LIBERATE TECHNOLOGIES
Form 10-Q
April 12, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended FEBRUARY 28, 2001

OR

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

For the transition period from___________ to__________

COMMISSION FILE NUMBER 000-26565

LIBERATE TECHNOLOGIES
(Exact name of registrant as specified in its charter)

DELAWARE	94-3245315
(State or Other Jurisdiction of Incorporation)	(I.R.S. Employer Identification No.)

2 CIRCLE STAR WAY, SAN CARLOS, CALIFORNIA	94070-6200
(Address of principal executive office)	(Zip Code)

(650) 701-4000
(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) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

104,371,186 shares of the Registrant's common stock were outstanding as of March 31, 2001.

LIBERATE TECHNOLOGIES

FORM 10-Q
FOR THE QUARTER ENDED FEBRUARY 28, 2001

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Condensed Consolidated Balance Sheets at May 31, 2000 and February 28, 2001........

Condensed Consolidated Statements of Operations and Comprehensive Loss for the Three Months and Nine Months Ended February 29, 2000 and February 28, 2001........

Condensed Consolidated Statements of Cash Flows for the Nine Months Ended February 29, 2000 and February 28, 2001........

Notes to Condensed Consolidated Financial Statements........

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

Item 3. Quantitative and Qualitative Disclosure About Market Risk........

PART II. OTHER INFORMATION

Item 1. Legal Proceedings........

Item 2. Changes in Securities and Use of Proceeds........

Item 3. Defaults in Securities........

Item 4. Submission of Matters to a Vote of Security Holders........

Item 5. Other Information........

Item 6. Exhibits and Reports on Form 8-K........

Signature........

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LIBERATE TECHNOLOGIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)
Unaudited

	MAY 31, 2000	FEB
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 132,962	$
Short-term investments	176,053	
Accounts receivable, net	3,058	
Receivable from affiliate, net	543	
Note receivable	204	
Prepaid expenses and other current assets	5,850	
Total current assets	318,670	
Property and equipment, net	12,759	
Restricted cash	8,788	
Long-term investments	121,607	
Warrants	106,127	
Purchased intangibles, net	177,482	
Other assets	754	
Total assets	$ 746,187	$ 1
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 1,759	$
Accrued payroll and related expenses	4,303	
Accrued liabilities	10,290	
Current portion of capital leases	607	
Deferred revenues	69,132	
Total current liabilities	86,091	
Capital lease obligations, net of current portion	1,019	
Long-term liabilities	910	
Total liabilities	88,020	
COMMITMENTS AND CONTINGENCIES (NOTE 5)		
STOCKHOLDERS' EQUITY:		
Common stock	909	
Contributed and paid-in capital	803,400	1
Warrants	89,770	

Deferred stock compensation	(5,583)	
Stockholder notes receivable	(8)	
Accumulated other comprehensive income	162	
Accumulated deficit	(230,483)	
Total stockholders' equity	658,167	1
Total liabilities and stockholders' equity	$ 746,187	$ 1

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

LIBERATE TECHNOLOGIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE LOSS
(in thousands, except per share data)
Unaudited

	THREE MONTHS ENDED		N
	FEBRUARY 29, 2000	FEBRUARY 28, 2001	FEBRUAR 200
REVENUES:			
License and royalty	$ 3,043	$ 8,608	$
Service	4,488	5,831	
Total revenues	7,531	14,439	
COST OF REVENUES:			
License and royalty	510	499	
Service	4,576	7,703	
Total cost of revenues	5,086	8,202	
Gross margin	2,445	6,237	
OPERATING EXPENSES:			
Research and development	9,633	14,758	
Sales and marketing	5,200	5,816	
General and administrative	2,370	2,932	
Amortization of purchased intangibles	1,521	55,289	
Amortization of warrants	4,023	5,721	
Amortization of deferred stock compensation	518	464	
Acquired in-process research and development	--	--	
Total operating expenses	23,265	84,980	

Loss from operations	(20,820)	(78,743)	(
Interest income, net	2,218	7,898	
Other income (expense), net	(123)	454	
Loss before income tax provision	(18,725)	(70,391)	(
Income tax provision	12	--	
Net loss	$ (18,737)	$ (70,391)	$ (
Foreign currency translation adjustment	(12)	(48)	
Comprehensive loss	$ (18,749)	$ (70,439)	$ (
Basic and diluted net loss per share	$ (0.22)	$ (0.68)	$
Shares used in computing basic and diluted net loss per share	84,147	103,887	

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

LIBERATE TECHNOLOGIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
Unaudited

	NINE MONT
	FEBRUARY 29, 2000
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	$ (43,767)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	5,952
Amortization of warrants	5,092
Provision for doubtful accounts	266
Write-off of acquired in-process research and development	--
Loss on disposal of property and equipment	600
Non-cash compensation expense	1,547
Changes in operating assets and liabilities:	
Increase in accounts receivable	(1,956)
(Increase) decrease in receivable from affiliate, net	(562)
Increase in prepaid expenses and other current assets	(2,054)
Increase in other assets	(260)
Increase in restricted cash	(8,788)
Increase in accounts payable	1,277
Increase (decrease) in accrued liabilities	3,704

Increase in accrued payroll and related expenses	466
Increase (decrease) in deferred revenues	9,766
Increase in other long-term liabilities	--
Net cash used in operating activities	(28,717)
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchases of property and equipment	(8,189)
Purchase of investments	(74,723)
Issuance of note receivable	--
Investment in Everypath	--
Cash acquired in MoreCom acquisition	--
Net cash used in investing activities	(82,912)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from secondary public offering, net	297,219
Proceeds from initial public offering, net	97,970
Proceeds from private placement, net	12,500
Proceeds from exercise of stock options	3,237
Principal payments on capital lease obligations	(155)
Payments of notes payable	(52)
Net cash provided by financing activities	410,719
Effect of exchange rate changes on cash	(12)
Net increase in cash and cash equivalents	299,078
Cash and cash equivalents, beginning of period	33,657
Cash and cash equivalents, end of period	$ 332,735

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

LIBERATE TECHNOLOGIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Unaudited

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements include the accounts of Liberate Technologies ("Liberate" or "the Company") and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated. These financial statements have been prepared by Liberate, without audit, and reflect all adjustments that in the opinion of management are necessary to present fairly the financial position and the results of operations for the interim periods. These financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. However, they omit certain information and footnote disclosures necessary to conform to generally accepted accounting principles. These

statements should be read in conjunction with the audited consolidated financial statements and notes to consolidated financial statements included in Liberate's Form 10-K and subsequent reports on Form 10-Q filed with the Securities and Exchange Commission since August 25, 2000. The results of operations for such periods do not necessarily indicate the results expected for the full fiscal year or for any future period.

RECENT ACCOUNTING PRONOUNCEMENTS. In March 2000, the Financial Accounting Standards Board's (FASB) Emerging Issue Task Force ("EITF") reached a consensus on EITF 00-2, "Accounting for Web Site Development Costs." EITF 00-2 discusses how an entity should account for costs incurred to develop a web site. The Company does not believe that the adoption of EITF 00-2 will have a material effect on its financial position or results of operations.

In June 1998, the FASB issued Statement of Financial Accounting Standard (SFAS) No. 133, Accounting For Derivative Instruments And Hedging Activities. SFAS No. 133 establishes accounting and reporting standards for derivative financial instruments and hedging activities related to those instruments, as well as other hedging activities. The Company expects that the adoption of SFAS No. 133 will have no material impact on its financial position, results of operations or cash flows. The Company will be required to adopt SFAS No. 133 in fiscal 2002.

NOTE 2. OFFERINGS OF COMMON STOCK

COMMON STOCK. In July 2000, Cisco Systems, Inc. purchased 3,963,780 shares of the Company's common stock at approximately $25.23 per share, resulting in aggregate cash proceeds to the Company of approximately $100.0 million.

During the nine months ended February 28, 2001, Liberate issued 1,634,989 shares of common stock to employees, external consultants and other service providers upon the exercise of stock options and an additional 332,552 shares of common stock to certain customers upon the exercise of warrants.

WARRANTS. In fiscal year 1999, the Company entered into letter agreements with several network operators whereby it agreed to issue warrants to purchase up to an aggregate of 4,599,992 shares of common stock that are exercisable if those network operators satisfy certain milestones. The value of the warrants is estimated using the Black-Scholes model as of the earlier of the grant date or the date that it becomes probable that the warrants will be earned. Pursuant to the requirements of Emerging Issues Task Force No. 96-18, the warrants will continue to be revalued in situations where they are granted prior to the establishment of a performance commitment. The value of the warrants is recorded primarily as a non-current asset on the accompanying condensed consolidated balance sheet and is being amortized over the estimated economic life of the arrangements with the network operators.

As of February 28, 2001, warrants to purchase up to 2,336,660 shares of the Company's common stock were earned by these network operators. The fair market value of these warrants at the time they were earned was $117.2 million. Amortization of warrants was approximately $4.0 million and $5.7 million for the three months ended February 29, 2000 and February 28, 2001, respectively. This increase was primarily due to amortization related to additional warrants earned since February 29, 2000.

If the remaining warrants are earned, the Company may be required to record significant non-cash accounting expenses. As a result, the Company could incur net losses or increased net losses for a given period and this could seriously harm the operating results and stock price of the Company.

NOTE 3. SEGMENT INFORMATION

The Company operates solely in one segment - providing software and services to a broad range of information appliances, primarily cable and satellite set-top boxes. As of February 28, 2001, the Company's long-term assets were located primarily in the United States. The Company's revenues by geographic area are as follows:

	THREE MONTHS ENDED		NINE MONTHS END	
	FEBRUARY 29, 2000	FEBRUARY 28, 2001	FEBRUARY 29, 2000	FEBRU 2
	(in thousands)			
England	$ 2,524	$ 7,189	$ 4,691	
United States	3,222	4,119	9,126	
Canada	703	1,115	1,049	
Japan	538	263	2,350	
Other	544	1,753	1,677	
Total revenues	$ 7,531	$ 14,439	$ 18,893	

International revenues consist of sales to customers incorporated in foreign countries. International revenues were 57% and 71% of total revenues for the three months ended February 29, 2000 and February 28, 2001, respectively. For the nine months ended February 29, 2000 and February 28, 2001, international revenues were 52% and 68% of total revenues, respectively.

