

NETFLIX INC  
Form 4  
March 05, 2013

**FORM 4**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

OMB APPROVAL

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**STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES**

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person \*  
**HALEY TIMOTHY M**

(Last) (First) (Middle)  
  
100 WINCHESTER CIRCLE  
  
(Street)

LOS GATOS, CA 95032

(City) (State) (Zip)

2. Issuer Name and Ticker or Trading Symbol  
**NETFLIX INC [NFLX]**

3. Date of Earliest Transaction  
(Month/Day/Year)  
**03/01/2013**

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

Director  10% Owner  
 Officer (give title below)  Other (specify below)

6. Individual or Joint/Group Filing(Check Applicable Line)  
 Form filed by One Reporting Person  
 Form filed by More than One Reporting Person

**Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned**

| 1. Title of Security (Instr. 3) | 2. Transaction Date (Month/Day/Year) | 2A. Deemed Execution Date, if any (Month/Day/Year) | 3. Transaction Code (Instr. 8) | 4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5) | 5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4) | 6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4) | 7. Nature of Ownership (Instr. 4) |       |
|---------------------------------|--------------------------------------|--|--------------------------------|---|---|--|-----------------------------------|-------|
|                                 |                                      |  |                                | (A) or (D)  | Price   |  |                                   |       |
|                                 |                                      |  |                                | Code  | V   | Amount   | (D)                               | Price |

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

**Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)**

| 1. Title of Derivative Security (Instr. 3) | 2. Conversion or Exercise Price of | 3. Transaction Date (Month/Day/Year) | 3A. Deemed Execution Date, if any (Month/Day/Year) | 4. Transaction Code (Instr. 8) | 5. Number of Derivative Securities | 6. Date Exercisable and Expiration Date (Month/Day/Year) | 7. Title and Amount of Underlying Securities (Instr. 3 and 4) |
|--|------------------------------------|--------------------------------------|--|--------------------------------|------------------------------------|--|---|
|--|------------------------------------|--------------------------------------|--|--------------------------------|------------------------------------|--|---|

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| Derivative Security |  | Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5) | Code | V | (A) | (D) | Date Exercisable | Expiration Date | Title | Amount or Number of Shares |
|---------------------|--|--|------|---|-----|-----|------------------|-----------------|-------|----------------------------|
|                     |  |  |      |   |     |     |                  |                 |       |                            |

## Reporting Owners

| Reporting Owner Name / Address                                  | Relationships |           |         |       |
|---|---------------|-----------|---------|-------|
|   | Director      | 10% Owner | Officer | Other |
| HALEY TIMOTHY M<br>100 WINCHESTER CIRCLE<br>LOS GATOS, CA 95032 |               |           | X       |       |

## Signatures

By: David Hyman, Authorized Signatory For: Timothy M. Haley  
 Date: 03/05/2013

Signature of Reporting Person: \_\_\_\_\_ Date: \_\_\_\_\_

## Explanation of Responses:

- \* If the form is filed by more than one reporting person, see Instruction 4(b)(v).
  - \*\* Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).
- Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, see Instruction 6 for procedure. Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. ngs under contracts with recording artists. During 2005, DMGI cancelled certain of these contracts and concluded that future cash flows would not be sufficient to recover the advances and costs that were capitalized under the remainder of the

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**DIGITAL MUSIC GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

contracts. Management is no longer seeking to sign additional artists to record new material as a means of furthering DMGI's digital music strategy.

*Goodwill*

Goodwill represents the excess of the purchase price over the estimated fair value of the net tangible and intangible assets of the DRA acquisition. Goodwill is deemed to have an indefinite life and is not amortized but is subject to impairment tests in accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142). DMGI will test goodwill for impairment on at least an annual basis using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any.

*Income Taxes*

Deferred income taxes result primarily from temporary differences between financial and tax reporting. Deferred income tax assets and liabilities are determined based on the difference between the financial statement bases and the tax bases of assets and liabilities using enacted tax rates. A valuation allowance is established to reduce a deferred income tax asset to the amount that is expected to be realized.

*Revenue Recognition*

DMGI distributes its music and video content through agreements with digital entertainment services that make DMGI's content available to consumers to purchase as a digital download or on a subscription basis. DMGI earns revenue based on each download or a percentage of each digital entertainment service's subscription revenue, as defined in DMGI's agreements with the digital entertainment service. Each digital entertainment service reports DMGI's download revenue or proportionate share of subscription revenue on a monthly or quarterly basis, depending on the agreement, and pays DMGI at the same time. DMGI recognizes revenue related to downloads and subscriptions in the month the transactions occur.

*Industry Segments and Foreign Revenue*

DMGI operates in one industry segment, acquisition, management and distribution of digital music and video content. For the year ended December 31, 2006, revenue from digital entertainment services serving consumers in foreign locations was 16% from Europe and 5% from other countries. For the year ended December 31, 2005 and for the period from February 26, 2004 (Inception) to December 31, 2004, revenue from digital entertainment services serving customers in foreign locations was 5% and 6%, respectively.

*Foreign Currency Translation*

DMGI receives revenue from digital entertainment services selling content owned or distributed by DMGI in foreign countries. These services collect cash from consumers and report sales to DMGI in their local currency. The monthly or quarterly revenue due from these digital entertainment services is paid to DMGI in local currencies and converted to U.S. dollars at the market-based foreign exchange rate at time of receipt. DMGI converts the sales reported by digital entertainment services to U.S. dollars at the average exchange rate for the period, based on published daily rates. The net difference represents a foreign currency gain or loss which is recorded in other income (expense) and the impact was not material for all periods presented in the accompanying Consolidated Statements of Operations.

**Table of Contents****Index to Financial Statements****DIGITAL MUSIC GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Advertising Costs*

DMGI expenses advertising costs as incurred. For the years ended December 31, 2006 and 2005 and for the period from February 26, 2004 (Inception) to December 31, 2004, advertising expense was \$127,146, \$84,448 and \$26,886, respectively, included in operating, general and administrative expenses in the accompanying Consolidated Statements of Operations.

*Share-Based Compensation*

DMGI elected early adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Compensation* (SFAS No. 123R), which requires entities to recognize compensation expense in an amount equal to the estimated fair value of share-based awards and issuances, such as restricted stock, stock options and warrants granted to employees and non-employees. Equity instruments issued to employees are measured at estimated fair value at the issuance date and expensed in the periods over which the benefit is expected to be received, which is generally the vesting period. Equity instruments issued to non-employees in exchange for goods or services that are fully vested and non-forfeitable are measured at estimated fair value at the issuance date and expensed in the period in which the goods or services are received.

Prior to January 1, 2006, DMGI utilized Black-Scholes, a standard option pricing model, to measure the fair value of stock options granted to employees. While SFAS No. 123R permits entities to continue to use such a model, the standard also permits the use of a lattice model. Beginning in 2006, DMGI determined that the Trinomial Lattice Model was the best available measure of the fair value of employee stock options because it accounts for changing employee behavior as the stock price changes and captures the observed pattern of increasing rates of exercise as the stock price increases.

