as well as the satisfaction of any potential legal judgments or settlements and the expenses associated with any new business activities, which may be undertaken by us. These factors, among others, indicate that we may be unable to continue as a going concern. No adjustment has been made in the accompanying consolidated financial statements to the amounts and classifications of assets and liabilities which could result should we be unable to continue as a going concern. We continue to consider future alternatives, including the possible acquisition of other businesses or the possibility of adopting a plan of liquidation. However, we have not consummated any significant transactions to date and any business prospects remain uncertain. To the extent that the our management moves forward on any alternative strategy, such strategy may have an impact on our liquidity.

Principles of consolidation

The financial statements include our accounts and our wholly-owned (inactive) subsidiary. Significant intercompany transactions and balances have been eliminated.

Investments

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

During the fiscal year 2003, we purchased 30,207 shares of Warnaco Group Inc. (NASDAQ: WRNC), an available-for-sale security with a fair market value of \$470,323 and a cost basis of \$457,639. This is the only available-for-sale security that we ever owned. As of November 12, 2003, we liquidated our entire remaining position in this security, which resulted in a realized gain of \$48,777. Following such date, we did not own any shares of available-for-sale securities, and all of our liquid assets are held as cash and cash equivalents. We do not intend to make any additional purchases of available-for-sale securities, and do not intend to trade in available-for-sale securities in the future. All of our liquid assets will continue to be held as cash and cash equivalents on a going forward basis.

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

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expensive and further deplete our cash balances, which would leave us with fewer resources to pursue further operating alternatives. Registration would also subject us to restrictions that may be inconsistent with any future business strategy we may decide upon. In order to avoid these regulations, we may have to take actions that we would not otherwise choose to take to avoid registration under the Investment Company Act.

Stock-based compensation

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation, Transition and Disclosure*. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure requirements are effective for interim periods ending after December 15, 2002.

We account for stock issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force (EITF) Issue No. 96-18 *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

Consistent with the disclosure provisions of SFAS 123, our net loss and basic and diluted net loss per share would have been adjusted to the pro forma amounts indicated below (in thousands, except per share amounts).

| | Three Months Ended March 31, 2004 | Three Months Ended March 31, 2003 |
|---|--|--|
| | <u> </u> | <u> </u> |
| Net loss as reported | \$ (134) | \$ (1,188) |
| Less stock-based compensation (income) expense determined under fair value based method, net of tax effects | (45) | (316) |
| | <u> </u> | <u> </u> |
| Net loss pro forma | \$ (179) | \$ (1,504) |
| | <u> </u> | <u> </u> |
| Basic and diluted net loss per share as reported | \$ (.01) | \$ (.05) |
| Basic and diluted net loss per share pro forma | \$ (.01) | \$ (.07) |

NOTE 2 ACCRUED LIABILITIES:

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The components of accrued liabilities are as follows (in thousands):

| | <u>March 31,</u> <u>2004</u> | <u>December 31,</u> <u>2003</u> |
|--------------------------------------|---------------------------------|------------------------------------|
| Accrued liabilities: | | |
| Consulting and professional services | \$ 45 | \$ 124 |
| Litigation settlement | | 1,766 |
| Other | | 45 |
| | <u>\$ 45</u> | <u>\$ 1,935</u> |

NOTE 3 COMPREHENSIVE LOSS:

Comprehensive loss includes net loss and other comprehensive income (loss). Other comprehensive income (loss) includes accumulated translation adjustments. The components of comprehensive loss are as follows (in thousands):

| | <u>Three Months Ended</u> <u>March 31,</u> | |
|--|---|-------------------|
| | <u>2004</u> | <u>2003</u> |
| Comprehensive loss: | | |
| Net loss | \$ (134) | \$ (1,188) |
| Foreign currency translation adjustments | (1) | (1) |
| | <u>\$ (135)</u> | <u>\$ (1,189)</u> |

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Basic and diluted net loss per share is computed by dividing the net loss for the period by the weighted average number of common shares outstanding during the period. The calculation of diluted net loss per share excludes potential common shares if the effect is anti-dilutive. Potential common shares consist of unvested restricted common stock, incremental common shares issuable upon the exercise of stock options and common shares issuable upon the exercise of common stock warrants.

| | Three Months Ended March 31, | |
|-----------------------|---|--------------|
| | 2004 | 2003 |
| Common stock options | 1,368 | 361 |
| Common stock warrants | 264 | 748 |
| | 1,632 | 1,109 |

