

FAIRMARKET INC  
Form 10-Q  
May 09, 2003

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

For the Quarterly Period Ended March 31, 2003

**o 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 000-29423

**FAIRMARKET, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**04-3351937**

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

**500 Unicorn Park Drive, Woburn, MA 01801-3341**

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: **(781) 376-5600**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 126-2 of the Exchange Act).

Yes  No

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The number of shares outstanding of the registrant's common stock as of May 7, 2003 was 26,702,862.

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FAIRMARKET, INC.

FORM 10-Q

For the Quarter Ended March 31, 2003

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*FAIRMARKET and MarketSelect are registered service marks, and the FairMarket logo and FairMarket Network are service marks, of FairMarket, Inc. The names of other companies and products mentioned in this Report may be the trademarks of their respective owners.*

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## FAIRMARKET, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS  
(Unaudited)(In thousands)

	March 31, 2003		December 31, 2002	
<b>Assets</b>				
Current assets:				
Cash and cash equivalents	\$	30,243	\$	32,743
Marketable securities		2,675		6,991
Restricted cash		549		548
Accounts receivable, net of allowance for doubtful accounts of \$168 and \$267 at March 31, 2003 and December 31, 2002, respectively		1,057		1,328
Prepaid expenses		1,338		610
Other assets		515		534
Total current assets		36,377		42,754
Long-term marketable securities		20,016		15,000
Long-term prepaid expenses				35
Property and equipment, net		994		1,478
Total assets	\$	57,387	\$	59,267
<b>Liabilities, Preferred Stock and Stockholders Equity</b>				
Current liabilities:				
Accounts payable	\$	127	\$	133
Deferred revenue		523		520
Accrued expenses		1,369		1,489
Short-term unutilized office space		1,040		1,040
Total current liabilities		3,059		3,182

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Long-term unutilized office space		791		1,040
Other long-term liabilities		127		169
Total liabilities		3,977		4,391
Preferred stock		1,983		1,967
Stockholders' equity:				
Common stock		30		30
Additional paid-in capital		188,385		188,747
Treasury stock		(3,466)		(3,795)
Deferred compensation and equity-related charges		(69)		(159)
Accumulated other comprehensive income, net		24		12
Accumulated deficit		(133,477)		(131,926)
Total stockholders' equity		51,427		52,909
Total liabilities, preferred stock and stockholders' equity	\$	57,387	\$	59,267

See accompanying notes to condensed consolidated financial statements.

**FAIRMARKET, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
*(Unaudited)**(In thousands, except per share amounts)*

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
Revenue	\$ 1,357	\$ 1,311
Operating expenses:		
Cost of revenue (exclusive of \$5 in 2003 and \$39 in 2002 reported below as equity-related charges)	759	1,024
Sales and marketing (exclusive of \$24 in 2003 and \$4,322 in 2002 reported below as equity-related charges)	562	634
Development and engineering (exclusive of \$16 in 2003 and \$72 in 2002 reported below as equity-related charges)	352	794
General and administrative (exclusive of \$7 in 2003 and \$46 in 2002 reported below as equity-related charges)	1,400	2,125
Unutilized office space charge		4,500
Equity-related charges	52	4,479
Total operating expenses	3,125	13,556
Loss from operations	(1,768)	(12,245)
Other income, net	215	405
Net loss	\$ (1,553)	\$ (11,840)
Dividend and accretion on redeemable convertible preferred stock	49	
Net loss attributable to common shareholders	\$ (1,602)	\$ (11,840)
Basic and diluted net loss per common share	\$ (0.06)	\$ (0.41)
Shares used to compute basic and diluted net loss per common share	26,586	29,157

See accompanying notes to condensed consolidated financial statements.





## FAIRMARKET, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

*(Unaudited)**(In thousands)*

	Three Months Ended March 31,	
	2003	2002
<b>Cash flows from operating activities:</b>		
Net loss	\$ (1,553)	\$ (11,840)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	482	891
Reserve for uncollectible accounts	2	42
Amortization of deferred compensation and equity-related charges	52	4,479
Loss on disposal of property and equipment		1,169
Unutilized office space charge		3,338
Changes in operating assets and liabilities:		
Accounts receivable	268	114
Prepaid expenses and other current assets	(709)	(1,012)
Long-term prepaid	35	
Accounts payable	(7)	(120)
Accrued expenses	(121)	(93)
Deferred revenue	4	274
Other non-current liabilities	(291)	(42)
Net cash used in operating activities	(1,838)	(2,800)
<b>Cash flows from investing activities:</b>		
Purchases of property, plant and equipment	(3)	
Purchases of marketable securities	(112,906)	(48,000)
Proceeds from maturity of marketable securities	112,222	50,060
Net cash (used in) provided by investing activities	(687)	2,060
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock, net of issuance costs	57	60
Dividends paid on redeemable convertible preferred stock	(33)	
Repayment of capital lease		(49)
Net cash provided by financing activities	24	11
Effect of foreign exchange rates on cash and cash equivalents	1	44

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Net decrease in cash and cash equivalents	(2,500)	(685)
Cash and cash equivalents, beginning of period	32,743	20,329
Cash and cash equivalents, end of period	\$ 30,243	\$ 19,644

See accompanying notes to condensed consolidated financial statements.

**FAIRMARKET, INC.**

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited) (in Thousands)

## 1. **Nature of Business**

FairMarket, Inc. ( FairMarket or the Company ) is an online auction and promotions technology and service provider that enables marketers to create results-oriented rewards programs and helps commerce companies automate the process of selling their excess inventory online to wholesale and consumer buyers. Our solutions enable merchants to sell to their existing base of wholesale buyers or to buyers on eBay as well as consumers on their own sites. Our technology is designed to enable our customers to leverage their existing inventory, transaction and fulfillment infrastructures by integrating seamlessly with those systems.

## 2. **Basis of Presentation**

The accompanying consolidated interim financial statements of FairMarket are unaudited and have been prepared on a basis substantially consistent with our audited financial statements for the year ended December 31, 2002. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Consequently, these statements do not include all disclosures normally required by generally accepted accounting principles for annual financial statements. These consolidated interim financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2002, which are contained in our Annual Report on Form 10-K, filed with the Securities and Exchange Commission. The consolidated interim financial statements, in the opinion of management, reflect all adjustments (including all normal recurring accruals) necessary for a fair presentation of the results of operations and cash flows for the interim periods ended March 31, 2003 and 2002. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the fiscal year. The consolidated interim financial statements include the accounts of FairMarket, Inc. and its wholly owned subsidiaries, FairMarket UK Limited, The FairMarket Network Pty Ltd, FairMarket GmbH and FairMarket Securities Corporation. All intercompany transactions and balances have been eliminated in consolidation.

## 3. **Accounting for Stock-Based Compensation**

Statement of Financial Accounting Standards ( SFAS ) No. 123 as amended by SFAS No. 148, Accounting for Stock-Based Compensation, encourages but does not require companies to record compensation costs for stock-based employee compensation at fair value. The Company has chosen to account for stock-based compensation granted to employees using the intrinsic value method prescribed in Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, compensation costs for stock options granted to employees is measured as the excess, if any, of the fair value of the Company's stock at the date of the grant over the amount that must be paid by the employee to acquire the stock under the terms of the stock option. Subsequent changes to option terms can also give rise to compensation. Stock-based compensation issued to non-employees is measured and recorded using the fair value method prescribed in SFAS

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No. 123.

The Company follows the disclosure provisions of SFAS No. 123 and has applied APB Opinion No. 25 and related interpretations in accounting for its stock option plans. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates as calculated in accordance with SFAS No. 123, the Company's net loss for the quarter ended March 31, 2003 and 2002 would have increased to the pro forma amounts indicated below (in thousands, except per share amounts):

	March 31, 2003	March 31, 2002
<b>Net loss attributable to common stockholders</b>		
As reported	\$ (1,602)	\$ (11,840)
Add: Stock-based employee compensation expense included in reported results	52	176
Deduct: Total stock-based employee compensation expense determined under the fair-value-based method for all awards	(234)	(537)
Pro forma	\$ (1,784)	\$ (12,201)
<b>Net loss per common share</b>		
As reported	\$ (0.06)	\$ (0.41)
Pro forma	\$ (0.07)	\$ (0.42)

## 4. Equity-related and Unutilized Office Space Charges

Equity-related charges consist of the amortization of (i) deferred stock compensation resulting from the grant of stock options to employees at exercise prices deemed to be less than the fair value of the common stock on the grant date and (ii) the fair value of warrants issued to strategic customers and shares of Series D convertible preferred stock issued to strategic customers at prices below their fair value. At March 31, 2003, on the consolidated balance sheet deferred stock compensation was \$69,000 net of equity-related charges of \$52,000 amortized to the consolidated statement of operations and canceled stock options valued at \$38,000. This \$69,000 is being amortized ratably over the vesting periods of the applicable stock options, typically four years, with 25% vesting on the first anniversary of the grant date and the balance vesting 6.25% quarterly thereafter. For the three months ended March 31, 2003 and 2002, related expense recognized was \$52,000 and \$176,000, respectively.

In the first quarter of 2002, we recorded a charge of \$4.5 million for unutilized office space at our Woburn, Massachusetts headquarters. This charge included rent and other related costs for a significant portion of our leased space which has been vacated for the remaining lease term and the write-down of related leasehold improvements and furniture and fixtures. In the fourth quarter of 2002, we recorded a reversal of \$513,000 related to a sublease of approximately 11,000 square feet of the unutilized office space. During 2002, we paid \$746,000 against this accrual, which represented rent payments related to unutilized office space. In addition, we recorded \$1.2 million for the write-down of leasehold improvements and furniture and fixtures. During the period ending March 31, 2003 we paid \$249,000 against this accrual for rent payments related to unutilized office space. As of March 31, 2003, \$1.8 million of the total charge remained accrued and unpaid relating to future rent payments related to unutilized office space.