The following weighted-average assumptions were used in estimating the fair value per share of the options granted under stock option plans, assuming no dividends for the years ended December 31, 2006 and 2005:

|                            | 2006  | 2005  |
|----------------------------|-------|-------|
| Risk-free rate of return   | 4.69% | 4.50% |
| Expected volatility        | 35.0% | 75.0% |
| Expected life (in years)   | 5.1   | 6.0   |
| Suboptimal exercise factor | 2     | n/a   |
| Exit rate post-vesting     | 22.8% | n/a   |
| Exit rate pre-vesting      | 19.0% | n/a   |

DMGI calculates the expected volatility for stock-based awards using the historical volatility for its peer group public companies because sufficient historical trading data does not yet exist for DMGI's stock. DMGI estimates the forfeiture rate for stock-based awards based on historical data. The risk-free rate for stock options granted during the period is determined by using a zero-coupon U.S. Treasury rate for the period that coincides with the expected option terms.

*Net Loss Per Share*

Basic and diluted net loss per share have been computed using the weighted-average number of shares of common stock outstanding for the years ended December 31, 2006 and 2005 and for the period from February 26, 2004 (Inception) to December 31, 2004 of 8,071,393, 2,249,941 and 2,249,941, respectively. As of December 31, 2006, common stock equivalents included outstanding stock options, warrants and non-vested restricted stock totaling 366,500, 423,000 and 10,000 shares, respectively, all of which were issued during 2006.



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**DIGITAL MUSIC GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

These were excluded from the calculation of the weighted-average number of shares outstanding due to their antidilutive effect. Restricted stock vesting over two years which was issued to three executives in August 2005, of which 133,334 shares were non-vested at December 31, 2006, were nominal issuances and are included in basic and diluted earnings per share for the year ended December 31, 2006.

The weighted average number of shares of common stock used in the calculation of basic and diluted net loss per share for the year ended December 31, 2005 and for the period from February 26, 2004 (Inception) to December 31, 2004 was 2,249,941, the number of shares issued by DMGI in connection with the acquisition of DMI, DMGI's acquiror for accounting purposes.

*Recent Accounting Pronouncements*

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), an interpretation of Statement of Financial Accounting Standards No. 109. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on accounting for derecognition, interest, penalties, accounting in interim periods, disclosure and classification of matters related to uncertainty in income taxes, and transitional requirements upon adoption of FIN 48. FIN 48 is effective for fiscal years beginning after December 15, 2006. Management does not believe that the adoption of FIN 48 will have a material impact on the consolidated financial statements of DMGI.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ( SFAS No. 157 ), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles ( GAAP ). As a result of SFAS No. 157, there is now a common definition of fair value to be used throughout GAAP. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the impact of this statement on the consolidated financial statements of DMGI.

**3. ACQUISITIONS AND INITIAL PUBLIC OFFERING**

On February 7, 2006, DMGI completed its initial public offering of common stock, selling 3,900,000 shares at \$9.75 per share and generating net cash proceeds (after fees and expenses) of approximately \$33,200,000. On the same date, in connection with the closing of the IPO, DMGI issued to the underwriters in the offering warrants to purchase an aggregate of 273,000 shares of DMGI's common stock in exchange for \$100. Each of the warrants has an exercise price of \$12.1875 per share, and are exercisable at any time from February 7, 2007 until February 6, 2011. The warrants had an estimated fair value at the date of issuance of \$620,529 as determined in accordance with SFAS No. 123R, assuming a dividend yield of 0%, expected volatility of 35%, risk free rate of return of 4.52%, and an expected term to exercise of 4.6 years. The fair value of the warrants was recorded as an offering cost. Accordingly, the total net proceeds from DMGI's IPO were approximately \$32,600,000.

Also on February 7, 2006, DMGI concurrently acquired DMI and certain assets of Rio Bravo Entertainment LLC in exchange for 2,249,941 and 25,000 shares, respectively, of DMGI's common stock. DMI has been deemed the acquiror for financial reporting purposes. DMGI had net liabilities and a stockholders' deficit of \$73,305 on the date of its acquisition of DMI. The purchase price of the assets acquired from Rio Bravo

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Entertainment LLC on February 7, 2006 totaled \$243,750, which has been allocated to digital rights. Such rights are being amortized over 24 months, the estimated remaining life of the assets.

On September 8, 2006, DMGI acquired all of the ownership interests in DRA in exchange for \$3,200,000 in cash, 420,000 shares of Company common stock and a warrant issued to the former Managing Director of DRA to purchase 150,000 shares of common stock with an exercise price of \$5.57 per share. The warrant had an estimated fair value at the date of issuance of \$97,350 as determined in accordance with SFAS No. 123R, assuming a dividend yield of 0%, expected volatility of 35%, risk free rate of return of 4.7%, and an expected term to exercise of 4.75 years. The fair value of the warrant was recorded as acquisition consideration. The warrant is exercisable in various installments beginning in September 2007, is fully exercisable by September 2009, and expires in September 2013. The shares and warrant were issued in a private placement under federal and state securities law and are subject to restrictions on resale thereunder, and a substantial majority of the shares are subject to contractual restrictions on resale, short selling and other forms of hedging for varying terms ranging from one to two years from the acquisition date.

The purchase consideration for DRA was comprised of the following:

|  |              |
|--|--------------|
| Cash consideration                                       | \$ 3,200,000 |
| Common stock issued (420,000 shares at \$4.14 per share) | 1,738,800    |
| Liabilities assumed                                      | 1,929,667    |
| Acquisition costs  | 131,466      |
| Estimated fair value of common stock warrant issued      | 97,350       |
|  | \$ 7,097,283 |

The total purchase price was allocated to DRA's assets and liabilities based on their estimated fair values as of the acquisition date. A summary of the preliminary purchase price allocation, which is subject to finalization, is as follows:

|                         |              |
|-------------------------|--------------|
| Cash                    | \$ 430,646   |
| Accounts receivable     | 946,375      |
| Other current assets    | 399,680      |
| Furniture and equipment | 115,800      |
| Digital rights          | 775,000      |
| Goodwill                | 4,429,782    |
|                         | \$ 7,097,283 |

DMGI is obligated to pay up to \$1,155,000 in cash and to issue up to 87,000 shares of common stock in additional consideration if certain financial targets are achieved through December 31, 2007. Any additional consideration obligation will be recognized when deemed probable and will be allocated to goodwill.