NOTE 5 CONTINGENCIES AND LEGAL PROCEEDINGS:

On or about April 7, 2000, SightSound, Inc. (SightSound) filed an Amended Complaint in a lawsuit in the United States District Court for the Western District of Pennsylvania (the Pennsylvania Court) alleging that certain former customers of ours, N2K, Inc., CDNow, Inc. and CDNow Online, Inc., which have since merged into BeMusic, infringed one or more of three patents (Nos. 5,191,573; 5,675,734; and 5,996,440). In January 2002, we entered into an agreement with BeMusic's predecessor, CDNow Online, Inc., in which we agreed to share evenly with CDNow Online, Inc. all legal fees incurred by CDNow Online, Inc. in defending the patent infringement action, but requires BeMusic to consult in good faith with us regarding its defense and/or settlement of the patent infringement action. On February 20, 2004, an Order was entered in the Pennsylvania Court ending the lawsuit by SightSound against BeMusic. As a result of the entry of the Order and pursuant to a separate agreement between SightSound and BeMusic executed on February 12, 2004, SightSound dismissed the SightSound litigation and released all claims against us. Entry of the Order also made effective a Settlement Agreement and Mutual Release executed on February 13, 2004 by us and BeMusic (the Settlement Agreement). The Settlement Agreement finally resolves all matters between BeMusic and us relating to the SightSound litigation. Under the terms of the Settlement Agreement, we paid \$1,452,000 to BeMusic and approximately \$314,000 in legal fees relating to the SightSound litigation. These payments were in addition to \$335,827 previously paid by us for our share of attorney fees incurred in connection with this matter. As a result of the Settlement Agreement, we have no further obligation to maintain available cash on hand in connection with the SightSound litigation. Neither party to the Settlement Agreement admitted any wrongdoing or any indemnification obligations in connection with this litigation.

We, certain of our former officers and directors, and various of the underwriters in our initial public offering (IPO) and secondary offering, were named as defendants in a consolidated action filed in the United States District Court for the Southern District of New York, *In re Liquid Audio*,

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Inc. Initial Public Offering Securities Litigation, CV-6611. The consolidated amended complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in our IPO and secondary offering of securities. The plaintiffs brought claims for violation of several provisions of the federal securities laws against those underwriters, and also against us and certain of our former directors and officers, seeking unspecified damages on behalf of a purported class of purchasers of our common stock between July 8, 1999 and December 6, 2000.

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LQ CORPORATION, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Various plaintiffs filed similar actions asserting virtually identical allegations against more than 40 investment banks and 250 other companies. All of these IPO allocation securities class actions currently pending in the Southern District of New York have been assigned to Judge Shira A. Scheindlin for coordinated pretrial proceedings as *In re Liquid Audio, Inc. Initial Public Offering Securities Litigation*, 21 MC 92. Defendants have filed motions to dismiss the actions. In October 2002, such directors and officers were dismissed without prejudice. A proposal has been made for the settlement and release of claims against the issuer defendants, including us, in exchange for a contingent payment to be made by the issuer defendants insurance carriers and an assignment of certain claims. On July 16, 2003, our Board of Directors approved participation in the settlement. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court. On May 18, 2004, the parties are scheduled to meet with the mediator to finalize the formal settlement papers and resolve any remaining settlement issues. If the settlement does not occur, and litigation against us continues, we believe that we have meritorious defenses and intend to defend the case 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.

NOTE 6 CASH DISTRIBUTION TO STOCKHOLDERS:

On January 29, 2003, we distributed \$2.50 per share, for a total of \$57,771,000, to our common stockholders of record as of December 10, 2002.

NOTE 7 DECREASE IN STOCK OPTION EXERCISE PRICE:

On March 18, 2003, our Board of Directors elected to reduce the exercise price of all outstanding stock options by \$2.50, but not lower than \$0.10, to reflect the \$2.50 cash distribution to our stockholders. Consequently, we will account for approximately 61,000 of these stock options as variable.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis contains forward-looking statements within the meaning of Federal securities laws. You can identify these statements because they use forward-looking terminology such as may, will, expect, anticipate, estimate, continue, and intend or other similar words. These words, however, are not the exclusive means by which you can identify these statements. You can also identify forward-looking statements because they discuss future expectations, contain projections of results of operations or of financial conditions, characterize future events or circumstances or state other forward-looking information. We have based all forward-looking statements included in Management's Discussion and Analysis on information currently available to us, and we assume no obligation to update

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any such forward-looking statements. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, actual results could differ materially from those projected in the forward-looking statements. Potential risks and uncertainty include, but are not limited to, those set forth under the caption "Additional Factors Affecting Future Results" included in this Management's Discussion and Analysis of Financial Condition and Results of Operations.