The percentage of sales to significant customers is as follows:

	THREE MONTHS ENDED		NINE MONTHS END	
	FEBRUARY 29, 2000	FEBRUARY 28, 2001	FEBRUARY 29, 2000	FEBRU 2
Customer A	26%	21%	18%	
Customer B	14%	*	17%	
Customer C	10%	*	*	
Customer D	*	28%	*	

* Less than 10%

NOTE 4. CALCULATION OF NET LOSS PER SHARE

Shares used in computing basic and diluted net loss per share are based on the weighted average shares outstanding in each period. The effect of outstanding stock options and warrants are excluded from the calculation of diluted net loss per share, as their inclusion would be antidilutive. Previously issued preferred stock, which converted to common stock, is weighted from the time the shares were converted. As of May 31, 2000, options to purchase 13,298,048 shares of common stock and warrants to purchase 2,103,328 shares of common stock were outstanding and were excluded from the calculation of net loss per share. As of February 28, 2001, options to purchase 16,205,141 shares of common stock and warrants to purchase 1,619,996 shares of common stock were outstanding and were excluded from the calculation of net loss per share.

NOTE 5. COMMITMENTS AND CONTINGENCIES

COMMITMENTS. In June 2000, the Company acquired MoreCom, Inc. At the closing of the acquisition, the Company assumed MoreCom's obligations under an office lease for approximately 16,000 square feet of office space in Horsham, Pennsylvania. Future minimum lease payments as of February 28, 2001 are approximately $198,000.

In October 2000, the Company entered into a facility lease for approximately 10,000 square feet in Murray City, Utah. Future minimum lease payments as of February 28, 2001 are approximately $707,000. In November 2000, the Company terminated its Salt Lake City, Utah facility lease.

In October 2000, the Company committed to a 68-month lease, for approximately 4,700 square feet of office space, in London, England. The lease commenced in November 2000, and occupancy took place in January 2001. Upon occupancy, the Company terminated its month-to-month London, England facility lease with Oracle Corporation. Future minimum lease payments related to the new lease are expected to be approximately $1.4 million, excluding potential rent increases and the effect of foreign currency exchange rates.

In November 2000, the Company entered into a convertible term loan facility to advance up to $7.0 million to Two Way TV Ltd. at an interest rate of 15% per annum. In addition, for every $1.00 borrowed, the Company will earn 0.94 of a Two Way TV warrant at an exercise price of approximately (pound)0.001 per warrant. As of February 28, 2001, a total of $7.0 million has been advanced to Two Way TV and the Company has earned 6,580,000 Two Way TV warrants.

In January 2001, the Company entered into extended loans in exchange for promissory notes from Coleman Sisson, its President and Chief Operating Officer, and David Limp, its Executive Vice President and Chief Strategy Officer. Each loan is in the amount of $500,000 at 5.9% compounded annually and is due and payable two years from issuance. Also in January 2001, the Company entered into employee retention agreements with Mr. Sisson, Mr. Limp and Donald Fitzpatrick, its Executive Vice President of Sales and Services. Each retention agreement provides approximately $820,000 to the employee over the next two years of continued service.

SUBLEASES. In July 2000, the Company signed an agreement with a third party to sublease furniture and office equipment and approximately 25,000 square feet in the Company's headquarters building located in San Carlos, California. The sublease is for 13 months and commenced in July 2000. As of February 28, 2001, future minimum sublease income under this agreement is approximately

$825,000.

In January and February 2001, two subtenants, each leasing approximately 26,000 square feet in the Company's headquarter building, notified the Company that they would not be able to meet their sublease obligations after February and April 2001, respectively. As a result, monthly rent expense will increase approximately $71,000 per subtenant.

In October 2000, by mutual agreement with the landlord, the Company terminated its Sunnyvale, California facility lease. Therefore, the Company's sublease of this facility was also terminated.

LITIGATION. As part of the Company's acquisition of the Virtual Modem software product and related assets and technology of SourceSuite, LLC, the Company acquired certain patents that were the subject of a patent infringement lawsuit. This lawsuit was initially brought by Interactive Channel Technologies, Inc. and SMI Holdings, Inc., affiliated companies of SourceSuite, against Worldgate Communications, Inc. in May 1998. The patent infringement claims have been assigned to the Company as a result of the merger with SourceSuite. In June 1998, Worldgate filed a counterclaim against the plaintiffs and Source Media, Inc., a shareholder of SourceSuite, alleging among others, violations of the Lanham Act and Delaware's Uniform Deceptive Trade Practices Act, common law unfair competition, tortious interference with existing and prospective business relationships and misappropriation of confidential information and trade secrets. Following discovery and briefing of the patent claim construction issues, the parties have entered into settlement negotiations covering both the Company's patent infringement claims against Worldgate and Worldgate's cross-complaint against Interactive Channel, SMI Holdings and Source Media. On March 26, 2001, the U.S. District Court hearing this matter ruled that the parties have entered into a settlement agreement under which each side will dismiss its claims against the other.

NOTE 6. OTHER

ACQUISITION OF MORECOM. In June 2000, the Company acquired MoreCom. In connection with the acquisition, the Company issued an aggregate of 7,310,830 shares of common stock in exchange for all of the

6

outstanding stock of MoreCom and assumed all of MoreCom's stock options. The acquisition was accounted for as a purchase. The fair market value of the equity securities issued in the acquisition was approximately $459.0 million.

The value assigned to acquired in-process research and development was determined by identifying research projects in areas for which technological feasibility has not been established. The value was determined by estimating the costs to develop the acquired in-process technology into commercially viable products, estimating the resulting net cash flows from such projects, and discounting the net cash flows back to their present values. The discount rate includes a factor that takes into account the uncertainty surrounding the successful development of the acquired in-process technology. Failure to successfully develop these projects could seriously harm future revenue and profitability of the Company. Additionally, the value of the other purchased intangible assets may be reduced.

In connection with the acquisition, net assets acquired were as follows:

	(in thousands)
Purchased intangibles, including in-process technology..............	$ 471,202
Property, plant and equipment and other non-current assets..........	842
Cash, receivables and other current assets..........................	1,500
Current liabilities assumed...	(550)
Net assets acquired...	$ 472,994

The following table presents the unaudited pro forma results assuming that the Company had merged with MoreCom at the beginning of fiscal year 2000. Net income has been adjusted to exclude the write-off of acquired in-process research and development of $22.4 million and includes amortization of purchased intangibles of approximately $39.3 million for each of the quarters ended February 29, 2000 and February 28, 2001. This information does not necessarily indicate future combined results of operations of the Company.

	THREE MONTHS ENDED		NINE MONTHS END	
	FEBRUARY 29, 2000	FEBRUARY 28, 2001	FEBRUARY 29, 2000	FEBRU
	(in thousands, except per share data)			
Revenues...............................	$ 7,531	$ 14,439	$ 18,893	$
Net loss...............................	$ (59,785)	$ (70,391)	$ (165,279)	$
Basic net loss per share...............	$ (0.71)	$ (0.68)	$ (2.56)	$

Also in connection with the acquisition, the Company expensed approximately $22.4 million of acquired in-process research and development, which in the opinion of the Company's management has not reached technological feasibility and has no alternative future use. The Company also recorded goodwill and other intangibles of approximately $471.5 million to be amortized over an estimated economic life of three years.

LONG-TERM INVESTMENT. In August 2000, the Company made a strategic investment of approximately $3.0 million in Everypath, Inc. in exchange for 179,425 shares of Series C preferred stock of Everypath.

NOTE 7. SUBSEQUENT EVENTS

In March 2001, the Company's Board of Directors approved a voluntary option exchange program that will permit employees to cancel options with strike prices above the current market value of its shares in exchange for receiving new grants at market price after a delay of six months or more. The Company is instituting this program, which is not available to its officers and directors, in order to provide for employee retention and motivation as the Company gains commercial momentum.

In March 2001, the Company entered into a binding Letter of Understanding with a large cable services operator. The agreements between the parties contemplate various payments, including the Company's purchase of $2.0 million in various consulting, testing and market research services and its purchase of advertising and marketing services to assist in promoting interactive television services that have launched in select markets.

In conjunction with the Liberate Corporate Venture Fund, in April 2001, the Company made a strategic investment of approximately $1.2 million in MetaTV, Inc. in exchange for 512,821 shares of Series C Preferred stock of MetaTV.

In April 2001, the Company extended a loan in exchange for a promissory note from Donald Fitzpatrick, its Executive Vice President of Sales and Services. The loan is in the amount of $500,000 at 5.9% compounded annually and is due and payable two years from issuance.

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

This document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 23E of the Securities Act of 1934, as amended. These statements relate to future events or our future financial performance. Any statements contained in this document that are not statements of historical fact may be deemed to be forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expect," "plan," "anticipate," "intend," "believe," "estimate," "predict," "potential" or "continue," or similar words. These statements are only predictions. Actual events or results may differ materially.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements. We are under no obligation to update any of the forward-looking statements after the filing of this Form 10-Q to conform such statements to actual results or to changes in our expectations.

The following discussion should be read in conjunction with our financial statements, related notes and the other financial information appearing elsewhere in this Form 10-Q. Readers are also urged to carefully review and consider the various disclosures made by us that attempt to advise interested parties of the factors that affect our business, including without limitation, the disclosures made under the caption "Risk Factors," and the factors and risks discussed in our Form 10-K and subsequent reports on Form 10-Q filed since August 25, 2000.