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## DIGITAL MUSIC GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The unaudited pro forma combined statements of operations for the years ended December 31, 2006 and 2005 presented below assume that the acquisitions of DMI, certain assets of Rio Bravo Entertainment LLC and DRA were completed on January 1, 2006 and 2005, respectively:

|  | For the Years Ended |                |
|--|---------------------|----------------|
|  | December 31,        |                |
|  | 2006                | 2005           |
| Revenue  | \$ 10,201,101       | \$ 3,706,005   |
| Cost of revenue:   |                     |                |
| Royalties and payments to content owners                     | 7,260,543           | 2,737,705      |
| Amortization of digital rights and master recordings         | 508,607             | 255,108        |
| Write-down of non-productive assets                          |                     | 295,356        |
| Gross profit   | 2,431,951           | 417,836        |
| Operating, general and administrative expenses               | 6,408,779           | 2,126,360      |
| Loss from operations   | (3,976,828)         | (1,708,524)    |
| Interest income  | 1,257,319           | 8,247          |
| Interest expense   | (19,854)            | (152,098)      |
| Other income (expense), net                                  | (16,982)            |                |
| Loss before income taxes                                     | (2,756,345)         | (1,852,375)    |
| Income taxes   | (800)               | (800)          |
| Net loss   | \$ (2,757,145)      | \$ (1,853,175) |
| Net loss per common share basic and diluted                  | \$ (0.32)           | \$ (0.36)      |
| Weighted average common shares outstanding basic and diluted | 8,615,283           | 5,119,941      |

Weighted average shares used in the calculation of the unaudited pro forma combined basic and diluted net loss per share for the years ended December 31, 2006 and 2005 include the 2,249,941 shares attributable to DMI, the 2,425,000 shares of DMGI outstanding at the IPO date, the 25,000 shares issued on February 7, 2006 in connection with the acquisition of the Rio Bravo Entertainment LLC assets, and the 420,000 shares issued on September 8, 2006 in connection with the acquisition of DRA. In addition to the 5,119,941 shares described in the preceding sentence, weighted average shares used in the calculation of the unaudited pro forma combined basic and diluted net loss per share for the year ended December 31, 2006 also included the 3,900,000 shares issued in DMGI's IPO, from February 7, 2006 until December 31, 2006.

The adjustments and methodology used in allocating the purchase consideration for DRA and in the preparation of these unaudited pro forma combined statements of operations are based on estimates, available information and certain assumptions which may be revised as additional information becomes available. The pro forma financial data do not purport to represent what DMGI's combined results of operations would actually have been if such acquisitions had in fact occurred at the beginning of the periods, and are not necessarily representative of DMGI's results of operations for any future period since the companies were not under common management or control during the periods presented.





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## DIGITAL MUSIC GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**4. FURNITURE AND EQUIPMENT**

Furniture and equipment comprise the following at:

|  | December 31, |            |
|--|--------------|------------|
|  | 2006         | 2005       |
| Computers and office equipment                     | \$ 696,220   | \$ 77,254  |
| Furniture and fixtures                             | 72,849       | 4,363      |
| Computer equipment under capital lease obligations | 219,959      | 122,268    |
|  | 989,028      | 203,885    |
| Less accumulated depreciation and amortization     | (185,825)    | (41,732)   |
|  | \$ 803,203   | \$ 162,153 |

Depreciation expense for DMGI's furniture and equipment totaled \$156,839, \$38,595 and \$3,137 for the years ended December 31, 2006 and 2005 and for the period from February 26, 2004 (Inception) through December 31, 2004, respectively, of which \$48,290, \$23,582 and \$1,949 related to equipment under capital lease obligations, respectively. Accumulated depreciation of equipment under capital lease was \$73,821 and \$25,531 at December 31, 2006 and 2005, respectively.

**5. ROYALTY ADVANCES**

DMGI has the exclusive right to distribute certain music and video content in certain geographic areas pursuant to long-term agreements with the content owners. These distribution agreements have initial terms ranging from five to ten years and, in certain cases, grant DMGI the right to extend the agreement for an additional term. Pursuant to these long-term agreements, DMGI typically pays advance royalties that are to be recouped from the content owners' share of future revenue which range from 25% to 57% of gross or net receipts, as defined in the agreements.

Royalty advances comprise the following at:

|  | December 31, |            |
|--|--------------|------------|
|  | 2006         | 2005       |
| Total royalty advances                         | \$ 6,657,938 | \$ 882,168 |
| Less cumulative recoupment of royalty advances | (1,101,156)  | (99,730)   |
|  | 5,556,782    | 782,438    |
| Current portion of royalty advances            | (1,326,379)  | (292,438)  |
|  | \$ 4,230,403 | \$ 490,000 |

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DMGI has acquired digital rights from record labels, artists and other owners of such rights to various catalogs of music and video content. In addition, in connection with the acquisitions during 2006 of certain assets of Rio Bravo Entertainment LLC and all of the ownership interests in DRA, DMGI allocated \$243,750 and \$775,000, respectively, of the purchase price to the digital rights acquired. Digital rights comprise the following at:

|                               | <b>December 31,</b> |                     |
|-------------------------------|---------------------|---------------------|
|                               | <b>2006</b>         | <b>2005</b>         |
| Digital rights                | \$ 3,405,605        | \$ 1,221,605        |
| Less accumulated amortization | (372,366)           | (25,558)            |
|                               | <b>\$ 3,033,239</b> | <b>\$ 1,196,047</b> |

Amortization expense was \$346,808, \$22,518 and \$3,040 for the years ended December 31, 2006 and 2005 and for the period from February 26, 2004 (Inception) to December 31, 2004, respectively.

**7. MASTER RECORDINGS**

DMGI has acquired master recordings, including all the rights (digital, physical and otherwise) to such recordings. Master recordings comprise the following at:

|                               | <b>December 31,</b> |
|-------------------------------|---------------------|
|                               | <b>2006</b>         |
| Master recordings             | \$ 1,853,161        |
| Less accumulated amortization | (75,681)            |
|                               | <b>\$ 1,777,480</b> |

Amortization expense was \$75,681 for the year ended December 31, 2006.

**8. INCOME TAXES**

Income taxes are comprised of the following:

|  | <b>Years Ended<br/>December 31,</b> | <b>Period from<br/>February 26,<br/>2004<br/>(Inception) to</b> |
|--|-------------------------------------|---|
|  | <b>2006</b>                         | <b>2005</b>   |

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|                     | December 31, |           |           |
|---------------------|--------------|-----------|-----------|
|                     | 2004         |           |           |
| <b>Current:</b>     |              |           |           |
| Federal             | \$           | \$        | \$        |
| State               | 800          | 800       | 800       |
| Total current       | 800          | 800       | 800       |
| <b>Deferred:</b>    |              |           |           |
| Federal             | (831,327)    | (480,708) | (199,781) |
| State               | (135,373)    | (137,026) | (56,901)  |
| Total deferred      | (966,700)    | (617,734) | (256,682) |
| Valuation allowance | 966,700      | 617,734   | 256,682   |
| Total deferred      |              |           |           |
| Income taxes        | \$ 800       | \$ 800    | \$ 800    |

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## DIGITAL MUSIC GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DMGI reports certain expenses for tax purposes in different periods than they are recorded for financial reporting purposes. These timing differences give rise to deferred income tax assets and liabilities. Net deferred income tax assets totaling \$2,093,912, \$874,416 and \$256,682 at December 31, 2006 and 2005 and for the period from February 26, 2004 (Inception) to December 31, 2004, respectively, have been fully offset by a valuation allowance due to the uncertainty of their ultimate realization.