	(in thousands)	
Roll forward of activity for unutilized office space		
Initial charge recorded in March 2002	\$	4,500
Non-cash write-down of leasehold improvements and furniture and fixtures		(1,161)
Cash payments made in 2002		(746)
Reversal of accrual in December 2002		(513)
Unutilized space accrual at December 31, 2002		2,080
Cash payments made in the first quarter ended March 31, 2003		(249)
Unutilized office space accrual at March 31, 2003	\$	1,831

## 5. Net Loss per Share

Basic net loss per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net loss per common share is computed using the weighted average number of common shares outstanding during the period plus the effect of any dilutive potential common shares. Dilutive potential common equivalent shares consist of the assumed exercise of stock options, the proceeds of which are then assumed to have been used to repurchase outstanding stock using the treasury stock method, and the assumed conversion of convertible preferred stock and warrants. Potential common shares were excluded from the calculation of net loss per common share for the periods presented since their inclusion would be antidilutive. For the three months ended March 31, 2003 and 2002, basic and diluted net loss per common share is computed based on the weighted average number of common shares outstanding during the period because the effect of potential common equivalent shares would be anti-dilutive.

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Certain securities were not included in the computation of diluted net loss per share for the quarters ended March 31, 2003 and 2002, because they would have had an anti-dilutive effect due to net losses for such periods. These securities include: (i) options to purchase approximately 3,464,633 shares of common stock with exercise

prices of \$0.10 to \$9.66 per share and 952,380 shares of convertible preferred stock at March 31, 2003 and options to purchase 5,313,989 shares of common stock with exercise prices of \$0.10 to \$9.66 per share at March 31, 2002.

## 6. Comprehensive Loss

For the three months ended March 31, 2003 and 2002, total comprehensive loss was as follows (in thousands):

	Three Months Ended March 31,	
	2003	2002
Net loss	\$ (1,553)	\$ (11,840)
Changes in other comprehensive loss:		
Foreign currency translation adjustments	8	(21)
Unrealized gain (loss) on marketable securities	16	(142)
Total comprehensive loss	\$ (1,529)	\$ (12,003)

## 7. Series B Preferred Stock

On May 17, 2002, the Company completed a private placement of 952,380 shares of its Series B redeemable convertible preferred stock, par value \$0.001 per share, to eBay Inc. for an aggregate purchase price of \$2.0 million. The Series B preferred stock is entitled to cash dividends payable quarterly at the rate of 6.5% per annum in preference to any dividend on any other series of preferred stock or common stock. The dividends are cumulative and are entitled to participate on a pro rata basis in any dividend paid on the common stock on an as if converted basis. As of March 31, 2003, the Company had accrued \$32,500 for dividends payable. The Series B preferred stock is convertible into shares of common stock on a one-for-one basis, subject to certain adjustment mechanisms including a weighted average anti-dilution mechanism. In the event of any liquidation, dissolution or winding up of the Company (a "Liquidation"), the holders of the Series B preferred stock are entitled to receive, in preference to the holders of certain junior securities, as defined in the Series B preferred stock terms, a per share amount equal to \$2.10 plus all accrued and unpaid dividends (the "Liquidation Preference"). In the event of a Liquidation, after payment of the Liquidation Preference and any other liquidation preference on any other series of stock, the Series B preferred stock is entitled to participate on a pro rata basis with the common stock in the distribution of the remaining assets of the Company on an as if converted basis. The holders of the Series B preferred stock have the right to require the Company to redeem the Series B preferred stock at any time after the earlier of (a) May 17, 2003, and (b) the happening of a material adverse effect on the Company's business, as defined in the Series B preferred stock terms. The Company has the right, at any time after May 17, 2004, to redeem the outstanding Series B preferred stock at \$2.10 per share plus all accrued and unpaid dividends. The net proceeds from this offering, after issuance costs, totaled \$1.8 million. At the issuance date, the Company estimated the fair value of the Series B preferred stock to be in excess of the amount paid by eBay by \$114,200. As a result, the Company recorded an \$114,200 adjustment to increase the carrying value of this investment and decrease revenue from eBay, Inc. in accordance with EITF 01-09. The Company is accreting the carrying value of the Series B preferred stock up to \$2.0 million through May 2003 in accordance with the redemption feature described above. The Company recorded \$57,000 in accretion in the year ending December 31, 2002 and \$16,000 for the quarter ending March 31, 2003. At March 31, 2003, the carrying value of the Series B preferred stock was approximately \$1.9 million.

## 8. **Stock Option Exchange**

On January 16, 2001, we implemented a one-time employee incentive program under which employees had the opportunity to exchange, on a one-for-one basis, their outstanding employee stock options with exercise prices of \$3.00 or more for new options with an exercise price of \$2.1875, the closing price of our common stock on the January 16, 2001 exchange date. Options held by executive officers and directors were not included in the exchange. Under this program, options covering approximately 1,155,000 shares of our common stock were exchanged for options covering an equal number of shares. Options granted under this program have special terms, with the options vesting quarterly over two years, beginning on the three-month anniversary of the grant date, if the option exchanged was unvested, or vesting on the six-month anniversary of the grant date, if the option exchanged was vested, and having a term of two and one-half years. For accounting purposes, the exchange constituted a repricing



of the existing options and will require variable accounting for the new options granted in the exchange. As a result, we (i) will recognize a non-cash compensation charge each quarter with respect to vested options if and to the extent that the per share fair market value of our common stock at the end of the quarter exceeds \$2.1875, the per share exercise price of the new options, and (ii) will adjust deferred compensation each quarter for unvested options. There is a potential for such a variable non-cash charge in each quarter until all of the new options are exercised or until the date the options expire (July 16, 2003) or otherwise terminate. The closing price of our common stock during 2002 and through March 31, 2003 was below \$2.1875, therefore no related charges were recognized during 2002 or for the quarter ended March 31, 2003.

## 9. Revenues and Long-lived Assets by Geographic Region

The table below presents revenues by principal geographic region for the three months ended March 31, 2003 and 2002 (in thousands):

	Three Months Ended March 31,	
	2003	2002
United States	\$ 975	\$ 950
United Kingdom	358	337
All other	24	24
Total	\$ 1,357	\$ 1,311

The table below presents long-lived assets by principal geographic region as of March 31, 2003 and December 31, 2002 (in thousands):

	March 31, 2003	December 31, 2002
United States	\$ 824	\$ 1,253
United Kingdom	170	225
Total	\$ 994	\$ 1,478

## 10. Commitments and Contingencies

We are subject to legal proceedings, claims, and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

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FairMarket has been named as a defendant in certain purported class action lawsuits filed by individual shareholders in the U.S. District Court for the Southern District of New York against FairMarket, Scott Randall (former President, Chief Executive Officer and Chairman of the Board of FairMarket), John Belchers (former Chief Financial Officer of FairMarket), U.S. Bancorp Piper Jaffray Inc., Deutsche Bank Securities Inc. and FleetBoston Robertson Stephens, Inc. The lawsuits have been filed by individual shareholders who purport to seek class action status on behalf of all other similarly situated persons who purchased the common stock of FairMarket between March 14, 2000 and December 6, 2000. The lawsuits allege that certain underwriters of FairMarket's initial public offering solicited and received excessive and undisclosed fees and commissions in connection with that offering. The lawsuits further allege that the defendants violated the federal securities laws by issuing a registration statement and prospectus in connection with FairMarket's initial public offering, which failed to accurately disclose the amount and nature of the commissions and fees paid to the underwriter defendants. On or about October 8, 2002, the Court entered an Order dismissing the claims asserted against certain individual defendants in the consolidated actions, including the claims against Mr. Randall and Mr. Belchers, without any payment from these individuals or the Company. On or about February 19, 2003, the Court entered an Order dismissing with prejudice the claims asserted against the Company under Section 10(b) of the Securities Exchange Act of 1934. As a result, the only claims that remain against the Company are those arising under Section 11 of the Securities Act of 1934. The Company intends to vigorously defend the remaining claims asserted against it in the actions.

## Indemnification Obligations

In November 2002, the FASB issued FIN No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34 (FIN 45). FIN 45 requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken by issuing the guarantee. FIN 45 also requires additional disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees it has issued. The accounting requirements for the initial recognition of guarantees are applicable on a prospective basis for guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for all guarantees outstanding, regardless of when they were issued or modified, during the first quarter of fiscal 2003. The adoption of FIN 45 did not have an effect on the Company's consolidated financial statements. The following is a summary of the agreements that the Company has determined are within the scope of FIN 45.

As permitted under Section 145 of the Delaware General Corporation Law, the by-laws of FairMarket, Inc. provide that FairMarket shall, to the extent legally permitted, indemnify each person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding by reason of the fact that such person is or was, or has agreed to become, a director or officer of FairMarket, or is or was serving, or has agreed to serve, at the request of FairMarket, as a director, officer, trustee, partner, employee or agent of, or in a similar capacity with, another corporation, partnership, joint venture, trust, employee benefit plan or other enterprise. The indemnification provided for in the by-laws is expressly not exclusive of any other rights to which those seeking indemnification may be entitled under any law, agreement or vote of stockholders or disinterested directors or otherwise, and shall inure to the benefit of the heirs, executors and administrators of such persons. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have a Director and Officer insurance policy that enables us to recover a portion of any future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal. We have no liabilities recorded for these agreements as of March 31, 2003.

Our customer contracts contain indemnification provisions as a standard term of those contracts. Generally, these indemnification provisions require that we indemnify, defend and hold harmless the customer and certain related parties for third party claims, liabilities and costs arising from the breach of any warranty, representation or covenant in the agreement by us or any claim that our technology or service infringes or violates any third party's copyright, patent, trade secret, trademark, right of publicity or right of privacy or contains any defamatory content. Generally, our aggregate potential liability under these indemnification provisions is capped at the total amount paid to us by the customer under the contract, although some customer contracts contain higher limits and some contain no limit for specified types of claims. The term of these indemnification provisions is generally perpetual from the time of execution of the agreement. Some of our other types of agreements with third parties contain similar provisions. We believe the estimated fair value of these indemnification agreements is minimal and we have no liabilities recorded for these provisions as of March 31, 2003.

## 11. Recent Accounting Pronouncements

In November 2002, the Emerging Issues Task Force issued EITF 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. EITF No. 00-21 establishes three principles: (1) revenue should be recognized separately for separate units of accounting; (2) revenue for a separate unit of accounting should be recognized only when the arrangement consideration is reliably measurable and the earnings process is substantially complete; and (3) consideration should be allocated among the separate units of accounting in an arrangement based on their fair values. EITF No. 00-21 is effective for all revenue arrangements entered into in fiscal periods beginning after June 15, 2003, with early adoption permitted. We do not expect the adoption of EITF No. 00-21 to have a material impact on our results of operations or financial condition.