OVERVIEW

Liberate Technologies ("Liberate," "we" or "us") is a leading provider of a comprehensive software platform for delivering content, services and applications to a broad range of information appliances, primarily cable and satellite set-top boxes. We began operations in December 1995 as a division of Oracle, developing server and client software for the consumer, corporate and educational markets. In April 1996, we incorporated in Delaware. We began shipping our initial products and generating revenues in the last quarter of fiscal 1997. (Our fiscal year runs from June 1 to May 31, with each fiscal year

ending on May 31 of the corresponding calendar year.)

We generate revenues by licensing our server and client products and providing related services to network operators, primarily providers of television services, and information appliance manufacturers, primarily set-top box manufacturers. In addition, service revenues are generated from consulting, training and maintenance provided in connection with client and server licenses.

License revenues consist principally of fees earned from the licensing of our software, as well as royalty fees earned upon the shipment or activation of products that incorporate our software. We typically recognize revenues from up-front software license fees upon final delivery of the licensed product, when collection is probable and when the fair market value and the fee for each element of the transaction is fixed

and determinable. In addition to up-front license fees, network operators typically pay server royalty fees on a per subscriber basis. We typically recognize revenue on these server subscriber fees when a network operator reports to us that a user of an information appliance has activated the operator's service. We also license our client software to either network operators or information appliance manufacturers, who typically pay us client royalties on a per unit basis. We typically recognize revenue when they report to us that an information appliance owner has activated the operators' service or an information appliance manufacturer has shipped the device.

Service revenues consist of consulting, engineering, training and maintenance services. Maintenance services include both updates and technical support. We generally recognize consulting, engineering and training revenues as services are performed. We recognize maintenance revenue, which typically ranges from 17% to 25% of annual license fees and activation royalties, ratably over the term of the agreement. In instances where software license agreements include a combination of consulting services, training and maintenance, these separate elements are unbundled from the arrangement based on each element's relative fair value. For the nine months ended February 28, 2001, total service revenues were $16.7 million, representing 47% of our total revenues. We expect service revenues to continue to account for a significant portion of total revenues until customers begin deploying services and information appliances incorporating our software on a large scale.

Deferred revenues consist primarily of payments received from customers for prepaid license and royalty fees and prepaid services for undelivered product and services. Deferred revenues decreased from $69.1 million at May 31, 2000 to $57.6 million at February 28, 2001. The majority of this decrease represents recognition of revenues related to both customer deployments and performance of services. We expect this downward trend to continue in future quarters as our customers begin to deploy. In addition, deferred revenues can fluctuate significantly as a result of several factors, including the timing of service performance, deployments and prepayments.

A significant event in our history was the acquisition of Navio Communications in August 1997. Navio was a development stage company involved in designing Internet application and server software for the consumer market. In connection with the acquisition, we changed our strategic direction and restructured our operations. Prior to the acquisition, we focused on selling software to original equipment manufacturers of network computer products for corporate customers. Following the acquisition, we focused our development and

marketing efforts on fewer products targeted primarily at the consumer information appliance market and aggressively pursued sales to a limited number of large network operators and information appliance manufacturers. As a result of this strategic shift, we significantly reduced our sales and engineering operations for corporate products and increased investment in the development of client and server software for the consumer market.

To more closely align our product offerings with this strategic shift in direction, we entered into an agreement with Sun Microsystems, Inc. in May 1999 to transfer our corporate network computer technology to Sun while retaining the right to ship, support and maintain these products for existing customers using this technology. In addition, we have agreed not to compete in the market for corporate network computers and, specifically, network computers intended to displace personal computers or terminals, until May 2002. However, outside of this market, we intend to continue developing new products based on network computer technology. Sales of our corporate network computer products and related services accounted for approximately $1.0 million and $400,000 of our total revenues for the quarters ended February 29, 2000 and February 28, 2001, respectively.

We have also agreed with Sun to co-develop television set-top box technology. We will distribute the co-developed technology pursuant to a non-exclusive license with Sun. In addition, under this license, we have agreed to incorporate Sun's Personal Java technology, television interface software and Jini technology in our software products and to pay Sun a royalty. Sun has also agreed to promote us as one of its preferred channel partners within the TV devices market. We believe this relationship will result in joint worldwide efforts with Sun to co-market and co-sell the jointly-developed technology.

In fiscal 1999, we entered into letter agreements with several network operators whereby we agreed to issue warrants to purchase up to an aggregate of 4,599,992 shares of common stock that are exercisable if those network operators satisfy certain milestones. The value of the warrants is estimated using the

9

Black-Scholes model as of the earlier of the grant date or the date that it becomes probable that the warrants will be earned. Pursuant to the requirements of Emerging Issues Task Force No. 96-18, the warrants will continue to be revalued in situations where they are granted prior to the establishment of a performance commitment. The value of the warrants is recorded primarily as a non-current asset on the accompanying consolidated balance sheet and is being amortized over the estimated economic life of the arrangements with the network operators. As of February 28, 2001, warrants to purchase up to 2,336,660 shares of our common stock were earned by these network operators. The fair market value of these warrants at the time they were earned was $117.2 million. As of February 28, 2001, accumulated amortization for the warrants was $28.3 million. If the remaining warrants are earned, we may be required to record significant non-cash accounting expenses. As a result, we could incur net losses or increased net losses for a given period and this could seriously harm our operating results and stock price.

In March 2000, we acquired the VirtualModem assets of SourceSuite in exchange for 1,772,000 shares of our common stock. The acquisition was accounted for as a purchase. The fair market value of the equity securities issued in the acquisition was approximately $190.5 million.

In June 2000, we acquired MoreCom. In connection with the acquisition, we

issued an aggregate of 7,310,830 shares of common stock in exchange for all of the outstanding stock of MoreCom and assumed all of MoreCom's stock options. The acquisition was accounted for as a purchase. The fair market value of the equity securities issued in the acquisition was approximately $459.0 million.

In connection with the MoreCom acquisition, we expensed approximately $22.4 million of acquired in-process research and development, which in the opinion of our management had not reached technological feasibility and had no alternative future use. We also recorded goodwill and other intangibles of approximately $471.5 million to be amortized over an economic useful life of three years.

In July 2000, Cisco Systems purchased 3,963,780 shares of our common stock at approximately $25.23 per share, resulting in aggregate cash proceeds to us of approximately $100.0 million.

In November 2000, we launched the Liberate Corporate Venture Fund, a $50.0 million fund dedicated to accelerating the development of interactive television through strategic investments in key industry participants.

Since Liberate's inception, we have incurred net losses of $457.4 million. These losses include write-offs totaling $82.5 million of acquired in-process research and development related to our acquisitions, $135.9 million of research and development expenditures, $193.6 million of amortization of purchased intangibles, $28.3 million of amortization of warrants and $4.0 million of amortization of deferred compensation. We anticipate incurring significant operating losses for the foreseeable future as we:

- continue to invest in research and development and professional and engineering services to support new devices for our software platform and large-scale deployments by our network operator customers

- record non-cash expenses related to the acquired in-process research and development and amortization of purchased intangibles associated with our acquisitions, amortization of deferred compensation and amortization of warrant expense associated with the issuance of warrants

RESULTS OF OPERATIONS

THREE MONTHS ENDED FEBRUARY 29, 2000 AND FEBRUARY 28, 2001

REVENUES

Total revenues increased 92%, from $7.5 million for the three months ended February 29, 2000 to $14.4 million for the three months ended February 28, 2001.

LICENSE AND ROYALTY. License and royalty revenues increased 183%, from $3.0 million for the three months ended February 29, 2000 to $8.6 million for the three months ended February 28, 2001. The increase was primarily due to increased deployments to our customers' subscribers. For the fourth quarter we expect license and royalty revenues to be relatively flat or to grow modestly. However, as we move into fiscal year 2002, we expect to see more growth for license and royalty revenues as additional network operators begin to come on line.

SERVICE. Service revenues increased 30%, from $4.5 million for the three months ended February 29, 2000 to $5.8 million for the three months ended February 28, 2001. The increase was primarily due to the continued growth in our customer base, which resulted in an increase in the integration and implementation services provided to those customers. We expect service revenues to increase in absolute dollar amounts to the extent existing and new customers install and initiate deployment of our products.

COST OF REVENUES

Total cost of revenues increased 61%, from $5.1 million for the three months ended February 29, 2000 to $8.2 million for the three months ended February 28, 2001. We anticipate that total cost of revenues will increase in absolute dollar amounts in future periods as we continue to provide services to support customer implementations and the possible introduction of third-party license costs from increased deployments.

LICENSE AND ROYALTY. Cost of license and royalty revenues decreased 2%, from $510,000 for the three months ended February 29, 2000 to $499,000 for the three months ended February 28, 2001. These amounts represented 17% and 6% of license and royalty revenues in the respective periods. The absolute dollar amounts of cost of license and royalty revenues have remained relatively flat. However, we expect the cost of license and royalty revenues, as a percentage of license and royalty revenues, to fluctuate in future periods. Our full amortization of certain third-party technology may decrease license and royalty costs as a percentage of related revenues in the near term. However, introduction of new third-party technologies would tend to increase license and royalty cost as a percentage of related revenues.

SERVICE. Cost of service revenues increased 68%, from $4.6 million for the three months ended February 29, 2000 to $7.7 million for the three months ended February 28, 2001. These amounts represented 102% and 132% of service revenues in the respective periods. The increase in absolute dollar amounts was primarily due to additional professional services expenses incurred to implement and integrate our products, slightly offset by a reduction in custom development work. We expect cost of service revenues to increase both in absolute dollar amounts and as a percentage of service revenues as we initiate new deployments and support limited trial installations of our products.

OPERATING EXPENSES

RESEARCH AND DEVELOPMENT. Research and development expenses consist primarily of salary and other related costs for personnel and external consultants as well as costs related to outsourced development projects to support product development. Research and development expenses increased 53%, from $9.6 million for the three months ended February 29, 2000 to $14.8 million for the three months ended February 28, 2001. These amounts represented 128% and 102% of total revenues over the respective periods. The increase in absolute dollar amounts was primarily due to increases in staffing and employee-related expenses, mainly due to the SourceSuite and MoreCom acquisitions, and a reduction in custom

development work. Research and development expenses are expected to remain relatively flat in the near term.