While we believe that the discussion and analysis in this report is adequate for a fair presentation of the information, we recommend that you read this discussion and analysis in conjunction with Management's Discussion and Analysis included in our Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Securities Exchange Commission (SEC).

Overview

During 2002, we continued to provide software products and services that enable artists, record companies and retailers to create, syndicate and sell music digitally over the Internet.

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In the spring of 2002, it became apparent to our management that we could not achieve financial success as an independent company with our current business model. In June 2002 we announced a definitive agreement to merge with Alliance 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 January 29, 2003, we distributed \$2.50 per share, for a total of \$57.8 million, to our common stockholders of record as of December 10, 2002.

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 transferred ownership of certain Liquid Audio related trademarks to Geneva and the Microsoft License. As a result of the sale, we are currently not operating any businesses, and are exploring options for the use of our remaining assets.

On March 18, 2003, our Board acknowledged that many of our outstanding options, whether or not currently exercisable, have exercise prices significantly higher than the current market price of our current stock, and therefore, in recognition of the \$2.50 per share cash distribution on January 29, 2003, unilaterally approved a reduction in the exercise price for all options by \$2.50. The Board further resolved that such reduction will in no event reduce the exercise price of any options to less than \$0.10 per share.

As a result of this reduction in option exercise price, a portion of our outstanding options will be treated for financial reporting purposes as variable awards. This means that we will be required to record non-cash accounting charges or credits for compensation expense reflecting any increases and decreases in the price of our common stock. We will have to continue to reflect decreases and increases in the price of our common stock in our statement of operations with respect to the options until they are exercised, forfeited or terminated. In recording these accounting charges or credits, the higher the market value of our common stock, the greater the non-cash compensation expense.

We traded shares of an available-for-sale security in August and September of 2003. Although we liquidated our entire remaining position in this security as of November 12, 2003 and do not intend to make any additional purchases of available-for-sale securities, we may inadvertently have become, or may become in the future, an investment company under the Investment Company Act of 1940 as a result of our lack of an operating business, our significant cash balance as a percentage of our total assets and our recent trading activities. Registration as an investment company would be very expensive, further depleting our cash reserves and would also subject us to restrictions that may be inconsistent with any future business strategy we may decide upon.

We entered into a Settlement Agreement and Mutual Release on February 12, 2004 with BeMusic which finally resolved all matters between BeMusic and us with respect to the litigation matter with SightSound, Inc. Under the terms of this Agreement we paid approximately \$1,452,000 to BeMusic as settlement expenses and approximately \$314,000 in legal fees relating to the SightSound litigation. These payments were in addition to the \$335,827 previously paid by us for our share of attorney fees incurred in connection with this matter.

Corporate Restructurings

In January 2003, we adopted a corporate restructuring program, consisting of a worldwide workforce reduction, in connection with the sale of our digital music fulfillment business and related assets to Geneva Media, LLC (Geneva), an affiliate of Anderson Merchandisers, LP. A restructuring charge of \$4,411,000 was recorded in

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operating expense for the year ended December 31, 2003. The restructuring charge included involuntary separation costs of \$796,000 for 29 employees worldwide, 5 in sales and marketing, 11 in research and development, 9 in general and administrative and 4 in operations functions in the U.S., lease termination fees of \$3,599,000 and asset impairment costs of \$46,000 for prepaid expenses related to assets sold to Geneva. As of March 31, 2004, we have 1 full time employee and are focused on settling our claims and liabilities and pursuing other uses for the remainder of our assets. As of March 31, 2004, \$10,543 related to involuntary separation costs remains unpaid and will be paid when the employee is terminated.

Future Operations and Financial Results

We are reviewing alternatives for the use 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 nor our stockholders have yet approved any such plan or use. 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 currently trades over the counter on The Nasdaq OTC Bulletin Board. Our common stock was traded on The Nasdaq National Market, but was delisted on June 5, 2003. The market price per share of our common stock 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 May 13, 2004 was \$0.271 per share. 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. 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.