In January 2003, the FASB issued FASB Interpretation FIN No. 46 Consolidation of Variable Interest Entities, an interpretation of ARB 51. FIN No. 46 provides guidance on the identification of entities for which control is achieved through means other than through voting rights called variable interest entities or VIEs and how to determine when and which business enterprise should consolidate the VIE (the primary beneficiary). This new model for consolidation applies to an entity which either (1) the equity investors (if any) do not have a controlling financial interest or (2) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. In addition, FIN No. 46 requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE make additional disclosures. Certain transitional disclosures are required in financial statements initially issued after January 31, 2003, if it is reasonably possible that once this guidance is effective the enterprise will either be required to consolidate a VIE or will hold a significant variable interest in a VIE. We currently do not have any interests that would change our current reporting entity or require additional disclosures outlined in FIN No. 46.

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

*This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. You can identify forward-looking statements by the use of the words believe, expect, anticipate, intend, estimate, assume and other similar expressions which predict or indicate future events and trends and which do not relate to historical matters. You should not rely on forward-looking statements, because they involve known and unknown risks, uncertainties and other factors, some of which are beyond our control. Our actual results could differ materially from those set forth in the forward-looking statements. Certain factors that might cause such a difference include the following: market acceptance of our online auction and other e-commerce services; growth of the market for dynamic e-commerce services; the competitive nature of the online markets in which we operate; economic conditions; our ability to generate significant revenue to reach profitability; our ability to retain existing customers and to obtain new customers; our ability to expand our operations in our geographic markets and the currency, regulatory and other risks associated with doing business in international markets; our ability to attract and retain qualified personnel; the operation and capacity of our network system infrastructure; our limited operating history; and the other risks and uncertainties discussed under the heading Factors that May Affect Results of Operations and Financial Condition on page 17 of this Form 10-Q. You should not place undue reliance on our forward-looking statements, and we assume no obligation to update any forward-looking statements.*

*The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements and the notes to those statements included elsewhere in this Report and in our Annual Report on Form 10-K, for the year ended December 31, 2002 and in other reports filed by us with the Securities and Exchange Commission.*

### Overview

FairMarket is an online auction and promotions technology and service provider that enables marketers to create results-oriented rewards programs and helps commerce companies automate the process of selling their excess inventory online to wholesale and consumer buyers.

In the promotions area we offer a range of services, technology and expertise that enable large brands to quickly and easily create fun, innovative, interactive and customized marketing programs in conjunction with off-line sales and marketing initiatives. We work with leading brands and agencies to execute programs that help marketers engage customers, drive sales and leverage the eBay community through the exclusive marketing arrangement we entered into with eBay during the second quarter of 2002. Our promotion solution is effective as either the central program concept for a rewards promotion using newly created points currency or as a value added redemption module for use with an existing loyalty program. Our auction and promotions platform can help optimize the return on investment on marketing and promotional budgets and lead to the creation of a higher quality customer database to assist future marketing initiatives.

We also utilize our technology, services and expertise in the commerce area to help large merchants maximize yield on clearance, excess and off-lease inventory and to realize process efficiencies. Our solutions enable merchants to sell to their existing base of wholesale buyers or to buyers on eBay as well as to consumers on their own sites. Our technology is designed to enable our customers to leverage their existing inventory, transaction and fulfillment infrastructures by integrating seamlessly with those systems.

Our services are used in four primary areas: (1) retail and discount clearance; (2) promotions and interactive marketing; (3) business-to-business surplus; and (4) outsourced auctions and e-commerce to portals and other web communities. We provide a broad suite of dynamic pricing and

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points based formats, including auctions, our primary format, as well as fixed price transaction formats for commerce and promotions, falling price formats for commerce, and integrated marketing capability, to create a comprehensive e-business selling and marketing service offering.

We offer our commerce customers the ability to distribute their listings to other sites through two methods. First, through our MarketSelect service, we enable customers (with or without their own FairMarket-hosted dynamic pricing site) to list, manage and transact sales on eBay. Second, because we host our customer s dynamic pricing sites on

our central systems, we have the ability to aggregate listings of goods and services available for sale on our customers' FairMarket-hosted sites and make those listings available for display and sale on other FairMarket-hosted customer sites.

We provide an array of operational and support services to customers. In addition to hosting, customer support and end-user support services, our professional services group provides our customers with a range of business applications, technical customization, integration, e-marketing, usability and other consulting services related to our product offerings.

We believe our success is dependent in large part on increasing our customer base and further enhancing the breadth and functionality of our service offerings, as well as on the volume of our customers' sales on their FairMarket-hosted sites and through our MarketSelect service. We intend to continue to invest in the further enhancement of our service offerings and technology and in the promotion of our service offerings.

Because of our limited operating history, there is limited operating and financial data about our business upon which to base an evaluation of our performance. During 2002, our net losses and negative operating cash flows improved during each quarter. For 2003, we expect our operating losses and negative operating cash flows to improve as we continue in our effort to achieve operating cash flow breakeven. Period-to-period comparisons of operating results should not be relied upon as an indicator of future operating results.

#### **Sources of Revenue**

We derive revenue from: (1) application fees, which consist of implementation and fixed monthly hosting, support and operating fees; (2) transaction fees; and (3) professional services fees, which include fees for the development of business applications, technical customization and integration (including as part of the implementation process), and e-marketing, usability and other consulting services.

We generally charge a one-time set-up fee for the design, development and implementation of a customer's dynamic pricing or points based site or our MarketSelect service. Implementation also frequently entails customization and other professional services, for which we charge a professional services fee. The set-up fee and implementation-related professional services fees vary depending on the nature and the anticipated complexity of the service being implemented. These fees are generally payable upon execution of the contract, recorded as deferred revenue and recognized as revenue, ratably, over the contract period.

Fixed monthly fees are generally charged to customers whose dynamic pricing sites we host and cover hosting services, direct customer support services, end-user customer support services, services for online billing and collection of fees for community sites and other monthly operating services. Fixed monthly fees vary by customer depending on the number of software modules employed, the required level of services and the anticipated level of site activity. These fees are recognized as revenue in the month that the service is provided.

Our Professional Services Group offers our customers a range of business applications, technical customization, integration, e-marketing, usability and other consulting services related to our product offerings for which we may charge either a one-time or a monthly professional services fee, generally based on time and materials used, depending on the nature of the service. These fees are generally recorded as deferred revenue and recognized as revenue, ratably, over the contract period if the service provided is related to an ongoing service relationship, and are recognized as revenue in the period in which the service is provided if unrelated to an ongoing service relationship.



Merchant customers, including MarketSelect customers, pay transaction fees at varying percentages based on the gross proceeds from the sale of their listed products and services, whether sold on their sites, on eBay or on other FairMarket Network sites. For community customers, transaction fees consist of our share of success fees charged to sellers upon a completed sale, listing fees, and enhanced listing fees, which are fees charged for the prominent display of a particular seller or listing (such as under a list of Featured Merchants or Featured Listings ). Community customers pay transaction fees calculated in one of two ways. Generally, under contracts entered into before 2000, these fees are calculated based on a percentage of the gross proceeds from the sale of the items that are listed through the community site and sold either on the community site or on other FairMarket Network sites. The fee percentages vary by customer

depending on the anticipated level of activity on the customer's site and the level of the fixed monthly fees. These communities receive a percentage of the gross proceeds from the sale of items that are listed directly on other sites in the FairMarket Network and sold through the community site. Contracts entered into starting in early 2000 generally provide for payment by the community customer of transaction fees with respect to the sale of listings that are placed on the community site that are calculated as a percentage of the percentage transaction fee that the community charges to its end-users when the listing sells; similarly, for listings that are listed directly through other sites in the FairMarket Network and sold through the community site, the community site receives a percentage of the percentage transaction fee that the listing site charges to the listing site's end-user when the listing sells. We record revenue net of amounts shared with our customers, which we recognize as revenue at the end of the listing period.

Beginning in the second half of 2001, we began to experience a shift in the nature of our revenue, from the fixed monthly fees we traditionally charge for hosting and maintaining customers' sites, to transaction-based fees. We believe that this revenue shift is partly a result of recent economic conditions and pricing competition, and partly a result of an increasing portion of our customers using our MarketSelect service (which we launched during the second quarter of 2001), the fees for which are primarily transaction-based. We are uncertain if this shift from monthly fixed revenue to transaction revenue is permanent in nature. Revenue derived from promotions customers is primarily fixed in nature and we expect to experience an increase in revenue derived from promotions customers in the future.

At no point during the sale process do we take possession of either the products being sold or the buyers' payment for the item. Because merchants and individual sellers, rather than FairMarket, sell the items listed, we have no cost of goods sold, procurement, or carrying or shipping costs and no inventory risk related to the items sold.

### **Critical Accounting Policies**

In December 2001, the SEC requested that all registrants discuss their most critical accounting policies in management's discussion and analysis of financial condition and results of operations. The SEC indicated that a critical accounting policy is one which is both important to the portrayal of the company's financial condition and results and requires management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Our significant accounting policies are more fully described in Note 2, Summary of Significant Accounting Policies, to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2002. These critical accounting policies relate to revenue recognition, allowance for doubtful accounts, deferred tax assets and unutilized office space. No changes to these critical policies have taken place in during the quarter ended March 31, 2003.

### **New Accounting Pronouncements**

In November 2002, the Emerging Issues Task Force issued EITF 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. EITF No. 00-21 establishes three principles: (1) revenue should be recognized separately for separate units of accounting; (2) revenue for a separate unit of accounting should be recognized only when the arrangement consideration is reliably measurable and the earnings process is substantially complete; and (3) consideration should be allocated among the separate units of accounting in an arrangement based on their fair values. EITF No. 00-21 is effective for all revenue arrangements entered into in fiscal periods beginning after June 15, 2003, with early adoption permitted. We do not expect the adoption of EITF No. 00-21 to have a material impact on our results of operations or financial condition.

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In January 2003, the FASB issued FASB Interpretation FIN 46 Consolidation of Variable Interest Entities, an interpretation of ARB 51. FIN 46 provides guidance on the identification of entities for which control is achieved through means other than through voting rights called variable interest entities or VIEs and how to determine when and which business enterprise should consolidate the VIE (the primary beneficiary). This new model for consolidation applies to an entity which either (1) the equity investors (if any) do not have a controlling financial interest or (2) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. In addition, FIN No. 46 requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE make additional disclosures. Certain transitional disclosures are

required in financial statements initially issued after January 31, 2003, if it is reasonably possible that once this guidance is effective the enterprise will either be required to consolidate a VIE or will hold a significant variable interest in a VIE. We currently do not have any interests that would change our current reporting entity or require additional disclosures outlined in FIN No. 46.