SALES AND MARKETING. Sales and marketing expenses consist primarily of salaries and other related costs for sales and marketing personnel, sales commissions, travel, public relations, marketing materials and trade shows. Sales and marketing expenses increased 12%, from $5.2 million for the three months ended February 29, 2000 to $5.8 million for the three months ended February 28, 2001. These amounts represented 69% and 40% of total revenues over the respective periods. The increase in absolute dollar amounts was primarily due to increased staffing and employee-related expenses and increased spending on public relations, offset slightly by a reduction in commission expense. We believe sales and marketing expenses will increase in absolute dollar amounts in future periods as we expand our direct sales and marketing efforts both domestically and internationally.

GENERAL AND ADMINISTRATIVE. General and administrative expenses consist primarily of salaries and other related costs for corporate development, finance, human resources and legal employees, as well as outside legal and other professional services. General and administrative expenses increased 24%, from $2.4 million for the three months ended February 29, 2000 to $2.9 million for the three months ended February 28, 2001. These amounts represented 31% and 20% of total revenues over the respective periods. The increase in absolute dollar amounts was primarily due to increased staffing and employee-related expenses, expanded infrastructure outlays and higher outside professional service costs, offset slightly by one-time merger termination costs recognized in the three months ended February 29, 2000. We expect that these expenses will increase modestly in absolute dollars in future quarters.

AMORTIZATION OF PURCHASED INTANGIBLES. Purchased intangibles represent the purchase price of Navio, SourceSuite and MoreCom in excess of identified tangible assets and are amortized over three years. In August 1997, we recorded approximately $18.3 million of purchased intangibles, related to the Navio acquisition. In March 2000, we recorded approximately $192.0 million of purchased intangibles related to the SourceSuite acquisition. In June 2000, we recorded approximately $471.5 million of purchased intangibles related to the MoreCom acquisition. We recorded approximately $1.5 million of amortization expense for the three months ended February 29, 2000 and approximately $55.3 million for the three months ended February 28, 2001.

AMORTIZATION OF WARRANTS. As of February 28, 2001, warrants to purchase up to 2,336,660 shares of common stock were earned by network operators. The fair market value of these warrants at the time they were earned was $117.2 million. Amortization of warrants was approximately $4.0 million and $5.7 million for the three months ended February 29, 2000 and February 28, 2001, respectively. This increase was primarily due to amortization related to additional warrants earned since February 29, 2000. We expect warrant amortization to continue to increase as additional warrants are earned. If the remaining warrants are earned, we may be required to record significant non-cash accounting expenses. As a result, we could incur net losses or increased net losses for a given period and this could seriously harm our operating results and stock price.

AMORTIZATION OF DEFERRED STOCK COMPENSATION. Deferred stock compensation represents the difference between the estimated fair value of our common stock for accounting purposes and the option exercise price of such options at the grant date. In fiscal 1999, we began recording deferred stock compensation for stock options granted to employees and others. These amounts are amortized on a straight-line basis over the 48-month vesting period of such options. Amortization of deferred stock compensation was approximately $518,000 and $464,000 for the three months ended February 29, 2000 and February 28, 2001, respectively. We anticipate that deferred stock compensation expense will decrease modestly over the next three years, based on the effect of employee terminations and the completion of the vesting of stock option grants.

INTEREST INCOME, NET

Net interest income consists of interest earned on our cash, cash equivalents and short-term and long-term investments, partially offset by interest expense related to capital leases. Net interest income was approximately $2.2 million for the three months ended February 29, 2000 compared to $7.9 million for the three months ended February 28, 2001. The increase was due to interest income on proceeds from our secondary offering in February 2000 and the purchase of our common stock by Cisco Systems in July 2000.

OTHER INCOME (EXPENSE), NET

Other income (expense), net is comprised primarily of bank charges, losses on disposals of fixed assets, foreign exchange gains and losses and other non-operating income and expenses. Net other expense was approximately $123,000 for the three months ended February 29, 2000 compared to net other income of $454,000 for the three months ended February 28, 2001. The change was primarily due to the recording of sublease income in excess of related costs and a one-time gain related to an investment sold during the period. These sources of income were offset slightly by the loss on disposal of assets.

INCOME TAX PROVISION

Income tax provision is comprised primarily of foreign withholding tax expense. Income tax provision was approximately $12,000 for the three months ended February 29, 2000. There was no income tax provision for the three months ended February 28, 2001.

NINE MONTHS ENDED FEBRUARY 29, 2000 AND FEBRUARY 28, 2001

REVENUES

Total revenues increased 88%, from $18.9 million for the nine months ended February 29, 2000 to $35.6 million for the nine months ended February 28, 2001.

LICENSE AND ROYALTY. License and royalty revenues increased 190%, from $6.5 million for the nine months ended February 29, 2000 to $18.9 million for the nine months ended February 28, 2001. The increase was primarily due to increased deployments to our customers' subscribers.

SERVICE. Service revenues increased 35%, from $12.4 million for the nine months ended February 29, 2000 to $16.7 million for the nine months ended February 28, 2001. The increase was primarily due to the continued growth in our customer base, which resulted in an increase in the integration and implementation services provided to those customers.

COST OF REVENUES

Total cost of revenues increased 24%, from $16.9 million for the nine months ended February 29, 2000 to $20.9 million for the nine months ended

February 28, 2001.

LICENSE AND ROYALTY. Cost of license and royalty revenues increased 9%, from $1.6 million for the nine months ended February 29, 2000 to $1.8 million for the nine months ended February 28, 2001. These amounts represented 25% and 9% of license and royalty revenues in the respective periods. The absolute dollar amounts of cost of license and royalty revenues have remained relatively flat.

SERVICE. Cost of service revenues increased 25%, from $15.3 million for the nine months ended February 29, 2000 to $19.1 million for the nine months ended February 28, 2001. These amounts represented 123% and 115% of service revenues in the respective periods. The increase in absolute dollar amounts was primarily due to additional professional services expenses incurred to implement and integrate our products, slightly offset by a reduction in custom development work.

OPERATING EXPENSES

RESEARCH AND DEVELOPMENT. Research and development expenses consist primarily of salary and other related costs for personnel and external consultants as well as costs related to outsourced development projects to support product development. Research and development expenses increased 80%, from $21.3 million for the nine months ended February 29, 2000 to $38.3 million for the nine months ended February 28, 2001. These amounts represented 113% and 108% of total revenues over the respective periods. The increase in absolute dollar amounts was primarily due to increases in staffing and employee-related expenses, mainly due to the SourceSuite and MoreCom acquisitions, and by fewer custom development projects.

SALES AND MARKETING. Sales and marketing expenses consist primarily of salaries and other related costs for sales and marketing personnel, sales commissions, travel, public relations, marketing materials and trade shows. Sales and marketing expenses increased 37%, from $12.1 million for the nine months ended February 29, 2000 to $16.6 million for the nine months ended February 28, 2001. These amounts represented 64% and 47% of total revenues over the respective periods. The increase in absolute dollar amounts was primarily due to increased staffing and employee-related expenses, including international growth, as well as increased spending for trade shows, advertising and public relations.

GENERAL AND ADMINISTRATIVE. General and administrative expenses consist primarily of salaries and other related costs for corporate development, finance, human resources and legal employees, as well as outside legal and other professional services. General and administrative expenses increased 47%, from $5.6 million for the nine months ended February 29, 2000 to $8.2 million for the nine months ended February 28, 2001. These amounts represented 29% and 23% of total revenues over the respective periods. The increase in absolute dollar amounts was primarily due to increased staffing and related expenses, the

establishment of the infrastructure necessary to support our expansion and higher outside professional service costs, offset slightly by one-time merger termination costs recognized in the nine months ended February 29, 2000.

AMORTIZATION OF PURCHASED INTANGIBLES. Purchased intangibles represent the purchase price of Navio, SourceSuite and MoreCom in excess of identified

tangible assets and are amortized over three years. In August 1997, we recorded approximately $18.3 million of purchased intangibles, related to the Navio acquisition. In March 2000, we recorded approximately $192.0 million of purchased intangibles related to the SourceSuite acquisition. In June 2000, we recorded approximately $471.5 million of purchased intangibles related to the MoreCom acquisition. We recorded approximately $4.6 million of amortization expense for the nine months ended February 29, 2000 and approximately $160.8 million for the nine months ended February 28, 2001.

AMORTIZATION OF WARRANTS. As of February 28, 2001, warrants to purchase up to 2,336,660 shares of common stock were earned by network operators. The fair market value of these warrants at the time they were earned was $117.2 million. Amortization of warrants was approximately $5.1 million and $17.5 million for the nine months ended February 29, 2000 and February 28, 2001, respectively. This increase was primarily due to amortization related to additional warrants earned since February 29, 2000.

AMORTIZATION OF DEFERRED STOCK COMPENSATION. Deferred stock compensation represents the difference between the estimated fair value of our common stock for accounting purposes and the option exercise price of such options at the grant date. In fiscal 1999, we began recording deferred stock compensation for stock options granted to employees and others. These amounts are amortized on a straight-line basis over the 48-month vesting period of such options. Amortization of deferred stock compensation was approximately $1.5 million for the nine months ended February 29, 2000 and $1.4 million for the nine months ended February 28, 2001.

INTEREST INCOME, NET

Net interest income consists of interest earned on our cash, cash equivalents and short-term and long-term investments, partially offset by interest expense related to capital leases. Net interest income was approximately $5.1 million for the nine months ended February 29, 2000 compared to $23.8 million for the nine months ended February 28, 2001. The increase was due to interest income on proceeds from our secondary offering in February 2000 and the purchase of our common stock by Cisco Systems in July 2000.