The temporary differences that give rise to deferred income tax assets and liabilities comprise the following at:

|                                  | December 31, |            |
|----------------------------------|--------------|------------|
|                                  | 2006         | 2005       |
| Deferred income tax assets:      |              |            |
| Net operating loss carryforwards | \$ 1,847,433 | \$ 899,390 |
| Share-based compensation         | 130,057      |            |
| Depreciation and amortization    | 68,565       |            |
| Accrued expenses                 | 47,857       | 7,030      |
|                                  | 2,093,912    | 906,420    |
| Deferred income tax liabilities: |              |            |
| Depreciation and amortization    |              | (32,004)   |
| Net deferred income tax assets   | 2,093,912    | 874,416    |
| Valuation allowance              | (2,093,912)  | (874,416)  |
| Net deferred income tax assets   | \$           | \$         |

Beginning in 2006, DMGI will file a consolidated federal tax return including all merged entities and acquired subsidiaries. At December 31, 2006, DMGI has federal and state net operating loss carryforwards estimated to be approximately \$4,680,000 and \$4,390,000, respectively, available to reduce future taxable income. Such amounts include the net operating loss carryforwards generated by DMGI as well as those generated by DMI between its inception in 2004 and its merger with DMGI in 2006. Included in DMGI's valuation allowance as of December 31, 2006 and 2005, are tax benefits of \$270,000 and \$17,000, respectively, attributable to the exercise of DMI stock options and warrants, which will be recorded directly to additional paid in capital, when DMGI utilizes its net operating loss carryforwards. If not utilized prior to such dates, the federal net operating loss carryforwards begin to expire in 2024 and the state net operating loss carryforwards begin to expire in 2014. In addition to potential expiration, there are other factors that could limit DMGI's ability to use these federal and state tax loss carryforwards. Under Section 382 of the Internal Revenue Code of 1986 (Section 382), as amended, use of prior net operating loss carryforwards can be limited after an ownership change. DMGI's ability to fully utilize DMI's net operating loss carryforward will be subject to limitation under Section 382 as a result of its merger with DMGI and other transactions, and may be subject to further limitations as a result of future sales of securities, if any. Accordingly, it is not certain how much of the existing net operating loss carryforwards will be available for use by DMGI. If DMGI generates taxable income in the future the use of net operating loss carryforwards that have not expired would have the effect of reducing DMGI's tax liability and increasing after-tax net income.

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Income taxes reported in the Consolidated Statements of Operations differ from the amount computed by applying the U.S. federal statutory tax rate (34%) to loss before income taxes as follows:

|   | Years ended December 31, |              | Period from   |
|---|--------------------------|--------------|---|
|   | 2006                     | 2005         | February 26, 2004<br>(Inception) to<br>December 31, |
| Federal income tax benefit at statutory rate    | \$ (891,628)             | \$ (529,317) | \$ (218,891)  |
| State income tax benefit, net of federal effect | (134,845)                | (90,295)     | (37,562)  |
| Change in valuation allowance                   | 966,700                  | 617,734      | 256,682   |
| Other, net                                      | 60,573                   | 2,678        | 571   |
|   | \$ 800                   | \$ 800       | \$ 800  |

**9. LEASES***Operating Leases*

DMGI leases its office facilities under non-cancelable operating leases for periods ranging from three to four years. DMGI's total rent expense for the years ended December 31, 2006 and 2005 and for the period from February 26, 2004 (Inception) to December 31, 2004 was \$203,485, \$68,842 and \$8,360, respectively.

As of December 31, 2006, future minimum payments under these leases, by calendar year, are as follows:

|      |            |
|------|------------|
| 2007 | \$ 290,724 |
| 2008 | 299,080    |
| 2009 | 191,710    |
| 2010 | 60,780     |
|      | \$ 842,294 |

*Capital Leases*

DMGI leases certain of its technology and office equipment under capital leases with interest rates ranging from 11% to 15% per annum. Future minimum lease payments for assets under capital lease obligations at December 31, 2006 are as follows:

|            |           |
|------------|-----------|
| Year: 2007 | \$ 54,409 |
| 2008       | 10,667    |

|  |                 |
|--|-----------------|
|  | 65,076          |
| Less amount representing interest          | (5,245)         |
| <b>Total capital lease obligations</b>     | <b>59,831</b>   |
| Less current portion                       | (50,496)        |
| <b>Long-term capital lease obligations</b> | <b>\$ 9,335</b> |

**10. COMMITMENTS AND CONTINGENCIES**

*Industry Conditions and Risks*

DMGI operates in a new and rapidly changing and evolving industry - the digital distribution of music and video content. DMGI is still in the early stages of its development and management is attempting to position it as

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**DIGITAL MUSIC GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

a leader and first-mover in this emerging industry. As such, there are numerous risks involved in DMGI's business, many of which are outside of management's control, including potential changes in consumer tastes and preferences that could drive industry-wide changes in the pricing structure and terms that DMGI receives from digital entertainment services and the formats and technology specifications under which it must deliver digital content for sale to consumers. DMGI has incurred losses throughout its limited operating history and management's plans to achieve profitability depend upon a number of factors, including certain minimum levels of consumer demand for the older classic music and television catalogs that comprise the majority of the content that DMGI owns or distributes under long-term agreements as well as overall growth in consumer demand for digital music and video content.

*Commitments for Content Acquisitions*

At December 31, 2006, DMGI is contractually obligated to pay up to \$5,433,000 over the next twelve months in additional advance royalties, digital rights and master recordings purchase consideration. These payments are due under various digital rights agreements as music and video recordings and related metadata and artwork are received from the content owners for processing by DMGI. In addition, DMGI is obligated to pay a total of \$360,000 in equal quarterly installments through February 2016 as additional advances against future royalties under one long-term agreement.

*Indemnification Agreements*

In the ordinary course of business, DMGI enters into contractual arrangements with digital entertainment services under which it agrees to provide indemnification of varying scope with respect to certain matters, including losses that might arise out of DMGI's breach of such agreements and out of intellectual property infringement claims made by third parties. Conversely, DMGI is indemnified by content owners for losses that might arise out of any breach of their agreements to sell or provide music and video content to DMGI for digital distribution or any intellectual property infringement claims arising from the recordings they have sold or provided to DMGI for digital distribution. The terms of such indemnification provisions vary. Generally, a maximum obligation is not explicitly stated, so the overall maximum amount of these indemnification obligations cannot be reasonably estimated. To date, DMGI has not incurred any material costs as a result of such indemnifications in favor of digital entertainment services and has not accrued any liabilities related to such obligations in the consolidated financial statements.

In addition, DMGI has entered into standard indemnification agreements with its directors and certain officers that will require it, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. DMGI has never received a notice of claim under these agreements and maintains director and officer liability insurance (subject to certain deductibles and maximum aggregate amounts) that covers third-party claims against DMGI or against its directors and officers for their actions in such capacity.

*Employment Agreements*

DMGI maintains employment agreements with its officers wherein duties and responsibilities and specific compensation arrangements are established for each officer. These agreements also include standard non-competition and confidentiality covenants, require that the officer devote full-time to furthering the business of DMGI, provide that technology and inventions created during the course of employment belong to DMGI, and contain other customary provisions. Officers are entitled to certain severance compensation if terminated by DMGI without cause (as defined in the agreements) or under other circumstances, and DMGI recorded \$189,000 in severance costs during 2006 in connection with the departure of two of its founding officers.



Table of ContentsIndex to Financial Statements**DIGITAL MUSIC GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Legal Matters*

DMGI from time-to-time becomes involved in commercial and contractual disputes and disagreements arising in the ordinary course of business, which management typically seeks to resolve through direct negotiations with the principals or representatives of the party involved. As of December 31, 2006, DMGI was not a party to any legal proceedings.