### **Results of Operations for the Quarters Ended March 31, 2003 and 2002**

For the quarter ended March 31, 2003, our net loss was \$1.6 million, or \$(0.06) per share, which was a significant decrease compared to our net loss of \$11.8 million, or \$(0.41) per share, for the quarter ended March 31, 2002. The improvement of \$10.2 million in net loss for the quarter ended March 31, 2003 was primarily a result of a decrease in operating expenses of \$10.4 million which included a decrease in equity-related charges of \$4.4 million and a decrease in unutilized office space charge of \$4.5 million when compared to March 31, 2002.

### **Revenue**

Total revenue was \$1.4 million for the quarter ended March 31, 2003, an increase of \$46,000 when compared to total revenue of \$1.3 million for the quarter ended March 31, 2002. The increase in revenue was due primarily to higher transaction revenue which was offset by a slight decline in application fees and professional service fees when compared to the same period of the prior year.

International revenue for the quarter ended March 31, 2003 was \$382,000 (primarily from customers in the U.K.), representing 28.1% of total revenue for the quarter. International revenue for the quarter ended March 31, 2002 was \$361,000 (also primarily from customers in the U.K.), representing 27.5% of total revenue for the quarter. There are risks inherent in doing business internationally, including, among others, fluctuating currency exchange rates, differing legal and regulatory requirements and differing accounting practices. We price, invoice and collect fees for our international services primarily in the local currency. To date, currency fluctuations have not had a material effect on our results of operations and financial condition.

We generally charge a one-time set-up fee for the design, development and implementation of a customer's dynamic pricing site or our MarketSelect service. Implementation also frequently entails customization and other professional services, for which we charge a professional services fee. The set-up fee and implementation-related professional services fees vary depending on the nature and the anticipated complexity of the service being implemented. These fees are generally payable upon execution of the contract, recorded as deferred revenue and recognized as revenue, ratably, over the contract period. At March 31, 2003 and 2002, there was \$523,000 and \$520,000, respectively, of deferred revenue primarily relating to set-up fees and professional services fees.

We ended the first quarter of 2003 with 50 customers, compared to 51 customers at December 31, 2002 and 56 customers at March 31, 2002. For the period ending March 31, 2003 and 2002, we had two customers that each accounted for more than 10% of total revenue; Sam's West, Inc. accounted for 14.6% and 13.2% and Microsoft Corporation accounted for 13.3% and 13.7%, respectively.

Average revenue per customer increased to \$27,100 for the first quarter of 2003 from \$23,600 for the first quarter of 2002. Average revenue per customer for future periods will depend on a number of factors such as our customer mix, the mix of our service offerings, technological changes, our pricing strategies and pricing competition.

**Operating Expenses**

**Cost of revenue** consists of costs for direct customer support, end-user customer service, depreciation of network equipment, fees paid to network providers for bandwidth and monthly fees paid to third-party network providers. Cost of revenue was \$759,000 for the quarter ended March 31, 2003, a decrease of \$265,000, or 25.9%, compared to \$1.0 million for the quarter ended March 31, 2002. As a percentage of revenue, cost of revenue decreased to 56% for the three months ended March 31, 2003, compared to 78% for the three months ended March 31, 2002. The decrease of \$265,000 for the quarter ended March 31, 2003 compared to the same period of last year was due to a reduction in salaries and related expenses of \$115,000 due to reduced headcount and lower fees of \$150,000 paid to network providers for bandwidth.

Gross profit increased to 44% for the quarter ended March 31, 2003 compared to 22% for the quarter ended March 31, 2002. This increase in gross profit is primarily attributable to the decrease in expenses as described in cost of revenue. The gross profits reported above are not necessarily indicative of gross profits for future periods. Actual

gross profits may vary significantly depending on, among other things, customer mix, product mix, price competition, technological changes and extraordinary costs. Our cost of revenue components are fixed in nature and will continue to be fixed in the short term, as a result gross profit is largely based on revenue results.

**Sales and marketing** expenses were \$562,000 for the quarter ended March 31, 2003, a decrease of \$72,000, or 11.4%, compared to sales and marketing expenses of \$634,000 for the quarter ended March 31, 2002. The decrease in sales and marketing expenses was due primarily to a reduction in salaries and related expenses when compared to the prior year.

**Development and engineering** expenses were \$352,000 for the quarter ended March 31, 2003, a decrease of \$442,000, or 55.7%, compared to development and engineering expenses of \$794,000 for the quarter ended March 31, 2002. This decrease was primarily due to a reduction in salaries and related expenses resulting from lower headcount when compared to the quarter ended March 31, 2002.

**General and administrative** expenses were \$1.4 million for the three months ended March 31, 2003, a decrease of \$725,000, or 34%, compared to general and administrative expenses of \$2.1 million for the three months ended March 31, 2002. The decrease was due primarily to the reduction in facilities expenses of \$218,000 as a result of the charge for unutilized office space recorded during the first quarter of 2002 and a decrease in depreciation expense of \$300,000 as a result of certain assets being fully depreciated when compared to the quarter ended March 31, 2002.

**Unutilized office space charge.** In the first quarter of 2002, we recorded a charge of \$4.5 million for unutilized office space at our Woburn, Massachusetts headquarters. This charge included rent and other related costs for a significant portion of our leased space which has been vacated for the remaining lease term and the write-down of related leasehold improvements and furniture and fixtures. In the fourth quarter of 2002, we recorded a reversal of \$513,000 related to a sublease of approximately 11,000 square feet of the unutilized office space. During 2002, we paid \$746,000 against this accrual, which represented rent payments related to unutilized office space. In addition, we recorded \$1.2 million for the write-down of leasehold improvements and furniture and fixtures. During the period ending March 31, 2003 we paid \$249,000 against this accrual for rent payments related to unutilized office space. As of March 31, 2003, \$1.8 million of the total charge remained accrued and unpaid relating to future rent payments related to unutilized office space.

	(in thousands)
Roll forward of activity for unutilized office space	
Initial charge recorded in March 2002	\$ 4,500
Non-cash write-down of leasehold improvements and furniture and fixtures	(1,161)
Cash payments made in 2002	(746)
Reversal of accrual in December 2002	(513)
Unutilized space accrual at December 31, 2002	2,080

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Cash payments made in the first quarter ended March 31, 2003		(249)
Unutilized office space accrual at March 31, 2003	\$	1,831

**Equity-related charges** consist of the amortization of (i) deferred stock compensation resulting from the grant of stock options to employees at exercise prices subsequently deemed to be less than the fair value of our common stock on the grant date and (ii) the fair value of warrants issued to certain strategic customers and shares of our Series D convertible preferred stock issued to certain strategic customers at prices below fair value.

At March 31, 2003, deferred stock compensation, which is a component of deferred compensation and equity-related charges in stockholders equity, totaled \$69,000 net of equity-related charges of \$52,000 amortized to the consolidated statement of operations and canceled stock options valued at \$38,000. This \$69,000 is being amortized ratably over the vesting periods of the applicable stock options, typically four years, with 25% vesting on the first anniversary of the grant date and the balance vesting 6.25% quarterly thereafter.

**Other Income, net**

Other income, net, was \$215,000 for the three months ended March 31, 2003, a decrease of \$190,000 compared to other income, net, of \$405,000, for the three months ended March 31, 2002. This decrease was due to lower

interest income from lower average balances of cash, cash equivalents and investments and lower interest rates in the first quarter of 2003 compared to the same period of last year.

### **Liquidity and Capital Resources**

At March 31, 2003, cash and cash equivalents, marketable securities and restricted cash (related to a lease deposit) totaled \$53.6 million.

Cash used in operating activities was \$1.8 million for the three months ended March 31, 2003 and \$2.8 million for the three months ended March 31, 2002. Net cash flows used in operating activities for the three months ended March 31, 2003 reflect a net loss of \$1.6 million combined with an increase in prepaid expenses and other current assets, partially offset by depreciation and a decrease in accounts receivable. Net cash flows used in operating activities for the three months ended March 31, 2002 reflect a net loss of \$11.8 million combined with an increase in prepaid expenses and other current assets, partially offset by depreciation, amortization of deferred compensation and equity-related charges, loss on disposal of property and equipment, and short- and long-term liabilities related to the unutilized office space charge.

Cash used by investing activities was \$687,000 for the three months ending March 31, 2003 which was due mainly to the purchase of marketable securities. Cash provided by investing activities was \$2.1 million for the three months ended March 31, 2002. Net cash provided by investing activities for the three months ended March 31, 2002 was primarily attributable to proceeds from the sale of marketable securities.

Cash provided by financing activities was \$24,000 and \$11,000 for the three months ended March 31, 2003 and 2002, respectively which was due to the proceeds from the issuance of common stock. The holders of the Series B preferred stock have the right to require the Company to redeem the Series B preferred stock for cash at any time after the earlier of (a) May 17, 2003, and (b) the happening of a material adverse effect on the Company's business, as defined in the Series B preferred stock terms.

We believe, based on our present business plan, that our current cash, cash equivalents and marketable securities and our cash flows from operations will be sufficient to meet our working capital and operating resource expenditure requirements for at least the next twelve months. If the assumptions underlying our business plan regarding future revenue and expenditures change or if unexpected opportunities or needs arise, we may find it necessary to obtain additional equity or debt financing. If additional financing is required, we may not be able to raise it on acceptable terms or at all.

### **Factors that May Affect Results of Operations and Financial Condition**

*This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. You can identify forward-looking statements by the use of the words believe, expect, anticipate, intend, estimate, assume and other similar expressions which predict or indicate future events and trends and which do not relate to historical matters. You should not rely on forward-looking statements, because they involve known and unknown risks, uncertainties and other factors, some of which are beyond our control. Our actual results could differ materially from those set forth in the forward-looking statements.*



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*Some of the factors that might cause these differences include those set forth below. You should carefully review all of these factors, and you should be aware that there may be other factors that could cause these differences. These forward-looking statements were based on information, plans and estimates at the date of this Form 10-Q, and we do not promise to update any forward-looking statements to reflect changes in underlying assumptions or factors, new information, future events or other changes.*

## Risks Related to Our Business

**Our business is difficult to evaluate, our business strategy may not successfully address risks we face and your basis for evaluating us is limited.**

We were formed in February 1997 and we began to execute our current business model involving the offering of outsourced, private-label auction solutions in December 1998, which we have since expanded to include additional transaction pricing and points based promotions and distribution capabilities. While a high percentage of our operating expenses have historically been, and are expected to continue to be, fixed in the short term, our operating expenses are largely based on unpredictable revenue trends. Because of our limited operating history, our business strategy may not successfully address all of the risks we face, and you have limited operating and financial data about our business upon which to base an evaluation of our performance.