OTHER INCOME (EXPENSE), NET

Other income (expense), net is comprised primarily of bank charges, losses on disposals of fixed assets, foreign exchange gains and losses and other non-operating income and expenses. Net other expense was approximately $683,000 and $115,000 for the nine months ended February 29, 2000 and February 28, 2001, respectively. The change was primarily due to the recording of sublease income in excess of related costs and a one-time gain related to an investment sold during the period. These sources of income were offset slightly by the loss on disposal of assets.

INCOME TAX PROVISION

Income tax provision is comprised primarily of foreign withholding tax expense. Income tax provision was approximately $61,000 and $204,000 for the nine months ended February 29, 2000 and February 28, 2001, respectively.

LIQUIDITY AND CAPITAL RESOURCES

Our principal source of liquidity was cash, cash equivalents and short-term investments, which were approximately $313.4 million as of February 28, 2001. Additionally, we had approximately $162.9 million in long-term investments.

Net cash used in operating activities was approximately $28.7 million and $47.1 million for the nine months ended February 29, 2000 and February 28, 2001, respectively, an increase of approximately $18.4 million from year to year. This increase was primarily due to the increase in net loss and the decrease in deferred revenues, which was offset by an increase in depreciation and amortization as well as the write-off of acquired in-process research and development related to the MoreCom acquisition for the nine months ended February 28, 2001.

Net cash used in investing activities was approximately $82.9 million and $42.7 million for the nine months ended February 29, 2000 and February 28, 2001, respectively, a decrease of approximately $40.2 million from year to year. This decrease was primarily due to the timing and mix of our investment activity.

Net cash provided by financing activities was approximately $410.7 million and $105.2 million for the nine months ended February 29, 2000 and February 28, 2001, respectively, a decrease of approximately $305.5 million from year to year. This decrease was primarily due to the fact that our net proceeds from our secondary public offering, our initial public offering and a private placement of our stock for the nine months ended February 29, 2000 were greater than the net proceeds received by us from the sale of our common stock to Cisco Systems.

At February 28, 2001, we had approximately $148.8 million in cash and cash equivalents and did not have any material commitments for capital expenditures, other than a capital lease. At February 28, 2001, we also had approximately $164.6 million in short-term investments and $8.8 million in restricted cash.

Under a development agreement entered into with General Instrument Corporation (recently acquired by Motorola, Inc.) in April 1999, we are committed to pay $10.0 million in development fees for certain services to be provided by General Instrument. These fees are being paid out over a three-year period, of which $1.9 million was paid for each of the nine months ended February 29, 2000 and February 28, 2001.

In May 1998, we entered into a Technology License and Distribution Agreement ("Agreement") with Sun Microsystems. During March 2001, we amended our Agreement with Sun. This amendment requires us to pre-pay $1.4 million in royalties and support fees in exchange for the right to certain Sun technology and to maintain the status as a primary channel partner of Sun.

In November 2000, we launched the Liberate Corporate Venture Fund, a $50.0 million fund dedicated to accelerating the development of interactive television through strategic investments in key industry participants. As part of the Fund, we have made the following investments:

- In November 2000, we entered into a convertible term loan facility to advance up to $7.0 million to Two Way TV at an interest rate of 15% per annum. As of February 28, 2001, a total of $7.0 million has been advanced to Two Way TV.

- In April 2001, we made a strategic investment of approximately $1.2 million in MetaTV, Inc. in exchange for 512,821 shares of Series C Preferred stock of MetaTV.

In January 2001, we extended loans in exchange for promissory notes from Coleman Sisson, our President and Chief Operating Officer, and David Limp, our

Executive Vice President and Chief Strategy Officer. Each loan is in the amount of $500,000 at 5.9% compounded annually and is due and payable two years from issuance. Also in January 2001, the Company entered into employee retention agreements with Mr. Sisson, Mr. Limp and Donald Fitzpatrick, our Executive Vice President of Sales and Services. Each

retention agreement provides approximately $820,000 to the employee over the next two years of continued service.

In April 2001, we extended a loan in exchange for a promissory note from Donald Fitzpatrick, our Executive Vice President of Sales and Services. The loan is in the amount of $500,000 at 5.9% compounded annually and is due and payable two years from issuance.

In March 2001, we entered into a binding Letter of Understanding with a large cable services operator. The agreements between the parties contemplate various payments, including our purchase of $2.0 million in various consulting, testing and market research services and our purchase of advertising and marketing services to assist in promoting interactive television services that have launched in select markets.

We believe that the net proceeds from our various offerings, together with cash and cash equivalents generated from operations, will be more than sufficient to meet our working capital requirements for at least the next 12 months.

RISK FACTORS

WE HAVE A LIMITED OPERATING HISTORY THAT MAKES AN EVALUATION OF OUR BUSINESS DIFFICULT

We were incorporated in April 1996 and began shipping our initial products to customers in the last quarter of fiscal 1997. Our limited operating history makes evaluation of our business and prospects difficult. Companies in an early stage of development in a new market frequently encounter heightened risks and unexpected expenses and difficulties. For us, these risks include:

- The limited number of network operators, such as providers of television services, who have deployed products and services incorporating our technology

- The limited number of information appliance manufacturers, such as set-top box manufacturers, who have incorporated our technology into their products

- Delays in deployment of high speed networks and Internet-enhanced services and applications by our network operator customers

- Our unproven long-term business model, which depends on generating

the majority of our revenues from royalty fees paid by network operators and information appliance manufacturers

These risks and difficulties apply particularly to us because our market, the information appliance software market, is new and rapidly evolving.

WE HAVE A HISTORY OF LOSSES AND EXPECT TO INCUR LOSSES IN THE FUTURE

We incurred net losses of approximately $3.3 million in fiscal 1996, $19.0 million in fiscal 1997, $94.4 million in fiscal 1998, $33.1 million in fiscal 1999, $80.8 million in fiscal 2000 and $227.0 million for the nine months ended February 28, 2001. Our net losses of $94.4 million in fiscal 1998 included a $58.1 million charge for the Navio acquisition related to acquired in-process research and development. Our net losses of $80.8 million in fiscal 2000 included a $1.9 million charge for the SourceSuite acquisition related to acquired in-process research and development, amortization of purchased intangibles of $22.1 million and warrant amortization of $10.8 million. Our net losses of $227.0 million for the nine months ended February 28, 2001 included a $22.4 million charge for the MoreCom acquisition related to the acquired in-process research and development, amortization of purchased intangibles of $160.8 million and warrant amortization of $17.5 million. As of February 28, 2001, we had an accumulated deficit of approximately $457.4 million.

Since our inception, we have not had a profitable quarter and may never achieve or sustain profitability. Although our revenues increased for each of the last three fiscal years, we may not be able to sustain our historical revenue growth rates. We also expect that our costs of revenues and operating expenses will continue to increase. If we are to achieve profitability given our planned expenditure levels, we will need to generate and sustain substantially increased license and royalty revenues; however, we are unlikely to be able to do so in the near future. As a result, we may incur significant and increasing losses and negative cash flows in the near future. In addition, from the beginning of fiscal 1997 through February 28, 2001, approximately 58% of our revenues have been derived from services provided by us and not from license and royalty fees paid by network operators and information appliance manufacturers in conjunction with the deployment of products and services incorporating our software products. If we are unable to derive a greater proportion of our revenues from these license and royalty fees, our losses will likely continue indefinitely.

OUR QUARTERLY REVENUES AND OPERATING RESULTS ARE VOLATILE AND MAY CAUSE OUR STOCK PRICE TO FLUCTUATE

Our quarterly operating results have varied in the past and are likely to vary significantly from quarter to quarter. As a result, we believe that period to period comparisons of our operating results are not

a good indication of our future performance. Moreover, we expect to derive substantially all of our revenues for the near term from license fees and related professional and support services. Over the longer term, to the extent deployments increase, we expect to derive an increasing portion of our revenues from royalties paid by network operators and information appliance manufacturers. If deployments do not increase or this transition otherwise does not occur, we are unlikely to be able to generate or sustain substantially increased revenue, and our operating results will be seriously harmed.

In the short term, we expect our quarterly revenues to depend significantly on a small number of relatively large orders for our products and services, which generally have a long sales cycle. As a result, our quarterly operating results may fluctuate significantly if we are unable to complete one or more substantial sales in any given quarter. In some cases, we recognize revenues from services on a percentage of completion basis. Our ability to recognize these revenues may be delayed if we are unable to meet service milestones on a timely basis. Moreover, because our expenses are relatively fixed in the near term, any shortfall from anticipated revenues could result in greater short-term losses.

Although we have limited historical financial data, in the past we have experienced seasonal decreases in revenue growth in our quarter ending August 31. These seasonal trends may continue to affect our quarter to quarter revenues.

THE MARKET FOR INFORMATION APPLIANCES IS NEW AND MAY NOT DEVELOP AS WE ANTICIPATE

Because the market for information appliances such as set-top boxes is newly emerging, the potential size of the market opportunity and the timing of its development are uncertain. As a result, our profit potential is unproven. We depend upon the commercialization and broad acceptance by consumers and businesses of information appliances, primarily cable and satellite set-top boxes. Other types of information appliances may include game consoles and personal digital assistants. Broad acceptance of information appliances, particularly television set-top boxes, will depend on many factors. These factors include the development of content and applications for information appliances of interest to significant numbers of consumers and the emergence of industry standards that facilitate the distribution of content over the Internet to these devices. If the market for information appliances, and set-top boxes in particular, does not develop or develops more slowly than we anticipate, our revenues will not grow as fast as anticipated, if at all.

OUR SUCCESS DEPENDS ON NETWORK OPERATORS INTRODUCING, MARKETING AND PROMOTING PRODUCTS AND SERVICES FOR INFORMATION APPLIANCES BASED ON OUR TECHNOLOGY

Our success depends on large network operators introducing, marketing and promoting products and services based on our technology. There are, however, only a limited number of large network operators worldwide. Moreover, only a limited number of network operators are in the process of deploying products and services incorporating our technology and services for information appliances. In addition, none of our network operator customers is contractually obligated to introduce, market or promote products and services incorporating our technology, nor are any of them contractually required to achieve any specific introduction schedule. Accordingly, even if a network operator initiates a customer trial of products incorporating our technology, that operator is under no obligation to continue its relationship with us or to launch a full-scale deployment of these products. Further, our agreements with network operators are generally not exclusive, so network operators with whom we have agreements may enter into similar license agreements with one or more of our competitors.