At our September 29, 2003 meeting of our stockholders, our stockholders approved amendments to our certificate of incorporation to effect a 1-for-250 reverse stock split, to be followed immediately by a 35-for-1 forward stock split (collectively, the Reverse/Forward Stock Split), as well as a reduction in the number of common shares authorized for issuance from 50,000,000 shares to 30,000,000 shares (the Share Reduction).

Although our Board has received stockholder approval to implement the Reverse/Forward Stock Split and the Share Reduction, we have not yet consummated these corporate actions. We intend to file the amendments necessary to implement the Reverse/Forward Stock Split and the Share Reduction within the next few months. In the case of the Reverse/Forward Stock Split, we will issue a press release announcing the Reverse/Forward Stock Split prior to its effectiveness. For a more detailed discussion of the effect of the Reverse /Forward Stock Split and the Share Reduction on the capitalization of the Company, see Part II Item 5: Other Information. No retroactive effect has been given to any of the share or earnings per share information in these financial statements as a result of the Reverse/Forward Stock Split or the Share Reduction. Any retroactive effect on the share or earnings per share information will be recorded in the period it takes effect.

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The following table sets forth, for the periods presented, certain data derived from our unaudited condensed consolidated statement of operations as a percentage of total net revenues. The operating results in any period are not necessarily indicative of the results that may be expected for any future period. In particular, we are not currently operating any businesses and do not expect continuing revenue from sources we received revenue from in the past.

| | Three Months Ended March 31, | |
|---|---|-----------------|
| | 2004 | 2003 |
| Net revenues: | | |
| License | % | 9% |
| Services | | 91 |
| Business development (related party) | — | — |
| Total net revenues | — | 100 |
| Cost of net revenues: | | |
| License | | 12 |
| Services | | 4 |
| Non-cash cost of revenue | — | — |
| Total cost of net revenues | — | 16 |
| Gross profit (loss) | — | 84 |
| Operating expenses: | | |
| Sales and marketing | | 616 |
| Non-cash sales and marketing | | |
| Research and development | | 182 |
| Non-cash research and development | | |
| General and administrative | | 6,998 |
| Non-cash general and administrative | | |
| Strategic marketing-equity instruments | | |
| Restructuring | | 1,958 |
| Total operating expenses | — | 9,754 |
| Loss from operations | | (244) |
| Other income (expense), net | | 9,670 |
| Sale of intellectual property assets | | 244 |
| Gain on sale of digital music fulfillment business | — | 6,663 |
| Net loss | % | (2,763)% |

Three Months Ended March 31, 2004 and 2003

Total Net Revenues

Total net revenues were \$0 for the three months ended March 31, 2004 as compared to \$43,000 in the comparable period of 2003. We do not expect significant revenue in the remainder of 2004.

License. License revenues derived from our former operating business primarily consisted of fees from licensing our software products to third parties. License revenues were \$0 for the three months ended March 31, 2004 as compared to \$4,000 in the comparable period of 2003. This decrease was due to the discontinuation of the Liquid Player product line and the sale of our digital music fulfillment business to Geneva in January 2003.

Services. Services revenues derived from our former operating business primarily consisted of maintenance fees related to our licensed software products, hosting fees, encoding, music delivery and transaction fees, promotion and advertising services and kiosk-related equipment sales from third parties. Services revenues were \$0 for the three months ended March 31, 2004 as compared to \$39,000 in the comparable period of 2003. This decrease was due to the discontinuation of our software license and our music hosting businesses and the sale of our digital music fulfillment business to Geneva.

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Total Cost of Net Revenues

We had no sales or costs relating to sales for the three months ended March 31, 2004. Total cost of net revenues was \$0 in the three months ended March 31, 2004 as compared to \$7,000 in the three months ended March 31, 2003. We do not expect significant cost of net revenues in the remainder of 2004 since we are not currently operating any businesses.

License. Cost of license revenues primarily consists of royalties paid for third-party technology and costs of documentation, duplication and packaging. Cost of license revenues were \$0 for the three months ended March 31, 2004 as compared to \$5,000 in the comparable period of 2003. Cost of license revenues decreased due to our discontinuation of the digital music distribution business.