We face the following risks, expenses and difficulties as a company seeking to develop a new Internet-based service:

if we fail to attract and retain quality customers we may be unable to generate sufficient revenue to support our business;

if we fail to attract and retain qualified sales, engineering and other personnel we may be unable to maintain and expand our business;

if we fail to maintain and upgrade our service offerings and technology to keep pace with the rapidly growing Internet market we serve we may be unable to compete effectively; and

if we fail to raise additional capital if and when we need it we may be unable to develop or sustain our business.

**We expect to continue to incur substantial operating losses in the near future.**

For the quarter ended March 31, 2003, we incurred a net loss of approximately \$1.6 million, which represented approximately 114.4% of our revenue for the same period. As of March 31, 2003, we had an accumulated deficit of approximately \$133.5 million. We have not achieved profitability and we will continue to incur net losses until we can produce sufficient revenues to cover our costs, which may not occur. While it is our goal to achieve profitability, even if we achieve profitability, we may be unable to sustain or increase our profitability in the future because we intend to continue to invest in the further development of our service offerings and technology and in the promotion of our service offerings. Any such investment will depend on the availability of funds.

**We expect to continue to have negative operating cash flow in the near future, and we may need to seek additional financing, which could be difficult to obtain.**

We expect to continue to experience negative operating cash flows for the foreseeable future because we intend to continue to invest in the further enhancement of our service offerings and technology and in the promotion of our service offerings. We expect that we will fund these expenditures primarily from available cash.

We believe, based on our present business plan, that our current cash, cash equivalents and marketable securities and our cash flows from operations will be sufficient to meet our working capital and operating resource expenditure requirements for both the short-term and long-term. If the assumptions underlying our business plan regarding future revenue and expenditures change or if unexpected opportunities or needs arise, including potential acquisitions using cash, we may find it necessary to obtain additional equity or debt financing. If additional financing is required, we may not be able to raise it on acceptable terms or at all.

**We may acquire other businesses or technologies, which could result in dilution to our stockholders, or operational or integration difficulties which could impair our financial performance.**

If appropriate opportunities present themselves, we may acquire businesses, technologies, services or products that we believe will be useful in the growth of our business. We do not currently have any commitments or agreements with respect to any acquisition. We may not be able to identify, negotiate or finance any future acquisition successfully. Even if we do succeed in acquiring a business, technology, service or product, the process of integration may produce

unforeseen operating difficulties and expenditures and may require significant attention from our management that would otherwise be available for the ongoing development of our business. Moreover, we have not made any acquisitions, have no experience in integrating an acquisition into our business and may never achieve any of the benefits that we might anticipate from a future acquisition. If we make future acquisitions, we may issue shares of stock that dilute other stockholders, incur debt or assume contingent liabilities, any of which might harm our financial results and cause our stock price to decline. Any financing that we might need for future acquisitions may only be available to us on terms that restrict our business or that impose on us costs that reduce our revenue.

**We may not be able to continue to attract new customers or retain existing customers.**

The success of our business model depends in large part on our ability to increase our number of customers and to retain existing customers. The market for our services may grow more slowly than anticipated or become saturated with competitors, many of which may offer lower prices or broader distribution. In addition, the sales cycle for larger brand companies, retailers and manufacturers, where we currently focus our sales efforts, is generally longer than for the smaller companies and e-commerce companies that made up a larger part of our customer base in prior years. We also believe that uncertain economic conditions during 2001 and 2002, and which have continued in 2003, have resulted in a longer decision-making and implementation process with customers and during 2001 and 2002 led in many cases to customer contract terminations as a result of the customer ceasing operations or focusing on other areas of their business. If we cannot continue to attract new customers on a timely basis or at all, or if we cannot maintain our existing customer base, our business and revenues would be adversely affected.

**A loss of any client that accounts for a large portion of our revenues could cause our revenues to decline.**

For the quarter ending March 31, 2003, two of our customers accounted for approximately 28% of total revenue. If either of these contracts is not renewed or otherwise terminates, and if we are unable to replace it with other client agreements, our revenues would decline and our losses would likely increase.

**Because our industry is highly competitive and has low barriers to entry, we may not be able to effectively compete.**

The U.S. market for e-commerce services is extremely competitive. We expect competition to intensify as current competitors expand their product offerings and new competitors enter the market. In the surplus online auction market, in addition to competition from internally-developed solutions by individual organizations, we face competition for customers from third party online auction enablers, such as ChannelAdvisor and Auctionworks, that facilitate the distribution of listings to third party auction sites such as eBay and Yahoo! Auctions.

In the online loyalty program market, in addition to competition from internally-developed solutions by individual organizations, we face competition from third party providers in the following areas:

destination sites with loyalty auction programs, such as Yahoo! Auctions; and

third party loyalty program enablers such as SoftCoin, eDeals and Rocketcash who may extend their offerings to incorporate capabilities similar to those offered by our loyalty program service.

The principal competitive factors include price, quality and breadth of services provided and potential for successful transaction activity. E-commerce and marketing technology markets are characterized by rapidly changing technologies, changing requirements of customers and frequent new product and service introductions. We may fail to introduce new online pricing formats and features on a timely basis or at all. If we fail to introduce new service offerings or to improve our existing service offerings in response to industry developments, or if our prices are not competitive, we could lose customers, which could lead to a loss of revenues.

Because there are relatively low barriers to entry in the e-commerce market, competition from other established and emerging companies may develop in the future. Many of our competitors may also have well-established

relationships with our existing and prospective customers. Increased competition is likely to result, and in some cases has resulted, in fee reductions, reduced margins, longer sales cycles for our services and a decrease or loss of our market share, any of which could harm our business, operating results or financial condition.

Many of our competitors have, and new potential competitors may have, more experience developing Internet-based software applications and integrated purchasing solutions, larger technical staffs, larger customer bases, more and longer-standing distribution channels, greater brand recognition and greater financial, marketing and other resources than we have. In addition, competitors may be able to develop products and services that are superior to ours or that achieve greater customer acceptance. We cannot assure you that the e-commerce solutions offered by our competitors now or in the future will not be perceived as superior to ours by either businesses or consumers.

**Our customers may not successfully increase transactions on their dynamic pricing sites.**

Beginning in the second half of 2001, we began to experience a shift in the nature of our revenue, from the fixed monthly fees we traditionally charge for hosting and maintaining customers' sites, to transaction-based fees. We believe that this revenue shift is partly a result of recent economic conditions and pricing competition, and partly a result of an increasing portion of our customers using our MarketSelect service (which we launched during the second quarter of 2001), the fees for which are primarily transaction-based. To the extent this revenue shift continues, our success will increasingly depend on increases in the amount of user traffic and the number of transactions on our customers' FairMarket-hosted sites or on eBay through our MarketSelect service. For this to occur, our existing customers must drive sufficient numbers of users to their FairMarket-hosted sites, they must devote sufficient resources to making their sites attractive to buyers and sellers and there must be demand for the products being offered on those sites and on eBay through our MarketSelect service. We cannot assure you that our customers will be successful in accomplishing any of these objectives and their failure to do so could impede our growth and adversely affect our business and revenues.

**Our workforce reductions may impact our ability to attract or retain key personnel.**

Our future success will depend, in part, on attracting and retaining qualified personnel. In late June 2002, we eliminated 18 positions worldwide, representing approximately 31% of our total employee base. Previously, in 2001, we implemented two workforce reductions in which we eliminated 78 positions, and in 2000 we implemented a workforce reduction in which we eliminated 35 positions. We also experienced a number of management changes in the first half of 2001 and the first half of 2002. Management changes during the first half of 2002 included the election of Nanda Krish as full-time President and Chief Executive Officer, the appointment of three new directors to our Board of Directors, and the resignations of our Vice President of Sales and Marketing and our Vice President of Engineering. We experienced some attrition in personnel prior to and following these workforce reductions and believe that we may experience additional attrition in the future.

We cannot assure you that we will be successful in hiring or retaining qualified personnel. Our inability to attract and retain qualified personnel on a timely basis, or the departure of key employees, could harm our existing business and ability to expand or maintain our operations.

**We may not be successful in international markets.**

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A component of our strategy has been to attract customers outside the U.S. For the quarter ended March 31, 2003 and 2002, revenue under contracts with customers outside the U.S. (primarily in the United Kingdom) represented approximately 28.1% and 27.5% of our total revenue, respectively. During 2000, we opened offices in England, Australia and Germany. We completed the closing of our office in Germany during the third quarter of 2001 and the closing of our office in Australia during the first quarter of 2002. We continue to service our Australian customers out of our U.S. operations. We believe that significant opportunities exist in international markets, and we continue to evaluate our international strategy. Doing business in international markets requires significant management, financial, development, sales, marketing and other resources. We have limited experience in localizing our services, and some of our competitors have expanded or are undertaking expansion into foreign markets. We cannot assure you that we will expand into new, or continue our existing operations in, international markets or that we will be successful in international markets.

In addition to the uncertainty regarding our ability to generate revenues from foreign operations and expand or maintain our international presence, there are risks inherent in doing business internationally, including, among others:

different legal and regulatory requirements;

difficulties in staffing and managing foreign operations;

longer payment cycles;

different accounting practices;

fluctuating currency exchange rates;

problems in collecting accounts receivable;

legal uncertainty regarding liability, ownership and protection of intellectual property;

tariffs and other trade barriers;

seasonal reductions in business activity;

potentially adverse tax consequences; and

political instability.



Any of the above factors could adversely affect the success of our international operations. To the extent we expand our international operations; we will become more exposed to the above risks. To the extent we have increasing portions of our revenues denominated in foreign currencies, we will become subject to increased risks relating to foreign currency exchange rate fluctuations. We cannot assure you that one or more of the factors discussed above will not have a material adverse effect on our international operations and, consequently, on our results of operations and financial condition.