**11. CAPITAL STOCK***Recapitalization*

DMI has been designated DMGI's acquiror for financial reporting purposes. The historical shareholders' equity of DMI has been restated for all periods prior to February 7, 2006 to give retroactive effect to its merger with DMGI. DMI's historical common stock and preferred stock transactions have been restated as if they were issuances of DMGI's common stock as of February 26, 2004 (Inception), pursuant to the merger agreement exchange ratios. The following table reconciles the restated February 26, 2004 equity balances to DMI's historical equity activity:

| Original Equity Issuances   | Restated Equity Issuances |                        |                                  | Subscriptions Receivable |
|---|---------------------------|------------------------|----------------------------------|--------------------------|
|   | Common Stock<br>Shares    | Common Stock<br>Amount | Additional<br>Paid-in<br>Capital |                          |
| Issuances of common stock in exchange for cash, services and digital rights and exercise of options and warrants for net proceeds of \$57,963       | 709,365                   | \$ 7,094               | \$ 50,869                        | \$ (54,763)              |
| Issuance of series A convertible preferred stock for net proceeds of \$1,695,496  | 641,442                   | 6,415                  | 1,689,081                        | (1,695,496)              |
| Issuance of series B convertible preferred stock for cash and conversion of subordinated notes and accrued interest for net proceeds of \$2,899,747 | 899,134                   | 8,991                  | 2,890,756                        | (2,899,747)              |
| Total   | 2,249,941                 | \$ 22,500              | \$ 4,630,706                     | \$ (4,650,006)           |

Founders' shares in DMI, issued in exchange for services valued at \$3,200, are included in common stock in the above table but not in subscriptions receivable, as they were issued at the inception date.

*Common Stock*

DMGI completed its IPO on February 7, 2006 and issued 3,900,000 shares of its common stock. Concurrently, DMGI also issued 25,000 shares to acquire certain assets of Rio Bravo Entertainment LLC and 2,249,941 shares to acquire all of the outstanding common and preferred stock of DMI. As a result of treating DMI as the accounting acquiror, the 2,425,000 shares of common stock of Digital Music Group, Inc. which were outstanding at the time of the IPO were treated as issued on February 7, 2006. On September 8, 2006, DMGI issued 420,000 shares of its common stock in connection with its acquisition of the membership interests in DRA.

*Restricted Stock Grant*

In March 2006, DMGI issued to one of its senior executives a restricted stock grant of 15,000 shares of DMGI's common stock at a purchase price of \$.01 per share, subject to a Company repurchase option at the



Table of ContentsIndex to Financial Statements**DIGITAL MUSIC GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

original purchase price that lapsed with respect to 5,000 shares on September 22, 2006. The repurchase option lapses with respect to 5,000 shares each on March 22, 2007 and 2008, so long as the executive remains a service provider to DMGI. The fair value of the restricted shares at the date they were issued is being charged to operating, general and administrative expenses over the vesting period, and the shares will be included as outstanding for purposes of calculating basic earnings per share as the restrictions lapse.

**12. SHARE-BASED COMPENSATION**

DMGI's accounting acquiror, DMI, had a 2004 Stock Plan under which it granted stock options to directors and key employees during 2004 and 2005. In addition, during this period, DMI also issued warrants to purchase shares of its common stock to certain consultants and its law firm. The unvested options and warrants became fully exercisable pursuant to their terms immediately prior to DMGI's merger with DMI on February 7, 2006. The options and warrants exercised in February 2006 generated net proceeds of \$41,103 and \$2,220, respectively, and the holders received shares of DMI and participated pro rata in the total merger consideration of 2,249,941 shares of DMGI. Unexercised options and warrants were forfeited and the 2004 Stock Plan was terminated upon consummation of the merger.

DMGI has an Amended and Restated 2005 Stock Plan (the "Plan") under which 1,200,000 shares of its common stock have been reserved for issuance at December 31, 2006. The Plan provides for the grant of incentive stock options, within the meaning of Section 422 of the Internal Revenue Code, to employees and for the grant of non-statutory stock options, stock appreciation rights and restricted stock to employees, directors and consultants. The Compensation Committee of DMGI's Board of Directors administers the Plan and has authority to make awards under the Plan and establish vesting and other terms, but cannot grant options at less than fair value on the date of grant nor reprice options previously granted. All options granted to employees since inception of the Plan have a four-year vesting period. Annual option grants to non-employee directors are automatic pursuant to a formula within the Plan which establishes the number and terms of such grants.

Stock option activity under DMGI's Plan is summarized as follows:

|                                  | Number of | Exercise Price   | Weighted Average | Weighted Average           | Weighted Average          |
|----------------------------------|-----------|------------------|------------------|----------------------------|---------------------------|
|                                  | Shares    |                  | Exercise Price   | Remaining Contractual Term | Aggregate Intrinsic Value |
| Outstanding at December 31, 2005 |           |                  |                  |                            |                           |
| Granted                          | 390,000   | \$ 4.02 - \$9.75 |                  |                            |                           |
| Forfeited                        | (23,500)  | \$ 4.13 - \$9.32 |                  |                            |                           |
| Outstanding at December 31, 2006 | 366,500   | \$ 4.02 - \$9.75 | \$ 8.28          | 7.6 Years                  | \$ 44,650                 |
| Exercisable at December 31, 2006 | 63,000    | \$ 6.38 - \$9.75 | \$ 9.59          | 9.2 Years                  | \$                        |

The weighted average estimated grant-date fair value per share for the 390,000 options granted during the year ended December 31, 2006 was \$1.71. The weighted average estimated grant-date fair value per share for the 23,500 unvested stock options forfeited during 2006 was \$1.65.



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## DIGITAL MUSIC GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted stock activity is summarized as follows:

|                                | Number of | Weighted-Average<br>Grant Date |
|--------------------------------|-----------|--------------------------------|
|                                | Shares    | Fair Value                     |
| Nonvested at December 31, 2005 | 500,000   | \$                             |
| Issued                         | 15,000    | \$ 9.70                        |
| Vested                         | (371,666) | \$ 0.13                        |
| Nonvested at December 31, 2006 | 143,334   | \$ 0.68                        |

During the year ended December 31, 2006, 91,666 restricted shares became vested upon the resignation and termination of the employment of a former executive as required under the restricted stock agreement with such executive.

DMGI recorded a non-cash charge of \$326,495, \$8,304 and \$1,281 as a component of operating, general and administrative expenses related to share-based arrangements for the years ended December 31, 2006 and 2005 and for the period from February 26, 2004 (Inception) to December 31, 2004, respectively. The non-cash charge for the year ended December 31, 2006 included \$38,384 associated with the accelerated vesting of the DMI stock options. As of December 31, 2006, the future pre-tax share-based compensation expense for stock option grants is \$459,426 to be recognized in 2007 through 2010. Future pre-tax share-based compensation expense for restricted stock is \$64,600 to be recognized in 2007 through 2008.

As of December 31, 2006, a total of 818,500 shares remained available for grant under DMGI's Plan. On the first day of each calendar year, the shares available under the Plan are increased by the lesser of (i) 400,000 shares, (ii) 5% of the outstanding shares of common stock on such date, or (iii) an amount determined by DMGI's Board of Directors. As a result, 1,218,500 shares were available for grant at January 1, 2007.