Services. Cost of services revenues primarily consists of compensation for customer service, encoding and professional services personnel, kiosk-related equipment and an allocation of our occupancy costs and other overhead attributable to our services revenues. Cost of services revenues were \$0 for the three months ended March 31, 2004 as compared to \$2,000 in the three months ended March 31, 2003. The decrease in cost of services revenues was due to the termination of all of our encoding, customer service and professional services personnel and the sale of the digital music fulfillment business to Geneva.

Operating Expenses

Sales and Marketing. Sales and marketing expenses consist primarily of compensation for our sales, marketing and business development personnel, compensation for customer service and professional services personnel attributable to sales and marketing activities, advertising, trade show and other promotional costs, design and creation expenses for marketing literature and our website and an allocation of our occupancy costs and other overhead. Sales and marketing expenses were \$0 for the three months ended March 31, 2004 compared to \$265,000 in the comparable period of 2003. We do not expect to incur sales and marketing expenses in the remainder of 2004 since we are not currently operating any businesses.

Research and Development. Research and development expenses consist primarily of compensation for our research and development, network operations and product management personnel, payments to outside contractors and, to a lesser extent, depreciation on equipment used for research and development and an allocation of our occupancy costs and other overhead. Research and development expenses were \$0 for the three months ended March 31, 2004, compared to \$78,000 in the comparable period of 2003. We do not expect to incur research and development expenses in the remainder of 2004 since we are not currently operating any businesses.

General and Administrative. General and administrative expenses consist primarily of compensation for personnel and payments to outside contractors for general corporate functions, including finance, information systems, human resources, facilities, legal and general management, fees for professional services, bad debt expense and an allocation of our occupancy costs and other overhead. General and administrative expenses were \$179,000 for the three months ended March 31, 2004, compared to \$3,009,000 in the comparable period of 2003. The decrease in 2004 was primarily due to the cessation of business activity. The primary components of the \$179,000 general and administrative expense for the three months ended March 31, 2004, were \$82,000 for professional services and \$77,000 for insurance.

Other Income (Expense), Net. Interest income consists of earnings on our cash, cash equivalents and short-term investments. Other income (expense), net decreased to \$45,000 for the three months ended March 31, 2004 from \$105,000 in the comparable period of 2003. The decrease

is due to the decrease in interest income from lower average cash and cash equivalent balances.

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Liquidity and Capital Resources

Since inception, we have financed our operations primarily through the initial and follow-on public offerings of common stock, private placements of our preferred stock, equipment financing, lines of credit and short-term loans. As of March 31, 2004, we had raised \$65.9 million and \$93.7 million through our initial and follow-on public offerings of common stock, respectively, and \$29.8 million through the sale of our preferred stock. As of March 31, 2004, we had approximately \$7.2 million of cash and cash equivalents, reflecting, among other things, a one-time payout of \$3,569,000 in July 2003 to terminate the remaining term of our property lease on our former headquarters in Redwood City, California and a payment of \$1,452,000 to BeMusic to settle the SightSound litigation and \$314,000 in legal fees associated with that litigation.

Net cash used in operating activities was \$1.9 million and \$5.3 million for the three months ended March 31, 2004 and 2003, respectively. Net cash used for operating activities in the 2004 period was the result of net losses from operations of \$134,000 and a net decrease in working capital items of \$1.8 million. The net decrease in working capital items include an increase in other assets of \$97,000 and a decrease in accrued liabilities of \$1.9 million. Net cash used for operating activities in the 2003 period was the result of net losses from operations of \$1.1 million, depreciation and amortization of \$112,000, gain on sale of digital music fulfillment business and related assets of \$2.9 million, and a net decrease in working capital items of \$1.4 million. The net decrease in working capital items include a decrease in accounts receivable of \$25,000, increase in other assets of \$554,000, decrease in accounts payable of \$623,000, decrease in accrued liabilities of \$1.3 million and a decrease in deferred revenue of \$39,000.

Net cash provided by (used) in investing activities was \$0 and \$3.2 million for the three months ended March 31, 2004 and 2003, respectively. Net cash provided by investing activities in the 2003 period was due to the sale of our digital music fulfillment business and related assets to Geneva.

Net cash used in financing activities was \$0 and \$57.8 million for the three months ended March 31, 2004 and 2003, respectively. The net cash used in financing activities in the 2003 period is due to the payments made to our stockholders in connection with the return of capital cash distribution declared on December 6, 2002 to stockholders of record on December 10, 2002.