**Buyers and sellers might not adopt online auction or other dynamic pricing solutions as a means for buying and selling goods and services.**

Online auction and other dynamic pricing solutions are relatively new methods of buying and selling that market participants may not adopt at levels sufficient to sustain our business. Traditional purchasing is often based on long-standing relationships or familiarity with sellers. For online dynamic pricing solutions to succeed, buyers and sellers must adopt new purchasing practices. Buyers must be willing to rely less upon traditional relationships in making purchasing decisions, and businesses must be willing to offer products for sale through online dynamic pricing solutions. We cannot assure you that online dynamic pricing solutions will be adopted at levels sufficient to sustain our business.

**We may need to enter into strategic alliances or license technologies to expand our business or service offerings but may not be successful in doing so.**

In addition to internal development of new technologies, our future success may depend to a certain degree on our ability to enter into and implement strategic alliances to expand our product and service offerings and our distribution channels and/or to jointly market or gain market awareness for our service offerings. For example, during the second quarter of 2001 we expanded our auction service in the U.S. to provide customers with the opportunity to list, manage and transact sales through eBay. In the second quarter of 2002, we entered into an exclusive 18-month agreement with eBay to provide our loyalty marketing program technology platform to third parties. We may also expand our service offerings by licensing or purchasing complementary technologies from third parties. For example,

during the first quarter of 2001 we announced that we licensed certain real-time e-business infrastructure software from TIBCO Software Inc. to enable us to provide real-time messaging infrastructure. We cannot assure you that we will be successful in identifying, developing or maintaining such alliances and relationships or that such alliances and relationships will achieve their intended purposes.

**Others may assert that our technology infringes their intellectual property rights.**

The e-commerce industry is characterized by the existence of a large number of patents and frequent claims and litigation based on allegations of patent infringement and violation of other intellectual property rights. As the e-commerce market and the functionality of products in the industry continues to grow and overlap, we believe that the possibility of intellectual property claims against us will increase. For example, we may inadvertently infringe a patent of which we are unaware, or there may be patent applications now pending of which we are unaware which we may be infringing when they are issued in the future, or our service or systems may incorporate third party technologies that infringe the intellectual property rights of others. We have been and expect to continue to be subject to alleged infringement claims. The defense of any claims of infringement made against us by third parties, whether or not meritorious, could involve significant legal costs and require our management to divert time from our business operations. Either of these consequences of an infringement claim could have a material adverse effect on our operating results. If we are unsuccessful in defending any claims of infringement, we may be forced to obtain licenses or to pay royalties to continue to use our technology. We may not be able to obtain any necessary licenses on commercially reasonable terms or at all. If we fail to obtain necessary licenses or other rights, or if these licenses are costly, our operating results may suffer either from reductions in revenues through our inability to serve customers or from increases in costs to license third-party technologies.

**Our business may suffer if we are not able to protect important intellectual property.**

Our ability to compete effectively against other companies in our industry will depend, in part, on our ability to protect our proprietary technology and systems designs. While we have attempted to safeguard and maintain our proprietary rights, we cannot assure you that we have been or will be completely successful in doing so. Further, our competitors may independently develop or patent technologies that are substantially equivalent or superior to ours.

We have applied for patents on aspects of our technology and processes and those applications are pending with the U.S. Patent and Trademark Office. We cannot assure you that any patents will be issued. Even if some or all of these patents are issued, we cannot assure you that they will not be successfully challenged by others or invalidated, that they will adequately protect our technology and processes or that they will result in commercial advantages for us. FairMarket is a registered service mark in the U.S. We have applied for trademark registrations for some of our other brand names, and our marketing materials are copyrighted, but these protections may not be adequate. Effective patent, trademark, service mark, copyright and trade secret protection may not be available in every country where we provide services. We may, at times, have to incur significant legal costs and spend time defending our copyrights and, if issued, our service marks and patents. Any defense efforts, whether successful or not, would divert both time and resources from the operation and growth of our business.

**We may not be able to maintain the confidentiality of our proprietary knowledge.**

We rely, in part, on contractual provisions to protect our trade secrets and proprietary knowledge. These agreements may be breached, and we may not have adequate remedies for any breach. Our trade secrets may also be known without breach of such agreements or may be independently developed by competitors. Our inability to maintain the proprietary nature of our technology could harm our business, results of

operations and financial condition by adversely affecting our ability to compete.

**Our business may be adversely affected if we are unable to continue to license software that is necessary for our service offering.**

Through distributors, we license a variety of commercially-available Microsoft technologies, including our database software and Internet server software, which is used in our services and systems to perform key functions. We

also license other third party technology to perform certain functions of our service, such as our search functionality, which utilizes technology from Verity, Inc., and technology that we license from TIBCO Software Inc., which we use in certain of our integration solutions. As a result, we are to a certain extent dependent upon those third parties continuing to maintain their technologies. We cannot assure you that we would be able to replace the functionality provided by these third party technologies on commercially reasonable terms or at all. The absence of or any significant delay in the replacement of certain functionalities could have a material adverse effect on our business, financial condition and results of operations.

**Our systems infrastructure may not keep pace with the demands of our customers.**

Interruptions of service as a result of a high volume of traffic and/or transactions could diminish the attractiveness of our services and our ability to attract and retain customers. We cannot assure you that we will be able to accurately project the rate or timing of increases, if any, in the use of our service, or that we will be able to expand and upgrade our systems and infrastructure to accommodate such increases in a timely manner. We currently maintain separate systems in the U.S. for our U.S., U.K. and Australia services. Any failure to expand or upgrade our systems could have a material adverse effect on our results of operations and financial condition by reducing or interrupting revenue flow and by limiting our ability to attract new customers. Any such failure could also have a material adverse effect on the business of our customers, which could damage our reputation and expose us to a risk of loss or litigation and potential liability. The majority of the server capacity of our systems for each of the countries named above is currently not utilized.

**A system failure could cause delays or interruptions of service to our customers.**

Service offerings involving complex technology often contain errors or performance problems. Many serious defects are frequently found during the period immediately following introduction and initial implementation of new services or enhancements to existing services. Although we attempt to resolve all errors that we believe would be considered serious by our customers before implementation, our systems are not error-free. Errors or performance problems could result in lost revenues or cancellation of customer agreements and may expose us to litigation and potential liability. We have from time to time discovered errors in our software or software of others used in our operating systems after its incorporation into our systems. We cannot assure you that undetected errors or performance problems in our existing or future services will not be discovered or that known errors considered minor by us will not be considered serious by our customers. We have experienced periodic minor system interruptions, which may continue to occur from time to time. Most of our contracts provide for the payment or credit to the customer of specified money damages (based on the monthly service fee paid by the customer) if we are unable to maintain specified levels of service based on downtime of either their FairMarket-hosted sites or our centralized service over a specified period, typically one month. The total dollar amount of our potential payment or credit obligations under these provisions if the service levels specified in all of those agreements were not met over the typical one month measurement period could be material. In addition, certain of our contracts also provide the customer with the right to terminate the contract if we are unable to maintain a minimum specified level of service. Performance problems in our technology could also damage our reputation, which could reduce market acceptance of our services and lead to a loss of revenues.

**The functioning of our systems or the hosting facilities of third parties on which we rely could be disrupted by factors outside our control.**

Our success depends on the efficient and uninterrupted operation of our computer and communications hardware systems. Substantially all of our computer hardware for operating our U.S., U.K. and Australia services is currently located at the facilities of NaviSite, Inc. in Andover, Massachusetts. The computer hardware for our end-user customer service system is also hosted by a third party. These systems are vulnerable to damage or interruption from natural disasters, fires, power loss, telecommunication failures, break-ins, sabotage, computer viruses, intentional acts of vandalism, acts of terrorism and similar events. All of our systems are located in the same facility and we do not currently have a backup

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system in place for any of these systems. Despite any precautions we take or plan to take, the occurrence of a natural disaster or other unanticipated problems at any third party hosting facility could result in interruptions in our services. In addition, if any third party hosting service fails to provide the data communications capacity we require, as a result of human error, natural disaster or other operational disruption, interruptions in our

service could result. Any damage to or failure of our systems could result in reductions in, or terminations of, our service, which could have a material adverse effect on our business, results of operations and financial condition.

**Our business may suffer if buyers and sellers do not make payments or deliver goods.**

Our success may depend to some extent upon sellers on customer sites reliably delivering and accurately representing their listed goods and buyers paying the agreed purchase price. Our customers have received in the past, and we anticipate that they will receive in the future, communications from sellers and buyers who did not receive the purchase price or the goods that were to have been exchanged. Neither we nor our customers have the ability to require end-users to make payments or deliver goods or otherwise make end-users whole. Our customers also periodically receive complaints from buyers as to the quality of the goods purchased. We are unaware of any complaints that have materially impacted our customers' businesses in a detrimental manner. Neither we nor our customers have the ability to determine the level of such complaints that are made directly between buyers and sellers. We expect that both we and our customers will continue to receive requests from end-users requesting reimbursement or threatening legal action against either our customers or us if no reimbursement is made.

**We may have to monitor or control activities on customer sites.**

The law relating to the liability of providers of online services for the activities of users of their services is currently unsettled in the U.S. and in other countries. Our service automatically screens by key word all listings submitted by end-users for pornographic material. We also have notice and take-down procedures related to infringing and illegal goods. These procedures are not foolproof and goods that may be subject to regulation by U.S. local, state or federal authorities or local foreign authorities could be sold through our service. These goods include, for example, firearms, alcohol and tobacco. We cannot assure you that we will be able to prevent the unlawful exchange of goods on our service or that we will successfully avoid civil or criminal liability for unlawful activities carried out by users through our service. The potential imposition of liability for unlawful activities of end-users of our customers could require us to implement measures to reduce our exposure to such liability, which may require us, among other things, to spend substantial resources and/or to discontinue one or more of our service offerings. Any costs incurred as a result of such liability or asserted liability would harm our results of operations.