**Table of Contents****Index to Financial Statements****DIGITAL MUSIC GROUP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | <b>June 30, 2007</b><br><b>(Unaudited)</b> | <b>December 31, 2006</b> |
|---|--|--------------------------|
| <b>Assets</b>   |  |                          |
| Current assets:   |  |                          |
| Cash and cash equivalents   | \$ 13,968,883                              | \$ 20,505,674            |
| Accounts receivable   | 1,835,638                                  | 1,687,492                |
| Current portion of advance royalties  | 1,983,679                                  | 1,326,379                |
| Prepaid expenses and other current assets   | 601,844                                    | 492,799                  |
| <b>Total current assets</b>   | <b>18,390,044</b>                          | <b>24,012,344</b>        |
| Furniture and equipment, net  | 1,020,541                                  | 803,203                  |
| Digital rights, net   | 3,546,393                                  | 3,033,239                |
| Master recordings, net  | 2,122,843                                  | 1,777,480                |
| Royalty advances, less current portion  | 7,205,769                                  | 4,230,403                |
| Goodwill  | 5,355,944                                  | 4,429,782                |
| Other assets  | 42,563                                     | 39,289                   |
| <b>Total assets</b>   | <b>\$ 37,684,097</b>                       | <b>\$ 38,325,740</b>     |
| <b>Liabilities and Stockholders Equity</b>  |  |                          |
| Current liabilities:  |  |                          |
| Accounts payable  | \$ 99,957                                  | \$ 204,468               |
| Accrued liabilities   | 1,127,536                                  | 496,833                  |
| Royalties payable   | 2,204,311                                  | 1,952,342                |
| Accrued compensation and benefits   | 141,704                                    | 115,817                  |
| Current portion of capital lease obligations  | 34,090                                     | 50,496                   |
| <b>Total current liabilities</b>  | <b>3,607,598</b>                           | <b>2,819,956</b>         |
| Capital lease obligations, less current portion   | 1,719                                      | 9,335                    |
| Other long-term liabilities   | 89,285                                     | 92,461                   |
| <b>Total liabilities</b>  | <b>3,698,602</b>                           | <b>2,921,752</b>         |
| Commitments and contingencies   |  |                          |
| Stockholders equity:  |  |                          |
| Preferred stock, \$.01 par value, 1,000,000 shares authorized: none issued and outstanding  |  |                          |
| Common stock, \$.01 par value, 30,000,000 shares authorized: 9,121,939 shares issued and outstanding at June 30, 2007 and 9,034,941 issued and outstanding at December 31, 2006 | 91,219                                     | 90,350                   |
| Additional paid-in capital  | 40,564,757                                 | 40,138,284               |
| Accumulated deficit   | (6,670,481)                                | (4,824,646)              |
| <b>Total stockholders equity</b>  | <b>33,985,495</b>                          | <b>35,403,988</b>        |
| <b>Total liabilities and stockholders equity</b>  | <b>\$ 37,684,097</b>                       | <b>\$ 38,325,740</b>     |

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

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## DIGITAL MUSIC GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

|  | For the Six Months |                |
|--|--------------------|----------------|
|  | Ended June 30,     |                |
|  | 2007               | 2006           |
|  | (Unaudited)        |                |
| Revenue  | \$ 6,543,811       | \$ 1,560,187   |
| Cost of revenue:   |                    |                |
| Royalties and payments to content owners                     | 4,593,191          | 735,325        |
| Amortization of digital rights and master recordings         | 394,451            | 134,848        |
| Gross profit   | 1,556,169          | 690,014        |
| Operating, general and administrative expenses               | 3,482,509          | 2,294,862      |
| Merger-related expenses                                      | 328,844            |                |
| Loss from operations   | (2,255,184)        | (1,604,848)    |
| Interest income  | 441,516            | 608,006        |
| Interest expense   | (3,924)            | (6,066)        |
| Other expense  | (27,443)           |                |
| Loss before income taxes                                     | (1,845,035)        | (1,002,908)    |
| Income taxes   | (800)              | (400)          |
| Net loss   | \$ (1,845,835)     | \$ (1,003,308) |
| Net loss per common share basic and diluted                  | \$ (0.20)          | \$ (0.14)      |
| Weighted average common shares outstanding basic and diluted | 9,030,880          | 7,266,804      |

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



**Table of Contents****Index to Financial Statements****DIGITAL MUSIC GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | <b>For the Six Months</b> |                |
|---|---------------------------|----------------|
|   | <b>Ended June 30,</b>     |                |
|   | <b>2007</b>               | <b>2006</b>    |
|   | <b>(Unaudited)</b>        |                |
| <b>Cash flows from operating activities:</b>  |                           |                |
| Net loss  | \$ (1,845,835)            | \$ (1,003,308) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities:                           |                           |                |
| Non-cash charges to operations:   |                           |                |
| Depreciation of furniture and equipment   | 176,219                   | 47,183         |
| Amortization of digital rights and master recordings  | 394,451                   | 134,848        |
| Recoupment of royalty advances  | 590,033                   | 249,393        |
| Share-based compensation related to stock options, warrants and restricted shares issued                            | 196,200                   | 159,883        |
| Loss on asset sales   | 10,856                    |                |
| Changes in operating assets and liabilities:  |                           |                |
| Accounts receivable   | (148,146)                 | (58,331)       |
| Prepaid expenses and other current assets   | (109,045)                 | (396,124)      |
| Accounts payable  | (104,511)                 | 276,377        |
| Accrued liabilities   | (74,305)                  | (170,495)      |
| Royalties payable   | 251,969                   | 246,951        |
| Accrued compensation and benefits   | 25,887                    | 27,562         |
| Net cash used in operating activities   | (636,227)                 | (486,061)      |
| <b>Cash flows from investing activities:</b>  |                           |                |
| Purchases of furniture and equipment  | (406,713)                 | (196,731)      |
| Purchases of digital rights and master recordings   | (1,252,968)               | (1,812,127)    |
| Payments of advance royalties   | (4,222,699)               | (1,070,813)    |
| Proceeds from asset sales   | 2,300                     |                |
| Change in other assets and long-term liabilities, net   | 3,238                     | (27,068)       |
| Net cash used in investing activities   | (5,876,842)               | (3,106,739)    |
| <b>Cash flows from financing activities:</b>  |                           |                |
| Proceeds from initial public offering of common stock   |                           | 33,232,055     |
| Proceeds from the exercise of Digital Musicworks International, Inc. options and warrants prior to recapitalization |                           | 43,873         |
| Proceeds from issuance of restricted stock  | 300                       | 150            |
| Payments on capital lease obligations   | (24,022)                  | (39,231)       |
| Net cash (used in) provided by financing activities   | (23,722)                  | 33,236,847     |
| Net (decrease) increase in cash and cash equivalents  | (6,536,791)               | 29,644,047     |
| Cash and cash equivalents, beginning of period  | 20,505,674                | 468,490        |
| Cash and cash equivalents, end of period  | \$ 13,968,883             | \$ 30,112,537  |