We have no material commitments for capital expenditures or strategic investments and anticipate no capital expenditures during the remainder of 2004. We anticipate that we will experience a decline in our operating expenses for the foreseeable future and that our operating expenses will be a material use of our cash resources.

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

We believe that our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for working capital and capital expenditures in the near future. Additionally, we do not currently have an operating business and, consequently, we are currently exploring various options for the use of our remaining assets, including pursuit of a business strategy unrelated to digital music distribution. Acquisition and/or operation of any future business strategy may require additional cash resources. See ADDITIONAL FACTORS AFFECTING FUTURE RESULTS below.

Market Risk

No material changes exist to the market risk our investment portfolio of cash and money market funds faced during the three months ended March 31, 2004. As detailed in Overview in Management's Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-Q, we began trading in available-for-sale securities on August 8, 2003, and as of November 12, 2003, completely liquidated our position. Our trading activities resulted in a gain of \$48,777. We do not intend to invest in such securities in the future, and will maintain

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only cash and cash equivalents. For additional information, refer to Item 7A Quantitative and Qualitative Disclosures About Market Risk in Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Form 10-K for the year ended December 31, 2003 filed with the SEC.

ADDITIONAL FACTORS AFFECTING FUTURE RESULTS

Before deciding to invest in us or to maintain or increase your investment, you should carefully consider the risks described below, in addition to the other information contained in this report and in our other filings with the SEC, including our Annual Report on Form 10-K filed March 31, 2004. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. If any of these risks actually occur, our business, financial condition or results of operations could be seriously harmed. In that event, the market price of our common stock could decline and you may lose all or part of your investment.

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

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

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

We are considering various options for the use of our remaining assets, which may include business combinations with or investments in other operating companies, or entering into a completely new line of business. Nevertheless, we have not yet identified any appropriate business opportunities, and, due to a variety of factors outside of our control, we may not be able to identify or fully capitalize on any such opportunities. These factors include: (1) competition from other potential acquirors and partners of and investors in potential acquisitions, many of whom may have greater financial resources than we do; (2) in specific cases, failure to agree on the terms of a potential acquisition, such as the amount or price of our acquired interest, or incompatibility between us and management of the company we wish to acquire; and (3) the possibility that we may lack sufficient capital and/or expertise to develop promising opportunities. Even if we are able to identify business opportunities that our Board deems appropriate, we cannot assure you that such a strategy will provide you with a positive return on your investment, and may in fact result in a substantial decrease in the value of your stock. In addition, if we enter into a combination with a business that has operating income, we cannot assure you that we will be able to utilize all or even a portion of our existing net operating loss carryover for federal or state tax purposes following such a business combination. If we are unable to make use of our existing net operating loss carryover, the tax advantages of such a combination may be limited, which could negatively impact the price of our stock and the value of your investment. These factors will substantially increase the uncertainty, and thus the risk, of investing in our shares.

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

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

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.

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

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

been significantly impaired.

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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 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.

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.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See Market Risk in Part I, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations.

ITEM 4. CONTROLS AND PROCEDURES

The Securities and Exchange Commission defines the term "disclosure controls and procedures" to mean a company's controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and regulations. Based on the evaluation of the effectiveness of our disclosure controls and procedures by our management, with the participation of our co-chief executive officers and our chief financial officer, as of the end of the period covered by this report, our co-chief executive officers and our chief financial officer have concluded that our disclosure controls and procedures were

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effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.

No significant changes were made in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