**Future government regulation of auctions and auctioneers may add to our operating costs.**

Numerous U.S. jurisdictions have laws and regulations regarding the conduct of auctions and the liability of auctioneers, which were enacted for consumer protection many years ago. We believe that the U.S. laws and regulations do not apply to our online auction services. However, little precedent exists in this area, and one or more jurisdictions in the U.S. or in other countries in which we do business are attempting or may attempt to impose these laws and regulations on online auction providers and may attempt to impose these laws and regulations on our operations or the operations of our customers in the future. Certain states are currently considering whether to apply their auctioneer regulations to online auctions and at least one state has passed legislation that applies to the conduct of all auctions, including auctions conducted over the Internet. If any such statute or regulation is interpreted to apply to us or to our customers, we and/or those of our customers to whom the statute applies could be required to obtain a license. This could adversely affect our ability to attract and retain customers, could adversely affect our results of operations by decreasing activity on our customers' auction sites and could subject us or our customers to fines if we or our customers are unable to obtain the required licenses. In addition, as the nature of the products listed by our customers or their end-users changes, we may become subject to new regulatory restrictions. If we do become subject to these laws and regulations in the future, it could adversely affect our ability to attract and retain customers and could adversely affect our results of operations by decreasing activity on our customers' FairMarket-hosted sites.

**Future sales of our common stock could adversely affect our stock price.**

A substantial portion of our common stock is held by a small number of investors and can be resold or is subject to registration rights. Sales of substantial amounts of our common stock in the public market, or the perception that a large number of shares are available for sale, could cause the market price of our common stock to decline. In addition to the adverse effect a price decline could have on holders of our common stock, such a decline would likely

impede our ability to raise capital through the issuance of additional shares of our common stock or other equity securities. Such a decline could also cause our common stock to trade at a per share price of less than \$1.00 which could lead to a delisting of our common stock from Nasdaq.

The holders of approximately 9,757,029 shares of our common stock (including at least 952,380 shares of common stock issuable upon conversion of shares of Series B Preferred Stock), have rights, subject to some conditions, to require us to file registration statements covering their shares, or to include their shares in registration statements that we may file for FairMarket or other stockholders. Pursuant to the exercise of these rights, we have registered the resale of 9,757,029 shares of our common stock on a Form S-3 registration statement. By selling a large number of shares, these holders could cause the price of our common stock to decline. Furthermore, if we were to include in a FairMarket-initiated registration statement shares held by those holders pursuant to the exercise of their registration rights, those sales could impair our ability to raise needed capital by depressing the price at which we could sell our common stock.

### **Risks Related to Our Industry**

#### **Our success depends on the continued growth of the Internet and online commerce.**

Our future revenues and profits depend upon the widespread acceptance and use of the Internet and other online services as a medium for commerce by businesses and consumers. The use of the Internet and e-commerce may not continue to develop at past rates and a sufficiently broad base of business and individual customers may not adopt or continue to use the Internet as a medium of commerce. The market for the sale of goods and services over the Internet is an emerging market. Demand and market acceptance for online services and for the sale of goods and services over the Internet are subject to a high level of uncertainty. Growth in our customer base depends on obtaining businesses and consumers who have historically used traditional means of commerce to purchase goods and services. For us to be successful, these market participants must accept and use novel ways of conducting business and exchanging information.

E-commerce may not prove to be a viable medium for purchasing for the following reasons, any of which could seriously harm our business:

the necessary infrastructure for Internet communications may not develop adequately;

our potential customers, buyers and suppliers may have security and confidentiality/privacy concerns;

complementary products, such as high-speed modems and high-speed communication lines, may not be developed;

alternative purchasing solutions may be implemented;



buyers may dislike the reduction in the human contact inherent in traditional purchasing methods;

use of the Internet and other online services may not continue to increase or may increase more slowly than expected;

the development or adoption of new technology standards and protocols may be delayed or may not occur;  
and

new and burdensome governmental regulations may be imposed.

**Our success depends on the continued reliability of the Internet.**

The Internet continues to experience significant growth in the number of users, frequency of use and bandwidth requirements. We cannot assure you that the infrastructure of the Internet and other online services will be able to

support the demands placed upon them. Furthermore, the Internet has experienced a variety of outages and other delays as a result of damage to portions of its infrastructure, and could face such outages and delays in the future. These outages and delays could adversely affect the level of Internet usage and also the level of traffic and the processing of transactions. In addition, the Internet or other online services could lose their viability due to delays in the development or adoption of new standards and protocols required to handle increased levels of Internet or other online service activity, or due to increased governmental regulation. Changes in or insufficient availability of telecommunications services or other Internet service providers to support the Internet or other online services also could result in slower response times and adversely affect usage of the Internet and other online services generally and our service in particular. If use of the Internet and other online services does not continue to grow or grows more slowly than expected, if the infrastructure of the Internet and other online services does not effectively support growth that may occur, or if the Internet and other online services do not become a viable commercial marketplace, we will have to adapt our business model to the new environment, which would materially adversely affect our results of operations and financial condition.

**Government regulation of the Internet may impede our growth or add to our operating costs.**

Like many Internet-based businesses, we operate in an environment of tremendous uncertainty as to potential government regulation. The Internet has rapidly emerged as a commerce medium, and governmental agencies have not yet been able to adapt all existing regulations to the Internet environment. Laws and regulations have been introduced or are under consideration and court decisions have been or may be reached in the U.S. and other countries in which we do business that affect the Internet or other online services, covering issues such as pricing, user privacy, freedom of expression, access charges, content and quality of products and services, advertising, intellectual property rights and information security. In addition, it is uncertain how existing laws governing issues such as taxation, property ownership, copyrights and other intellectual property issues, libel, obscenity and personal privacy will be applied to the Internet. The majority of these laws were adopted prior to the introduction of the Internet and, as a result, do not address the unique issues of the Internet. Recent laws that contemplate the Internet, such as the Digital Millennium Copyright Act in the U.S., the European Union Electronic Commerce Directive (the Electronic Commerce Directive ) and the European Union Directive on Copyright in the Information Society ( Copyright Directive ), have not yet been fully interpreted by the courts and their applicability is therefore uncertain. The Digital Millennium Copyright Act provides certain safe harbors that limit the risk of copyright infringement liability for service providers such as FairMarket with respect to infringing activities engaged in by users of the service, such as end-users of our customers dynamic pricing sites. We have adopted policies and practices to qualify for one or more of these safe harbors, but we cannot assure you that our efforts will be successful since the Digital Millennium Copyright Act has not been fully interpreted by the courts and its interpretation is therefore uncertain. The European Union Electronic Commerce Directive has already been implemented in the United Kingdom, Spain and Germany. Other Member States should also be implementing this Directive in due course. The UK Electronic Commerce (EC Directive) Regulations contain informational requirements for online sellers, requirements for electronic communications and concluding contracts online and provisions limiting the liability of service providers for unlawful content in certain instances. These regulations may affect our operations in the U.K. if our customers or we, as applicable, do not adequately update our respective practices to comply with the new U.K. regulations implementing this EC Directive. Legislation implementing the Electronic Commerce Directive in other Member States may similarly affect us or our customers. In Australia, recent amendments have been made to the Copyright Act 1968 to regulate copyright issues arising in the context of the Internet. In addition, the Broadcasting Services Act 1992 has been recently amended to establish a notice and take-down procedure with respect to offensive or obscene content. These amendments provide specific immunities and/or defenses for Internet service providers. However, the full application of these immunities and defenses has not yet been tested. The Copyright Directive attempts to harmonize copyright in areas of digital transmission but has yet to be implemented in the Member States across Europe (including the U.K.). Although Member States should have implemented the Copyright Directive by December 22, 2002, this has not yet taken place. However implementation by Member States is expected to occur in the near future and this may impact on our and our customer s business.

In the area of user privacy, several states have proposed legislation that would limit the uses of personal user information gathered online or require online services to establish privacy policies. The Federal Trade Commission also has become increasingly involved in this area, and recently settled an action with one online service regarding the manner in which personal information is collected from users and provided to third parties. The European Union Directive on the Protection of Personal Data, as implemented in the relevant member states, may affect our operations in



the U.K. if we or our customers do not afford adequate privacy to end-users of our customers' sites. Additionally, the recently adopted European Union Directive on Protection of Privacy in the Electronic Communications sector, when implemented in the relevant Member States, may also affect our operations in the UK if we, or our customers, do not update our policies and practices accordingly. This Directive contains a number of provisions regulating unsolicited communications, including email. Member States have until October 31, 2003 to implement this Directive. The Australian Privacy Amendment (Privacy Sector) Act of 2000, which has an exemption for certain types of small businesses, became effective in December 2001 and may have a similar effect. We do not sell personal user information from our customers' sites. Generally, as between FairMarket and our customers, the personal user information belongs to the customer, not FairMarket, and each site is governed by the respective customer's own privacy policy. We do use aggregated data for analyses regarding our services, and do use personal user information in the performance of our services for our customers. Since we do not control what our customers do with the personal user information they collect, we cannot assure you that our customers' sites will be considered compliant.

As online commerce evolves, we expect that federal, state or foreign agencies will adopt regulations covering issues such as pricing, content, user privacy, hosting liability and quality of products and services. Any future regulation may have a negative impact on our business by restricting our methods of operation or imposing additional costs. Although many of these regulations may not apply to our business directly, we anticipate that laws regulating the solicitation, collection or processing of personal information could indirectly affect our business.

Title V of the Telecommunications Act of 1996, known as the Communications Decency Act of 1996, prohibited the knowing transmission of any comment, request, suggestion, proposal, image or other communication that is obscene or pornographic to any recipient under the age of 18. Substantial portions of the Communications Decency Act of 1996 regarding such communications have been held to be unconstitutional. Subsequent similar legislation, known as the Child Online Protection Act, designed to comport with the constitutional concerns articulated by the Supreme Court, has been enacted; however, the constitutionality of that legislation is currently being litigated as well. As such, the prohibition's scope and the liability associated with a violation are currently unsettled. In addition, we cannot be certain that similar legislation will not be enacted and upheld in the future. It is possible that such legislation could expose companies involved in online commerce to liability, which could limit the growth of online commerce generally. Legislation like the Communications Decency Act could reduce the growth in Internet usage and decrease its acceptance as a communications and commerce medium.

The worldwide availability of Internet web sites often results in sales of goods to buyers outside the jurisdiction in which we or our customers are located, and foreign jurisdictions may claim that we or our customers are required to comply with their laws. As an Internet company, it is unclear which jurisdictions may find that we are conducting business therein. Our failure to qualify to do business in a jurisdiction that requires us to do so could subject us to fines or penalties and could result in our inability to enforce contracts in that jurisdiction.