**Supplemental cash flow information:**

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|  |    |         |    |         |
|--|----|---------|----|---------|
| Interest paid  | \$ | 3,924   | \$ | 6,066   |
| <b>Supplemental disclosure of non-cash investing and financing transactions:</b>               |    |         |    |         |
| Increase in goodwill resulting from issuance of earn-out consideration for DRA acquisition     | \$ | 935,850 |    |         |
| Issuance of warrant to underwriters  | \$ |         | \$ | 620,529 |
| Purchase of certain assets of Rio Bravo Entertainment LLC through the issuance of common stock | \$ |         | \$ | 243,750 |
| Reduction in contract for digital rights   | \$ |         | \$ | 115,320 |
| Purchase of furniture and equipment under capital lease obligations                            | \$ |         | \$ | 77,791  |
| Holdback for purchase of master recordings   | \$ |         | \$ | 75,000  |
| Merger between Digital Music Group, Inc. and Digital Musicworks International, Inc.            | \$ |         | \$ | 73,305  |

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

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**DIGITAL MUSIC GROUP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. ORGANIZATION AND BASIS OF PREPARATION**

Digital Music Group, Inc. ( DMGI ) was incorporated in Delaware on April 11, 2005 for the purpose of pursuing digital music opportunities. In February 2006, DMGI completed its initial public offering (the IPO ). Concurrent with the closing of the IPO, DMGI acquired all of the outstanding common stock of Digital Musicworks International, Inc., a California corporation ( DMI ), and certain assets of Rio Bravo Entertainment LLC, a Delaware limited liability company doing business as Psychobaby ( Rio Bravo ). The financial statements for DMGI prior to February 7, 2006 are the financial statements of DMI, which has been designated as DMGI s acquiror for accounting purposes. The historical shareholders equity of DMI has been restated for all periods prior to February 7, 2006 to give retroactive effect to the acquisition by DMGI. The results of operations of the Rio Bravo assets and of DMGI are included in the financial statements beginning on February 7, 2006.

On September 8, 2006, DMGI entered into an Agreement and Plan of Merger with Digital Rights Agency, LLC, a California limited liability company ( DRA ), and DRA became a wholly-owned subsidiary of DMGI. The consolidated financial statements include the accounts of DMGI and its wholly-owned subsidiary. All intercompany accounts and transactions have been eliminated.

The accompanying unaudited condensed consolidated financial statements are presented pursuant to the rules and regulations of the United States Securities and Exchange Commission in accordance with the disclosure requirements for the quarterly report on Form 10-Q. In the opinion of management of DMGI, the unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary to fairly state the results for the interim periods presented. Operating results for the six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes of DMGI included in DMGI s Annual Report on Form 10-K for the year ended December 31, 2006.

Certain reclassifications have been made to the prior period s balance sheet in order to conform to the current period s presentation. All data for interim periods, including June 30, 2007 and 2006, is unaudited.

**2. ACQUISITIONS AND INITIAL PUBLIC OFFERING**

On February 7, 2006, DMGI completed its initial public offering of common stock, selling 3,900,000 shares at \$9.75 per share and generating net cash proceeds (after fees and expenses) of approximately \$33,200,000. On the same date, in connection with the closing of the IPO, DMGI issued to the underwriters in the offering warrants to purchase an aggregate of 273,000 shares of DMGI s common stock. Each of the warrants has an exercise price of \$12.1875 per share, and is exercisable at any time from February 7, 2007 until February 6, 2011. The underwriters paid an aggregate of \$100 for the warrants. The warrants had an estimated fair value at the date of issuance of \$620,529 as determined in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Compensation*, assuming a dividend yield of 0%, expected volatility of 35%, risk free rate of return of 4.52%, and an expected term to exercise of 4.6 years. The fair value of the warrants was recorded as an offering cost. Accordingly, the total net proceeds from DMGI s IPO were approximately \$32,600,000.

Also on February 7, 2006, DMGI concurrently acquired DMI and certain assets of Rio Bravo in exchange for 2,249,941 and 25,000 shares, respectively, of DMGI s common stock. DMI has been deemed the acquiror for financial reporting purposes. DMGI had net liabilities and a stockholders deficit of \$73,305 on the date of its

**Table of Contents****Index to Financial Statements****DIGITAL MUSIC GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

acquisition of DMI. The purchase price of the Rio Bravo assets on February 7, 2006 totaled \$243,750, which has been allocated to digital rights. Such rights are being amortized over 24 months, the estimated remaining life of the assets.

On September 8, 2006, DMGI acquired all of the ownership interests in DRA in exchange for \$3,200,000 in cash, 420,000 shares of DMGI common stock and a warrant issued to the former Managing Director of DRA to purchase 150,000 shares of DMGI's common stock at an exercise price of \$5.57 per share. The warrant had an estimated fair value at the date of issuance of \$97,350 as determined in accordance with Statement of Financial Accounting Standards No. 123R, assuming a dividend yield of 0%, expected volatility of 35%, risk free rate of return of 4.7%, and an expected term to exercise of 4.75 years. The fair value of the warrant was recorded as acquisition consideration. The warrant is exercisable in various installments beginning in September 2007, is fully exercisable by September 2009, and expires in September 2013 or upon a change in control of DMGI. The shares and warrant were issued in a private placement under federal and state securities law and are subject to restrictions on resale thereunder, and a substantial majority of the shares are subject to contractual restrictions on resale, short selling and other forms of hedging for varying terms ranging from one to two years from the acquisition date.

The estimated purchase price of DRA consisted of the following:

|  |                     |
|--|---------------------|
| Cash consideration   | \$ 3,905,008        |
| Common stock issued (420,000 shares at \$4.14 per share)             | 1,738,800           |
| Common stock subsequently issued (56,998 shares at \$4.05 per share) | 230,842             |
| Liabilities assumed  | 1,929,667           |
| Acquisition costs  | 131,466             |
| Estimated fair value of common stock warrant issued                  | 97,350              |
|  | <b>\$ 8,033,133</b> |

The total purchase price was allocated to DRA's assets and liabilities based on their estimated fair values as of the acquisition date. A summary of the preliminary purchase price allocation, which is subject to finalization, is as follows:

|                         |                     |
|-------------------------|---------------------|
| Cash                    | \$ 438,374          |
| Accounts receivable     | 948,335             |
| Other current assets    | 399,680             |
| Furniture and equipment | 115,800             |
| Digital rights          | 775,000             |
| Goodwill                | 5,355,944           |
|                         | <b>\$ 8,033,133</b> |

On June 21, 2007, DMGI entered into an amendment to the DRA acquisition agreement whereby it agreed to pay the former members of DRA \$705,008 in cash and 56,998 shares of DMGI common stock in lieu of any payments that would otherwise become due under the earn-out provisions of the acquisition agreement, pursuant to which DMGI would have been obligated to pay up to \$1,155,000 in cash and to issue up to 87,000 shares of DMGI common stock if certain financial targets were achieved through December 31, 2007. This amendment resulted in an increase in goodwill of \$935,850, with the cash portion recorded as a liability at June 30, 2007 and paid in full in July 2007.