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

On or about April 7, 2000, SightSound, Inc. ("SightSound") filed an Amended Complaint in a lawsuit in the United States District Court for the Western District of Pennsylvania (the "Pennsylvania Court") alleging that certain of our former customers, N2K, Inc., CDNow, Inc. and CDNow Online, Inc., which have since merged into BeMusic, infringed one or more of three United States patents (Nos. 5,191,573; 5,675,734; and 5,996,440). SightSound claimed compensatory damages of approximately \$16.0 million. SightSound also sought treble damages and attorneys fees under certain statutory provisions. BeMusic asserted a claim for indemnification against us based on certain licensing agreements between us and BeMusic's predecessors. In January 2002, we entered into an agreement with BeMusic's predecessor, CDNow Online, Inc., in which we agreed to share evenly with CDNow Online, Inc. all legal fees incurred by CDNow Online, Inc. in defending the patent infringement action. The fee-sharing agreement entitles BeMusic, to control the defense of the patent infringement action, but requires BeMusic to consult in good faith with us regarding its defense and/or settlement of the patent infringement action. On February 20, 2004, an Order was entered in the Pennsylvania Court ending the lawsuit by SightSound against BeMusic. As a result of the entry of the Order and pursuant to a separate agreement between SightSound and BeMusic executed on February 12, 2004, SightSound dismissed the SightSound litigation and released all claims against us. Entry of the Order also made effective a Settlement Agreement and Mutual Release executed on February 13, 2004 by us and BeMusic (the "Settlement Agreement"). The Settlement Agreement finally resolves all matters between BeMusic and us relating to the SightSound litigation. Under the terms of the Settlement Agreement, we paid approximately \$1,452,000 to BeMusic as settlement expenses and approximately \$314,000 in legal fees relating to the SightSound litigation. These payments were in addition to \$335,827 previously paid by us to BeMusic for their share of attorneys fees incurred in connection with this matter. As a result of the Settlement Agreement, we have no further obligation to maintain available cash on hand in connection with the SightSound litigation. Neither party to the Settlement Agreement admitted any wrongdoing or any indemnification obligations in connection with this litigation.

We, certain of our former officers and directors, and various of the underwriters in our initial public offering ("IPO") and secondary offering, were named as defendants in a consolidated action filed in the United States District Court for the Southern District of New York, *In re Liquid Audio, Inc. Initial Public Offering Securities Litigation*, CV-6611. The consolidated amended complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in our IPO and secondary offering of securities. The plaintiffs brought claims for violation of several provisions of the federal securities laws against those underwriters, and also against us and certain of our former directors and officers, seeking unspecified damages on behalf of a purported class of purchasers of our common stock between July 8, 1999 and December 6, 2000. Various plaintiffs filed similar actions asserting virtually identical allegations against more than 40 investment banks and 250 other companies. All of these IPO allocation securities class actions currently pending in the Southern District of New York have been assigned to Judge Shira A. Scheindlin for coordinated pretrial proceedings as *In re Liquid Audio, Inc. Initial Public Offering Securities Litigation*, 21 MC 92. Defendants have filed motions to dismiss the actions. In October 2002, such directors and officers were dismissed without prejudice. A proposal has been made for the settlement and release of claims against the issuer defendants, including us, in exchange for a contingent payment to be made by the issuer defendants' insurance carriers and an assignment of certain claims. On July 16, 2003, our Board approved participation in the settlement. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court. On May 18, 2004, the parties are scheduled to meet with the mediator to finalize the formal settlement papers and resolve any remaining settlement issues. If the settlement does not occur, and litigation against us continues, we believe that we have meritorious defenses to the claims against us and intend to defend ourselves vigorously.

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.

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ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

The effective date of our first registration statement, filed on Form S-1 under the Securities Act of 1933 (No. 333-82521) relating to our initial public offering of common stock, was July 8, 1999. A total of 4,800,000 shares of common stock were sold at a price of \$15.00 per share to an underwriting syndicate led by Lehman Brothers Inc., BancBoston Robertson Stephens Inc. and U.S. Bancorp Piper Jaffray Inc. Offering proceeds, net of aggregate expenses of approximately \$6.1 million, were approximately \$65.9 million.

The effective date of our second registration statement, filed on Form S-1 under the Securities Act of 1933 (No. 333-91541) relating to our follow-on public offering of common stock, was December 14, 1999. A total of 2,946,076 shares of Common Stock were sold at a price of \$33.63 per share to an underwriting syndicate led by Lehman Brothers Inc., BancBoston Robertson Stephens Inc., U.S. Bancorp Piper Jaffray Inc., Dain Rauscher Wessells and Fidelity Capital Markets. An additional 503,924 shares of common stock were sold on behalf of selling stockholders as part of the same offering. Offering proceeds to us, net of aggregate expenses of approximately \$5.4 million, were approximately \$93.7 million. Offering proceeds to selling stockholders, net of expenses of approximately \$847,000, were approximately \$16.1 million.

From the time of receipt through March 31, 2004, our proceeds from the offerings, except for the return of capital cash distribution paid to our stockholders on January 29, 2003 of \$57.8 million, were applied toward general corporate purposes, including the purchase of temporary investments consisting of cash, cash equivalents and short-term investments, working capital and capital expenditures, enhancing research and development and attracting key personnel.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

None.