Moreover, because the large-scale deployment of products and services incorporating our technology by network operators is complex, time consuming and expensive, each deployment of these products and services requires our expertise. The customization process for new customers requires a lengthy and significant commitment of resources by our customers and us. This commitment of resources may slow deployment, which could, in turn, delay market acceptance of these products and services. Unless network operators introduce, market and promote products and services incorporating our technology in a successful and timely manner, our software platform will not achieve widespread acceptance, information appliance manufacturers will not use our software in their products

and our revenues will not grow as fast as anticipated, if at all.

OUR PRODUCTS MAY CONTAIN ERRORS OR BE INFERIOR TO OUR COMPETITORS' PRODUCTS

Software development is an inherently complex and subjective process, which frequently results in products that contain errors ("bugs"), as well as defective or non-competitive features or functions. Moreover, our technology is integrated into the products and services of our network operator customers. Accordingly, a defect, error or performance problem with our technology could cause our customers' telecommunication, cable and satellite television or Internet service systems to fail for a period of time. Any such failure would cause severe customer service and public relations problems for our customers and could result in delayed or lost revenue due to adverse customer reaction, negative publicity and claims for substantial damages. Our current insurance policies may not protect against all of these risks.

In addition, our competitors may develop products, capabilities or technologies that render our products and services obsolete or noncompetitive or that shorten the life cycles of our existing products and services.

WHILE OUR SUCCESS DEPENDS ON OUR ABILITY TO KEEP PACE WITH THE LATEST TECHNOLOGICAL CHANGES, WE HAVE EXPERIENCED AND MAY IN THE FUTURE EXPERIENCE DELAYS IN COMPLETING DEVELOPMENT AND INTRODUCTION OF NEW SOFTWARE PRODUCTS

The market for information appliance software is characterized by evolving industry standards, rapid technological change and frequent new product introductions and enhancements. Our technology enables network operators to deliver content and applications to information appliances over the Internet. Accordingly, our success will depend in large part upon our ability to adhere to and adapt our products to evolving Internet protocols and standards. Therefore, we will need to develop and introduce new products that meet changing customer requirements and emerging industry standards on a timely basis. In the past, we have experienced delays in completing the development and introduction of new software products. We may encounter such delays in the development and introduction of future products as well. In addition, we may fail to design our current or future products to meet customer requirements or fail to develop and market products and services that respond to technological changes or evolving industry standards in a timely or cost effective manner.

IF INFORMATION APPLIANCE MANUFACTURERS DO NOT MANUFACTURE PRODUCTS THAT INCORPORATE OR OPERATE WITH OUR TECHNOLOGY, OR IF THESE PRODUCTS DO NOT ACHIEVE ACCEPTANCE, WE MAY NOT BE ABLE TO SUSTAIN OR GROW OUR BUSINESS

We do not typically manufacture hardware components that incorporate our technology. Rather, we license software technology to information appliance manufacturers and work with them to ensure that our products operate together. Accordingly, our success will depend, in part, upon our ability to convince a number of information appliance manufacturers to manufacture products that incorporate or operate with our technology and upon the successful introduction and commercial acceptance of these products. Our efforts also significantly depend on network operators deploying services using our server software.

While we have entered into a number of agreements with information appliance manufacturers, none of these manufacturers is contractually obligated to introduce or market information appliances incorporating our technology, nor is any of them contractually required to achieve any specific production

schedule. Moreover, our agreements with information appliance manufacturers are generally not exclusive, so information appliance manufacturers with whom we have agreements may enter into similar license agreements with one or more of our competitors. Our failure to convince information appliance manufacturers to incorporate our software platform into their products or modify their products to operate with our software, or the failure of these products to achieve broad acceptance with consumers and businesses, will result in revenues that do not grow as fast as expected, if at all.

COMPETITION FROM BIGGER, BETTER CAPITALIZED COMPETITORS COULD RESULT IN PRICE REDUCTIONS, REDUCED GROSS MARGINS AND LOSS OF MARKET SHARE

Competition in the information appliance software market is intense. Our principal competitors on the client software side include Microsoft, OpenTV (which recently acquired another former competitor, Spyglass), Canal + Technologies and PowerTV. On the server side, our primary competitor is Microsoft.

We expect additional competition from other established and emerging companies. We expect competition to persist and intensify as the information appliance market develops and competitors focus on additional product and service offerings. Increased competition could result in price reductions, fewer customer orders, reduced gross margins, longer sales cycles, reduced revenues and loss of market share.

Many of our existing and potential competitors, particularly Microsoft, have longer operating histories, a larger customer base, greater name recognition and significantly greater financial, technical, sales and marketing and other resources than we do. This may place us at a disadvantage in responding to our competitors' pricing strategies, technological advances, advertising campaigns, strategic partnerships and other initiatives. In addition, many of our competitors have well-established relationships with our current and potential customers. Moreover, some of our competitors, particularly Microsoft, have significant financial resources, which have enabled them in the past and may enable them in the future to make large strategic investments in our current and potential customers. Such investments may let them strengthen existing relationships or quickly establish new relationships with our current or potential customers. For example, as a result of an investment in AT&T, Microsoft obtained a nonexclusive licensing agreement under which AT&T will purchase licenses of Microsoft software for television set-top boxes. Investments such as this may discourage our potential or current customers who receive these investments from deploying our information appliance software, regardless of their views of the relative merits of our products and services.

ORACLE'S OWNERSHIP OF OUR STOCK AND OTHER RELATIONSHIPS WITH US COULD LIMIT THE ABILITY OF OTHER STOCKHOLDERS TO INFLUENCE THE OUTCOME OF DIRECTOR ELECTIONS AND OTHER TRANSACTIONS SUBMITTED FOR A VOTE OF OUR STOCKHOLDERS

Based on 104,226,554 shares outstanding on February 28, 2001, Oracle beneficially owns 33,899,843 shares, approximately 33% of our outstanding common stock. No Oracle designee currently serves on our Board of Directors. While Oracle has contributed these shares to a blind voting trust committed to vote them in proportion to all other voted shares, if Oracle were to withdraw the shares from this trust, it might exert significant influence over us, including influencing the election of directors, significant corporate transactions (such as acquisitions), efforts to block an unsolicited tender offer, and other

matters that require shareholder approval. This concentration of ownership could also delay or prevent a third party from acquiring control over us at a premium above the then-current market price of our common stock.

WE HAVE RELIED AND EXPECT TO CONTINUE TO RELY ON A LIMITED NUMBER OF CUSTOMERS FOR A SIGNIFICANT PORTION OF OUR REVENUES

We currently derive, and we expect to continue to derive, a significant portion of our revenues from a limited number of customers. For the nine months ended February 29, 2000, our five largest customers accounted for approximately 53% of our total revenues, with Cable & Wireless (recently acquired by NTL) accounting for 18% of our total revenues and Wind River accounting for 17% of our total revenues. For the nine months ended February 28, 2001, our three largest customers accounted for approximately 51% of our revenues, with Telewest and Cable & Wireless each accounting for 21% of our total revenues. We expect that we will continue to depend upon a limited number of customers for a significant portion of our revenues in future periods, although the customers may vary from period to period. As a result, if we fail to successfully sell our products and services to one or more customers in any particular period, or a large customer purchases fewer of our products or services, defers or cancels orders, or terminates its relationship with us, our revenues could decline significantly.

OUR LENGTHY SALES CYCLE AND POTENTIAL VARIATION IN THE TIMING OF REVENUE RECOGNITION MAY CAUSE FLUCTUATIONS IN OUR OPERATING RESULTS, WHICH COULD CAUSE OUR STOCK PRICE TO DECLINE

We believe that the purchase of our products and services involves a significant commitment of capital and other resources by a customer. In many cases, our customers' decision to use our products and services requires them to change their established business practices and conduct their business in new ways. As a result, we may need to educate our potential customers on the use and benefits of our products and services. In addition, our customers generally must consider a wide range of other issues before committing to purchase and incorporate our technology into their offerings. As a result of these and other

factors, including the approval at a number of levels of management within a customer's organization, our sales cycle averages from six to twelve months and may sometimes be significantly longer. Because of the length of our sales cycle, we have a limited ability to forecast the timing and amount of specific sales.

In addition, we base our quarterly revenue projections, in part, upon our expectation that specific sales will occur in a particular quarter. In the past, our sales have occurred in quarters other than those anticipated by us. Moreover, because we recognize certain revenues based on our receipt of royalty reports, delays in network operators' deployment schedules or our receipt of those reports could adversely affect our revenues for any given quarter. If our expectations, and thus our revenue projections, are not accurate for a particular quarter, our actual operating results for that quarter could fall below the expectations of financial analysts and investors resulting in a potential decline in our stock price.

DEMAND FOR OUR PRODUCTS AND SERVICES WILL DECLINE SIGNIFICANTLY IF OUR SOFTWARE CANNOT SUPPORT AND MANAGE A SUBSTANTIAL NUMBER OF USERS

Despite frequent testing of our software's scalability in a laboratory

environment and in customer deployments, the ability of our software platform to support and manage a substantial number of users is uncertain. If our software platform does not efficiently scale to support and manage a substantial number of users while maintaining a high level of performance, demand for our products and services and our ability to sell additional products to our existing customers will be significantly reduced.