**Regulation of promotional programs and email marketing may restrict our operations or increase our operating costs.**

We offer to our customers a variety of promotional and incentive programs including coupon and rebate programs as well as sweepstakes, contests and other games. These types of programs are subject to a variety of federal, state and local laws and regulations. Some of these states, including New York, Florida, Rhode Island and Arizona, require that sponsors of certain types of sweepstakes and contests register with the state and provide a bond to secure the prizes. In addition, a number of states have special disclosure and registration requirements for promotions offered in connection with certain industries, such as alcohol, gasoline, and milk or offered in conjunction with a charitable organization.

In addition, marketing via email continues to be an area of focus for both federal and state legislatures, and regulators. Presently, more than half the states have statutes regulating the sending of emails. Many of these states provide exemptions if the email is being sent to existing customers or to people who have consented to receive the emails. More states have legislation pending, some of which propose the establishment of an email do-not-solicit program, similar to the various state do-not-call programs established for solicitations via telemarketing.



These and the other applicable laws and regulations are very detailed and require extensive disclosures to consumers. However, some of the laws are conflicting or out of date. In addition, the applicable laws, cases and interpretations are often vague, inconsistent or incomplete and are subject to continual reinterpretation by attorneys general and other regulators. Furthermore, at almost all times there are relevant administrative rules or legislation pending which may become effective after a promotion commences making timely compliance extremely difficult. These laws and regulations could have a material impact on our business by restricting our method of operations or imposing additional compliance costs.

**New taxes may be imposed on Internet commerce.**

In the U.S., we do not collect sales or other similar taxes on goods sold by customers and users through customers' FairMarket-powered sites or service taxes on fees paid by end-users of those sites. The Internet Tax Freedom Act of 1998, which was extended through November 28, 2003 by the Internet Tax Non-Discrimination Act, prohibits the imposition of taxes on Internet access services and new taxes on electronic commerce by U.S. federal and state taxing authorities. If the moratorium is not extended past the November 28, 2003 deadline, states may seek to impose sales tax collection obligations on out-of-state companies which engage in or facilitate online commerce, and a number of proposals previously have been made at the state and local level that would impose additional taxes on the sale of goods and services through the Internet. Such proposals, if adopted, could substantially impair the growth of electronic commerce, and could adversely affect our opportunity to derive financial benefit from such activities. Many non-U.S. countries impose service tax (such as value-added tax) collection obligations on companies that engage in or facilitate Internet commerce. We do not collect sales or other similar taxes on goods sold by customers and/or users of our customers' sites in Australia or the U.K., it being the responsibility of our customers to do so if required. Our systems in each of those countries do enable value-added or goods and services taxes to be charged and collected with respect to site usage fees, the determination of which is also the responsibility of our customers. A successful assertion by one or more states or any foreign country that we (rather than our customers) should collect sales or other taxes on the exchange of merchandise or site usage fees or other Internet-based taxes (or any failure of our customers to collect any such taxes if required to do so) could impair our revenue and our ability to acquire and retain customers.

**There may be significant security risks and privacy concerns relating to online commerce.**

A significant barrier to online commerce and communications is the secure transmission of confidential information over public networks. A compromise or breach of the technology used to protect our customers' and their end-users' transaction data could result from, among other things, advances in computer capabilities, new discoveries in the field of cryptography, or other events or developments. Any such compromise could have a material adverse effect on our reputation and, therefore, on our business, results of operations and financial condition. Furthermore, a party who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. We may be required to expend significant capital and other resources to protect against such security breaches or to alleviate problems caused by such breaches. Concerns over the security of transactions conducted on the Internet and other online services and the privacy of users may also inhibit the growth of the Internet and other online services generally, especially as a means of conducting commercial transactions. We currently have practices and procedures in place to protect the confidentiality of our customers' and their end-users' information. However, our security procedures to protect against the risk of inadvertent disclosure or intentional breaches of security might fail to adequately protect information that we are obligated to keep confidential. We may not be successful in adopting more effective systems for maintaining confidential information, and our exposure to the risk of disclosure of the confidential information of others may grow with increases in the amount of information we possess. To the extent that our activities involve the storage and transmission of proprietary information, such as credit card numbers, security breaches could damage our reputation and expose us to a risk of loss or litigation and possible liability. Our insurance policies may not be adequate to reimburse us for losses caused by security breaches.

**We could be subject to potential product liability claims and third party liability claims related to products and services purchased through our customers' sites.**

Any errors, defects or other performance problems in our services and systems could result in financial or other damages to our customers. Although our agreements with our customers typically contain provisions designed to limit

our exposure to claims, existing or future laws or unfavorable judicial decisions could negate these limitation of liability provisions.

In addition, we may not be able to successfully avoid civil or criminal liability for problems related to the products and services sold on customer sites. Even if we are successful, any such claims or litigation could still require expenditure of management time and other resources to defend ourselves. Liability of this sort could require us to implement measures to reduce our exposure to this liability, which may require us, among other things, to expend substantial resources or to discontinue service offerings or to take precautions to ensure that certain products and services are not available on customer sites.

Moreover, deliveries of products purchased on customer sites that are nonconforming, late or are not accompanied by information required by applicable law or regulations, could expose us to liability or result in decreased adoption and use of those sites and therefore our services, which would lead to decreased revenue.

**Our stock price is likely to be highly volatile.**

The stock market, and in particular the market for Internet-related stocks, has, from time to time, experienced extreme price and volume fluctuations. Many factors may cause the market price for our common stock to decline, perhaps substantially, including:

failure to meet our development plans;

the demand for our common stock;

changes in general market conditions;

technological innovations by competitors or in competing technologies; and

investor perception of our industry or our prospects.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**



**Investment Portfolio**

We do not use derivative financial instruments for investment purposes and only invest in financial instruments that meet high credit quality standards, as specified in our investment policy guidelines. This policy also limits the amount of credit exposure of any one issue, issuer, and type of investment. Due to the conservative nature of our investments, we do not believe that we have a material exposure to interest rate risk.

**Foreign Currency Risk**

International sales are made from our foreign sales subsidiaries in the respective countries and are denominated in the local currency of each country. These subsidiaries also incur most of their expenses in the local currency. Accordingly, all foreign subsidiaries use the local currency as their functional currency. Our international business is subject to risks typical of an international business, including, but not limited to differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions, and foreign exchange rate volatility. Accordingly, our future results could be materially adversely impacted by changes in these or other factors. Our intercompany accounts are typically denominated in the functional currency of the foreign subsidiary in order to centralize foreign exchange risk with the parent company in the United States. We are also exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. As exchange rates vary, these results, when translated, may vary from expectations and adversely impact overall financial results. The effect of foreign exchange rate fluctuations on FairMarket in the quarter ended March 31, 2003 and 2002 was not significant.

**ITEM 4. CONTROLS AND PROCEDURES**

**(a) Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-14(c) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act ), within 90 days of the filing date of this report. Based on their evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective.

**(b) Changes in Internal Controls**

There have been no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referenced in paragraph (a) above.

## PART II. OTHER INFORMATION

### ITEM 1. Legal Proceedings

FairMarket has been named as a defendant in certain purported class action lawsuits filed by individual shareholders in the U.S. District Court for the Southern District of New York against FairMarket, Scott Randall (former President, Chief Executive Officer and Chairman of the Board of FairMarket), John Belchers (former Chief Financial Officer of FairMarket), U.S. Bancorp Piper Jaffray Inc., Deutsche Bank Securities Inc. and FleetBoston Robertson Stephens, Inc. The lawsuits have been filed by individual shareholders who purport to seek class action status on behalf of all other similarly situated persons who purchased the common stock of FairMarket between March 14, 2000 and December 6, 2000. The lawsuits allege that certain underwriters of FairMarket's initial public offering solicited and received excessive and undisclosed fees and commissions in connection with that offering. The lawsuits further allege that the defendants violated the federal securities laws by issuing a registration statement and prospectus in connection with FairMarket's initial public offering, which failed to accurately disclose the amount and nature of the commissions and fees paid to the underwriter defendants. On or about October 8, 2002, the Court entered an Order dismissing the claims asserted against certain individual defendants in the consolidated actions, including the claims against Mr. Randall and Mr. Belchers, without any payment from these individuals or the Company. On or about February 19, 2003, the Court entered an Order dismissing with prejudice the claims asserted against the Company under Section 10(b) of the Securities Exchange Act of 1934. As a result, the only claims that remain against the Company are those arising under Section 11 of the Securities Act of 1934. The Company intends to vigorously defend the remaining claims asserted against it in the actions.

### ITEM 2. Changes in Securities and Use of Proceeds

#### (d) Use of Proceeds

On March 17, 2000, we completed the sale of 5,750,000 shares of our common stock in an initial public offering pursuant to a Registration Statement on Form S-1 (File No. 333-92677), as amended, that was declared effective by the Securities and Exchange Commission on March 13, 2000. The proceeds to us from the initial public offering were \$89.1 million, net of offering expenses. We estimate that as of March 31, 2003, approximately \$31.6 million has been used for working capital purposes, including approximately \$5.1 million used for the purchase of equipment and \$4.0 million to repurchase 3.1 million shares of our common stock from our founder. At March 31, 2003, substantially all of the remaining net proceeds (approximately \$53.5 million) were held in investments in commercial paper, government bonds and other interest-bearing accounts.

### ITEM 3.

**Defaults upon Senior Securities. Not applicable.**

**ITEM 4. Submission of Matters to a Vote of Security Holders. Not applicable.**

**ITEM 5. Other Information. Not applicable.**

**ITEM 6. Exhibits and Reports on Form 8-K.**

**(a) Exhibits**

**99.1 and 99.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

**(b) Reports on Form 8-K**

Not applicable.

**SIGNATURES**

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

FairMarket, Inc.

Date: May 9, 2003

By: /s/ Nanda Krish  
Nanda Krish,  
Chief Executive Officer  
*(Principal Executive Officer)*

Date: May 9, 2003

By: /s/ Janet Smith  
Janet Smith,  
Chief Financial Officer  
*(Principal Financial and Accounting Officer)*

**CERTIFICATIONS**

I, Nanda Krish, Chief Executive Officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of FairMarket, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 9, 2003

/s/ Nanda Krish  
Nanda Krish  
Chief Executive Officer

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I, Janet Smith, Chief Financial Officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of FairMarket, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and



6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 9, 2003

/s/ Janet Smith  
Janet Smith  
Chief Financial Officer