ITEM 5. OTHER INFORMATION

On July 30, 2003, we held our 2003 Annual Meeting of Stockholders, at which our stockholders approved, among other things, a Name Change proposal to change our name to LQ Corporation, Inc. At the September 29, 2003 meeting, our stockholders approved amendments to our certificate of incorporation to effect the Reverse/Forward Stock Split, as well as the Share Reduction.

Our name was formally changed on January 7, 2004 to LQ Corporation, Inc.

Although our Board of Directors has received stockholder approval to implement the Reverse/Forward Stock Split and the Share Reduction, we have not consummated these corporate actions. We intend to file the amendments necessary to implement the Reverse/Forward Stock Split and the Share Reduction within the next few months. In the case of the Reverse/Forward Stock Split, we will issue a press release announcing the Reverse/Forward Stock Split prior to its effectiveness. No retroactive effect has been given to any of the share or earnings per share information in these financial statements as a result of the Reverse/Forward Stock Split. Any retroactive effect on the share or earnings per share information will be recorded in the period it takes effect.

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As discussed in our Notice of Annual Meeting of Stockholders, dated June 27, 2003 and filed with the Securities and Exchange Commission on July 1, 2003, our capitalization before and after the Reverse/Forward Stock Split and the Share Reduction is estimated as follows. Note that the exact figures may not be the same on the date the amendments to our certificate of incorporation are filed and become effective, due to continued trading by and among existing our stockholders:

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

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

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**(a) Exhibits**

- 3.1 Certificate of Incorporation as currently in effect (1)
- 3.2 Bylaws as currently in effect (2)
- 4.2 Form of Specimen Stock Certificate (1)
- 4.3 Second Amended and Restated Investor Rights Agreement dated July 31, 1998 (1)
- 10.1 Form of Indemnification Agreement entered into between the registrant and each of its directors and executive officers (1)
- 10.2 1996 Equity Incentive Plan (1)
- 10.3 1999 Employee Stock Purchase Plan (1)
- 10.21 Summary Plan Description of 401(K) Plan (1)
- 10.50 2000 Nonstatutory Stock Option Plan (2)
- 10.56 Termination Agreement, dated as of November 8, 2002, by and among Liquid Audio, Inc., April Acquisition Corp. and Alliance Entertainment Corp. (3)
- 10.57 Asset Purchase Agreement with Microsoft Corporation, dated as of September 27, 2002 (4)
- 10.71 Settlement Agreement with BeMusic, Inc. dated as of January 17, 2003 (5)

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- 10.72 Sublease Termination Agreement with Openwave Systems, Inc., dated as of July 14, 2003 (7)
- 10.73 Personal Property Lease Termination Agreement with Openwave Systems, Inc., dated as of July 14, 2003 (7)
- 10.74 Settlement Agreement and Mutual Release with BeMusic, Inc. dated February 13, 2004 (8)
- 11.1 Statement regarding computation of per share earnings (6)
- 31.1 Certification of Co-Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002
- 31.2 Certification of Co-Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002
- 31.3 Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002
- 32.1 Certification of Co-Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002
- 32.2 Certification of Co-Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002
- 32.3 Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002

(1) incorporated by reference to the Registration Statement on Form S-1 and all amendments thereto, Registration No. 333-77707, filed with the Securities and Exchange Commission on May 4, 1999 and declared effective July 8, 1999

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- (2) incorporated by reference to the Form 10-Q filed with the Securities and Exchange Commission on August 14, 2000
- (3) incorporated by reference to Exhibits of the Form 8-K filed with the Securities and Exchange Commission on November 12, 2002.
- (4) Incorporated by reference to the Form 10-K filed with the Securities and Exchange Commission on March 31, 2003
- (5) Incorporated by reference to Exhibits on Form 8-K filed with the Securities and Exchange Commission on January 28, 2003
- (6) this exhibit has been omitted because the information is shown in the financial statements or notes thereto
- (7) incorporated by reference to the Form 10-Q filed with the Securities and Exchange Commission on August 14, 2003
- (8) incorporated by reference to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2004

(b) Reports on Form 8-K

None

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LQ CORPORATION, INC.

SIGNATURES

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

DATE: May 14, 2004

LQ CORPORATION, INC.

/s/ James A. Mitarotonda

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

/s/ Seymour Holtzman

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

/s/ Melvyn Brunt

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