INTERNATIONAL REVENUES ACCOUNT FOR A SIGNIFICANT PORTION OF OUR REVENUES; ACCORDINGLY, IF WE ARE UNABLE TO EXPAND OUR INTERNATIONAL OPERATIONS IN A TIMELY MANNER, OUR FINANCIAL RESULTS WILL BE HARMED

International revenues accounted for approximately 52% of our total revenues for the nine months ended February 29, 2000 and approximately 68% for the nine months ended February 28, 2001. We anticipate that a significant portion of our revenues for the foreseeable future will be derived from sources outside the United States, especially as we increase our sales and marketing activities with respect to international licensing of our technology. Accordingly, our success will depend, in part, upon international economic conditions and upon our ability to manage international sales and marketing operations. To successfully expand international sales, we must establish additional foreign operations, hire additional personnel and increase our foreign direct and indirect sales forces. This expansion will require significant management attention and resources, which could divert attention from other aspects of our business. To the extent we are unable to expand our international operations in a timely manner, our growth in international sales, if any, will be limited.

Moreover, substantially all of our revenues and costs to date have been denominated in U.S. dollars. However, expanded international operations may result in increased foreign currency payables. Although we may from time to time undertake foreign exchange hedging transactions to cover a portion of our foreign currency transaction exposure, we do not currently attempt to cover potential foreign currency exposure. Accordingly, any fluctuation in the value of foreign currency could seriously harm our business.

WE MAY HAVE TO CEASE OR DELAY PRODUCT SHIPMENTS IF WE ARE UNABLE TO OBTAIN KEY TECHNOLOGY FROM THIRD PARTIES

We rely on technology licensed from third parties, including applications that are integrated with internally developed software and used in our products. Most notably, we license certain technologies from Sun Microsystems, Wind River Systems, BitStream, RealNetworks and RSA. These third-party technology licenses may not continue to be available to us on commercially reasonable terms, or at all, and we may not be able to obtain licenses for other existing or future technologies that we desire to integrate into our products. If we cannot maintain existing third-party technology licenses or enter into licenses for other existing or future technologies needed for our products we would be required to cease or delay product shipments while we seek to develop or license alternative technologies.

WE DO NOT CURRENTLY HAVE LIABILITY INSURANCE TO PROTECT AGAINST THIRD-PARTY INTELLECTUAL PROPERTY INFRINGEMENT CLAIMS THAT COULD BE EXPENSIVE TO DEFEND

We expect that, like other software product developers, we will increasingly be subject to infringement claims as the number of products and competitors developing information appliance software grows and the

functionality of products in different industry segments overlaps. From time to time, we hire or retain employees or external consultants who have worked for independent software vendors or other companies developing products similar to those offered by us. These prior employers may claim that our products are based on their products and that we have misappropriated their intellectual property. We cannot guarantee that an infringement claim will not be asserted against us in the future, that the assertion of such a claim will not result in litigation, that we would prevail in such litigation, or that we would be able to obtain a license for the use of any infringed intellectual property on commercially reasonable terms, or at all.

We currently do not have liability insurance to protect against the risk that licensed third-party technology infringes the intellectual property of others. Any claims relating to our intellectual property, regardless of their merit, could seriously harm our ability to develop and market our products and manage our day to day operations because they could be time consuming and costly to defend, divert management's attention and resources, cause product shipment delays, require us to redesign our products, and require us to enter into royalty or licensing agreements.

OUR LIMITED ABILITY TO PROTECT OUR INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS MAY HARM OUR COMPETITIVENESS

Our ability to compete and continue to provide technological innovation depends substantially upon internally developed technology. We rely primarily on a combination of patents, trademark laws, copyright laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary technology. While we have a number of patent applications pending, patents may not issue from these or any future applications. In addition, our existing and future patents may not survive a legal challenge to their validity or provide significant protection for us.

The steps we have taken to protect our proprietary rights may not be adequate to prevent misappropriation of our proprietary information. Further, we may not be able to detect unauthorized use of, or take appropriate steps to enforce, our intellectual property rights. Our competitors may also independently develop similar technology. In addition, the laws of many countries do not protect our proprietary rights to as great an extent as do the laws of the United States. Any failure by us to meaningfully protect our intellectual property could result in competitors offering products that incorporate our most technologically advanced features, which could seriously reduce demand for our products and services.

FAILURE TO MANAGE OUR GROWTH MAY SERIOUSLY HARM OUR ABILITY TO DELIVER PRODUCTS IN A TIMELY MANNER, FULFILL EXISTING CUSTOMER COMMITMENTS AND ATTRACT AND RETAIN NEW CUSTOMERS

Our rapid growth has placed, and is expected to continue to place, a significant strain on our managerial, operational and financial resources, especially as more network operators and information appliance manufacturers incorporate our software into their products and services. This potential for rapid growth is particularly significant in light of the large customer bases of network operators and information appliance manufacturers and the frequent need to tailor our products and services to our customers' unique needs. To the extent we add several customers simultaneously or add customers whose product needs require extensive customization, we may need to significantly expand our operations. Moreover, we expect to expand our domestic and international operations significantly by, among other things, expanding the number of employees in professional services, research and development and sales and marketing.

This additional growth will place a significant strain on our limited

personnel, financial and other resources. Our future success will depend, in part, upon the ability of our senior management to manage growth effectively. This will require us to implement additional management information systems, to further develop our operating, administrative, financial and accounting systems and controls, to hire

additional personnel, to develop additional levels of management within the corporation, to locate additional office space in the United States and abroad and to maintain close coordination among our research and development, sales and marketing, services and support and administrative organizations. Failure to meet any of these requirements would seriously harm our ability to deliver products in a timely fashion, fulfill existing customer commitments and attract and retain new customers.

THE LOSS OF ANY OF OUR KEY PERSONNEL WOULD HARM OUR COMPETITIVENESS

We believe that our success will depend on the continued employment of our senior management team and key technical personnel, particularly Mitchell E. Kertzman, our Chief Executive Officer, Coleman Sisson, our President and Chief Operating Officer, David Limp, our Executive Vice President and Chief Strategy Officer and Donald Fitzpatrick, our Executive Vice President of Sales and Services. If one or more members of our senior management team or key technical personnel were unable or unwilling to continue in their present positions, these individuals would be very difficult to replace and our ability to manage day to day operations, develop and deliver new technologies, attract and retain customers, attract and retain other employees and generate revenues, could be seriously harmed.

OUR PLANNED EXPANSION OF OUR INDIRECT DISTRIBUTION CHANNELS WILL BE EXPENSIVE AND MAY NOT SUCCEED

To date, we have sold our products and services principally through our direct sales force. In the future, we intend to expand the number and reach of our indirect channel partners, primarily overseas, through distribution agreements. The development of these indirect channels will require the investment of significant company resources, which could seriously harm our business if our efforts do not generate significant revenues. Moreover, we may not be able to attract indirect channel partners able to effectively market our products and services. The failure to do so could seriously hinder the growth of our business.

IN ORDER TO REMAIN COMPETITIVE IN OUR MARKET, WE MAY NEED TO MAKE ACQUISITIONS THAT COULD BE DIFFICULT TO INTEGRATE, DISRUPT OUR BUSINESS AND DILUTE STOCKHOLDER VALUE

We may acquire other businesses in the future in order to remain competitive or to acquire new technologies. As a result of future acquisitions, we may need to integrate product lines, technologies, widely dispersed operations and distinct corporate cultures. In addition, the product lines or technologies of future acquisitions may need to be altered or redesigned in order to be made compatible with our software products or the software architecture of our customers. These integration efforts may not succeed or may distract our management from operating our existing business. Our failure to successfully manage future acquisitions could seriously harm our operating results. In addition, our stockholders would be diluted if we finance acquisitions by incurring convertible debt or issuing equity securities.

WE MAY BE UNABLE TO SUCCESSFULLY INTEGRATE ACQUISITIONS INTO OUR BUSINESS OR ACHIEVE THE EXPECTED BENEFITS OF THE ACQUISITIONS

Our acquisitions of SourceSuite and MoreCom will continue to require integrating our business with their businesses, including integrating product lines, technologies, widely-dispersed operations and distinct corporate cultures. We may not be able to successfully assimilate the personnel, operations and customers of these acquired companies into our business. Additionally, we may fail to achieve the anticipated synergies from these acquisitions, including product development and other operational synergies. The integration process may further strain our existing financial and managerial controls and reporting systems and procedures. This may result in the diversion of management and financial resources from our core business objectives. In addition, we are not experienced in managing significant facilities or operations in geographically distant areas. Further, we may not be able to retain various individuals who provide services to these acquired companies that we have hired in connection with these acquisitions. Our failure to successfully manage these acquired companies could seriously harm our operating results.

WE MAY NOT BE SUCCESSFUL IN MAKING STRATEGIC INVESTMENTS

We have established the Liberate Corporate Venture Fund. Both through that fund and otherwise, we have made and plan to continue to make strategic investments in other companies. In most instances

these investments are in the form of equity securities of private companies for which there is no public market. These companies may be expected to incur substantial losses and may never become publicly traded companies. Even if they do, an active trading market for their securities may never develop and we may never realize any return on these investments. Further, if these companies are not successful, we could incur charges related to write-downs or write-offs of these types of assets. Losses or charges resulting from these investments could harm our operating results.

WE MAY INCUR NET LOSSES OR INCREASED NET LOSSES IF WE ARE REQUIRED TO RECORD A SIGNIFICANT ACCOUNTING EXPENSE RELATED TO THE ISSUANCE OF WARRANTS

In fiscal year 1999, we entered into letter agreements with several network operators whereby we agreed to issue warrants to purchase up to an aggregate of 4,599,992 shares of common stock which are exercisable if those network operators satisfy certain milestones. The value of the warrants is estimated using the Black-Scholes model as of the earlier of the grant date or the date that it becomes probable that the warrants will be earned. Pursuant to the requirements of Emerging Issues Task Force No. 96-18, the warrants will continue to be revalued in situations where they are granted prior to the establishment of a performance commitment. The value of the warrants is recorded primarily as a non-current asset on the accompanying condensed consolidated balance sheets and is being amortized over the estimated economic life of the arrangements with the network operators.

As of February 28, 2001, warrants to purchase up to 2,336,660 shares of our common stock were earned by these network operators. The fair market value of these warrants at the time they were earned was $117.2 million. As of February 28, 2001, accumulated amortization for the warrants was $28.3 million.

If the remaining warrants are earned, we may be required to record significant non-cash accounting expenses. As a result, we could incur net losses or increased net losses for a given period and this could seriously harm our operating results and stock price.

DEMAND FOR OUR PRODUCTS AND SERVICES WILL NOT INCREASE IF THE INTERNET DOES NOT CONTINUE TO GROW AND IMPROVE

Acceptance of our software depends substantially upon the widespread adoption of the Internet for commerce, communications and entertainment. As is typical in the case of an emerging industry characterized by rapidly changing technology, evolving industry standards and frequent new product and service introductions, demand for and acceptance of recently introduced Internet products and services are subject to a high level of uncertainty. In addition, critical issues concerning the commercial use of the Internet remain unresolved and may affect the growth of Internet use, especially in the consumer markets we target. The adoption of the Internet for commerce, communications and access to content and applications, particularly by those that have historically relied upon alternative means of commerce, communications and access to content and applications, generally requires understanding and acceptance of a new way of conducting business and exchanging information. Moreover, widespread application of the Internet outside of the United States will require reductions in the cost of Internet access to prices affordable to the average consumer.

NEW OR CHANGED GOVERNMENT REGULATION COULD CAUSE DEMAND FOR OUR PRODUCTS AND SERVICES TO DECLINE SIGNIFICANTLY

We are subject not only to regulations applicable to businesses generally, but also laws and regulations directly applicable to the Internet and cable and satellite television broadcasts. Although there are currently few such laws and regulations, state, federal and foreign governments may adopt a number of laws and regulations that adversely affect us or our markets in any of the following areas: user privacy, copyrights, consumer protection, taxation of e-commerce, the online distribution of content, and the characteristics and quality of online products and services.

We do not engage in e-commerce, nor do we distribute content over the Internet. However, one or more government agencies could enact regulations affecting companies, like us, which provide software that facilitates e-commerce and the distribution of content over the Internet. Moreover, the market for television, and particularly cable and satellite television, is extensively regulated by a large number of

national, state and local government agencies, including the Federal Communications Commission. New or altered laws or regulations regarding interactive television that change the competitive landscape or limit its market or affect its pricing could seriously harm our business prospects.

WE EXPECT OUR OPERATIONS TO CONTINUE TO PRODUCE NEGATIVE CASH FLOW; CONSEQUENTLY, IF WE CANNOT RAISE ADDITIONAL CAPITAL, WE MAY NOT BE ABLE TO FUND OUR CONTINUED OPERATIONS

Since our inception, cash used in our operations has substantially exceeded cash received from our operations, and we expect this trend to continue for the foreseeable future. We believe that our existing cash balances will be more than sufficient to meet our working capital and capital expenditure needs

for at least the next 12 months. After that, we may need to raise additional funds, and we cannot be certain that we will be able to obtain additional financing on favorable terms, or at all. If we need additional capital and cannot raise it on acceptable terms, we may not be able to develop our products and services, acquire complementary technologies or businesses, open new offices, hire and retain employees, or respond to competitive pressures or new business requirements.

PROVISIONS OF OUR CORPORATE DOCUMENTS AND DELAWARE LAW COULD DETER TAKEOVERS AND PREVENT STOCKHOLDERS FROM RECEIVING A PREMIUM FOR THEIR SHARES

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

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

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

- Limit who may call special meetings of stockholders

- Prohibit stockholder action by written consent, which requires all actions to be taken at a meeting of the stockholders

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

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

WE ARE AT RISK OF SECURITIES CLASS ACTION LITIGATION DUE TO OUR STOCK PRICE VOLATILITY

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. This risk is especially acute for us because technology companies have experienced greater than average stock price volatility in recent years and, as a result, have been subject to, on average, a greater number of securities class action claims than companies in other industries. Due to the volatility of our stock price, we may in the future be the target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

OUR STOCK PRICE COULD DECLINE BY SHARES BECOMING AVAILABLE FOR SALE IN THE FUTURE

Shares of our common stock that are restricted, either by law or otherwise, will become available for resale in the future. This includes the eligibility for sale on July 19, 2001 of 3,963,780 shares held by Cisco Systems, upon the satisfaction of the Rule 144 holding period. Resales of such shares could adversely affect the market price of our common stock and could impair our ability to raise capital through the sale of additional equity securities.

WE RELY ON CONTINUOUS POWER SUPPLY TO CONDUCT OUR OPERATIONS, AND CALIFORNIA'S CURRENT ENERGY CRISIS COULD DISRUPT OUR OPERATIONS AND INCREASE OUR EXPENSES

California is in the midst of an energy crisis that could disrupt our operations and increase our expenses. In the event of an acute power shortage, California may implement rolling blackouts throughout the state. If blackouts interrupt our power supply, we may be temporarily unable to operate. Any such interruption in our ability to continue operations could delay the development of our products, interfere with our ability to provide customer support, damage our reputation, and result in lost revenue, any of which could substantially harm our business and results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

INTEREST RATE RISK

As of February 28, 2001, our investment portfolio includes $430.1 million of U.S. government obligations, commercial paper and other corporate securities that are subject to no interest rate risk when held to maturity but may increase or decrease in value if interest rates change prior to maturity. We do not use derivative financial instruments in our investment portfolio. We place our investments with high credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we are averse to principal loss and seek to preserve our invested funds by limiting the fault risk, market risk and reinvestment risk. We currently maintain sufficient cash and cash equivalent balances to typically hold our investments to maturity. An immediate 10% change in interest rates would be immaterial to our financial condition or results of operations.

FOREIGN CURRENCY/EXCHANGE RATE RISK

We transact business in various foreign currencies and are accordingly subject to exposure from adverse movements in foreign currency exchange rates. To date, the effect of changes in foreign currency exchange rates on revenues and operating expenses have not been material. The majority of our revenues are earned in U.S. dollars. Operating expenses incurred by our foreign subsidiaries are denominated primarily in European currencies. We currently do not use financial instruments to hedge these operating expenses. We continue to assess the need to use financial instruments to hedge currency exposures.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

As part of our acquisition of the Virtual Modem software product and related assets and technology of SourceSuite, we acquired certain patents that were the subject of a patent infringement lawsuit. This lawsuit was initially brought by Interactive Channel Technologies and SMI Holdings, affiliated companies of SourceSuite, against Worldgate Communications in May 1998. The patent infringement claims have been assigned to us as a result of our merger with SourceSuite. In June 1998, Worldgate filed a counterclaim against the plaintiffs and Source Media, a shareholder of SourceSuite, alleging among others, violations of the Lanham Act and Delaware's Uniform Deceptive Trade Practices Act, common law unfair competition, tortious interference with existing and prospective business relationships and misappropriation of confidential information and trade secrets. Following discovery and briefing of the patent claim construction issues, the parties have entered into settlement negotiations covering both our patent infringement claims against Worldgate and

Worldgate's cross-complaint against Interactive Channel, SMI Holdings and Source Media. On March 26, 2001, the U.S. District Court hearing this matter ruled that the parties have entered into a settlement agreement under which each side will dismiss its claims against the other.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(c) CHANGES IN SECURITIES

On July 19, 2000, we agreed to issue 3,963,780 shares of common stock to Cisco Systems, resulting in aggregate cash proceeds of approximately $100.0 million. The issuance of these shares was deemed to be exempt from registration under the Securities Act of 1933 in reliance on Section 4(2) of the Securities Act of 1933, as amended.

On June 22, 2000, we issued an aggregate of 7,310,830 shares of common stock in exchange for all of the outstanding stock of MoreCom and assumed all of MoreCom's stock options. The issuance of these shares was deemed to be exempt from registration under the Securities Act of 1933 in reliance on Section 3(a)(10) of the Securities Act of 1933, as amended. The terms and conditions of such issuance were approved after a hearing upon the fairness of such terms and conditions by a government authority expressly authorized by law to grant such approval.

(d) USE OF PROCEEDS

On July 19, 2000 we agreed to issue 3,963,780 shares of common stock to Cisco Systems at approximately $25.23 per share. Aggregate cash proceeds from this transaction were approximately $100.0 million. The net proceeds have been applied to working capital and were predominantly held in cash, cash equivalents and short-term investments at February 28, 2001.

ITEM 3. DEFAULTS IN SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

In March 2001, Barry Schuler resigned from our Board of Directors in order to fulfill his new responsibilities as Chairman and Chief Executive Officer of America Online, Inc., a subsidiary of AOL Time Warner, Inc.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS

EXHIBIT NO.	EXHIBIT
2.3	Plan and Agreement of Reorganization with MoreCom, Inc., dated March 27, 2000. (Incorporated by reference to similarly numbered exhibit to the Form 8-K filed by the Registrant on July 7, 2000).
2.4	Amendment No. 1 to Plan and Agreement of Reorganization with MoreCom, Inc. (Incorporated by reference to similarly numbered exhibit to the Form 8-K filed by the Registrant on July 7, 2000).
3.1	Amended and Restated Bylaws of Liberate. (Incorporated by reference to Exhibit 3.4 to the Registration Statement on Form S-1 filed by the Registrant (Reg. No. 333-78781).)
3.2	Sixth Amended and Restated Certificate of Incorporation of Liberate. (Incorporated by reference to Exhibit 3.5 to the Registration Statement on Form S-1 filed by the Registrant (Reg. No. 333-78781).)
4.1	Specimen Certificate of Liberate's common stock. (Incorporated by reference to similarly numbered exhibit to the Registration Statement on Form S- 1 filed by the Registrant (Reg. No. 333-78781).)
10.50	Promissory Note, dated April 6, 2001, for loan extended to Don Fitzpatrick.

(b) REPORTS ON FORM 8-K

None

29

SIGNATURE

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 undersigned, thereunto duly authorized.

Liberate Technologies

Date: April 12, 2001 by: /s/ Nancy J. Hilker

Nancy J. Hilker,
Senior Vice President and
Chief Financial Officer

(duly authorized officer and
principal financial officer)