Table of ContentsIndex to Financial Statements**DIGITAL MUSIC GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The unaudited pro forma combined statements of operations for the six months ended June 30, 2006 presented below assume that the acquisitions of DMI, Rio Bravo and DRA were closed on January 1, 2006:

|  | <b>For the six months</b>  |
|--|----------------------------|
|  | <b>ended June 30, 2006</b> |
| Revenue  | \$ 4,865,545               |
| Cost of revenue  | 3,732,727                  |
| Gross profit   | 1,132,818                  |
| Operating, general and administrative expenses               | 2,791,602                  |
| Loss from operations   | (1,658,784)                |
| Interest income  | 613,929                    |
| Interest and other income (expense)                          | (12,240)                   |
| Loss before income taxes                                     | (1,057,095)                |
| Income taxes   | (400)                      |
| Net loss   | \$ (1,057,495)             |
| Net loss per common share basic and diluted                  | \$ (0.13)                  |
| Weighted average common shares outstanding basic and diluted | 8,258,154                  |

Weighted average shares used in the calculation of the unaudited pro forma combined basic and diluted net loss per share for the six months ended June 30, 2006 include the shares issued in connection with the acquisitions of DMI and Rio Bravo on February 7, 2006, and the shares issued in connection with the acquisition of DRA on September 8, 2006 and June 21, 2007, as if these acquisitions had all occurred on January 1, 2006.

The adjustments used in the preparation of this unaudited pro forma combined statement of operations are based on estimates, available information and certain assumptions, as they relate to DRA, which may be revised as additional information becomes available. The pro forma financial data do not purport to represent what DMGI's combined results of operations would actually have been if such acquisitions had in fact occurred at the beginning of the period, and are not necessarily representative of DMGI's results of operations for any future period since the companies were not under common management or control during the period presented.

**3. RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ( SFAS No. 157 ), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles ( GAAP ). As a result of SFAS No. 157, there is now a common definition of fair value to be used throughout GAAP. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the impact of this statement on DMGI.

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In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* ( SFAS No. 159 ). SFAS No. 159 permits entities to choose to measure eligible assets and liabilities at fair value with changes in value recognized in earnings. Fair value treatment for eligible assets and liabilities may be elected either prospectively upon initial recognition, or if an event triggers a new basis of accounting for an

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existing asset or liability. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the impact of this statement on DMGI.

**4. ACCOUNTING POLICIES**

The accounting policies of DMGI are set forth in Note 2 of the Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2006. There have been no changes to these policies other than the adoption of FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. See Note 9 below.

**5. CASH AND CASH EQUIVALENTS**

DMGI considers all highly liquid investments with an original maturity or remaining maturity from date of purchase of three months or less to be cash equivalents. Based upon its investment policy, DMGI may invest its cash primarily in demand deposits with major financial institutions, in highly rated commercial paper, United States treasury obligations, United States and municipal government agency securities, United States government sponsored enterprises, money market funds and highly liquid debt securities of corporations. DMGI held approximately \$12,100,000 and \$6,500,000 in cash equivalents at June 30, 2007 and December 31, 2006, respectively.

DMGI maintains its cash and cash equivalents at financial institutions. The combined account balances at several institutions exceed Federal Deposit Insurance Corporation ( FDIC ) insurance coverage and, as a result, there is a concentration of credit risk related to amounts on deposit in excess of FDIC insurance coverage. DMGI has not incurred losses on these deposits to date and does not expect to incur any losses based on the credit ratings of the financial institutions.

**6. DIGITAL RIGHTS**

Digital rights comprise the following at:

|                               | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|-------------------------------|--------------------------|------------------------------|
| Digital rights                | \$ 4,218,355             | \$ 3,405,605                 |
| Less accumulated amortization | (671,962)                | (372,366)                    |
|                               | <b>\$ 3,546,393</b>      | <b>\$ 3,033,239</b>          |

Amortization expense was \$299,596 and \$124,396 for the six months ended June 30, 2007 and 2006, respectively.

**7. MASTER RECORDINGS**

Master recordings comprise the following at:



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|                               | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|-------------------------------|--------------------------|------------------------------|
| Master recordings             | \$ 2,293,379             | \$ 1,853,161                 |
| Less accumulated amortization | (170,536)                | (75,681)                     |
|                               | <b>\$ 2,122,843</b>      | <b>\$ 1,777,480</b>          |

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## DIGITAL MUSIC GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amortization expense was \$94,855 and \$10,452 for the six months ended June 30, 2007 and 2006, respectively.

**8. ROYALTY ADVANCES**

Royalty advances comprise the following at:

|  | June 30,<br>2007 | December 31,<br>2006 |
|--|------------------|----------------------|
| Total royalty advances                         | \$ 10,880,637    | \$ 6,657,938         |
| Less cumulative recoupment of royalty advances | (1,691,189)      | (1,101,156)          |
|  | 9,189,448        | 5,556,782            |
| Current portion of royalty advances            | (1,983,679)      | (1,326,379)          |
|  | \$ 7,205,769     | \$ 4,230,403         |

**9. INCOME TAXES**

DMGI adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), on January 1, 2007. FIN 48 provides a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. There was no impact on DMGI's consolidated financial statements as a result of the adoption of FIN 48.

DMGI has incurred net losses since its inception and has fully offset the deferred income tax benefit of such losses by a valuation allowance due to the uncertainty of the ultimate realization of such tax benefits. DMGI has substantial net operating losses available for carryforward to reduce future taxable income for federal and state income tax reporting purposes. The federal net operating loss carryforwards begin to expire in 2024 and the state net operating loss carryforwards begin to expire in 2014. In addition to potential expiration, there are other factors that could limit DMGI's ability to use these federal and state tax loss carryforwards. Under Section 382 of the Internal Revenue Code of 1986 ( Section 382 ), as amended, use of prior net operating loss carryforwards can be limited after an ownership change. DMGI's ability to fully utilize DMI's net operating loss carryforward will be subject to limitation under Section 382 as a result of its merger with DMGI and other transactions, and may be subject to further limitations as a result of future sales of securities, if any. Accordingly, it is not certain how much of the existing net operating loss carryforward will be available for use by DMGI. DMGI's future tax benefits as of June 30, 2007 and 2006 have been fully offset by a valuation allowance due to the uncertainty of their ultimate realization. If DMGI generates taxable income in the future, the use of net operating loss carryforwards that have not expired would have the effect of reducing DMGI's tax liability and increasing after-tax net income.

**10. CONCENTRATION OF CREDIT RISK**

Accounts receivable from DMGI's largest digital entertainment service comprised approximately 40% and 51% of DMGI's consolidated accounts receivable at June 30, 2007 and December 31, 2006, respectively. Based on its previous cash collection experience and knowledge of the digital entertainment service, DMGI does not believe there is significant collection risk associated with this account.

**11. COMMITMENTS AND CONTINGENCIES**

At June 30, 2007, DMGI is contractually obligated to pay up to \$3.4 million over the next twelve months in additional advance royalties and digital rights and master recordings purchase consideration. These payments are

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## DIGITAL MUSIC GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

due under various digital rights agreements as music and video recordings and related metadata and artwork are received from the content owners for processing by DMGI. DMGI is also obligated to pay a total of \$348,750 in equal quarterly installments through February 2016 as additional advances against future royalties under one long-term agreement.

**12. SHARE-BASED COMPENSATION**

DMGI recorded non-cash charges of \$196,200 and \$159,883 as a component of operating, general and administrative expense related to share-based arrangements for the six months ended June 30, 2007 and 2006, respectively. The share-based compensation charge for the six months ended June 30, 2006 included \$38,834 associated with the accelerated vesting of DMI stock options due to the merger of DMI with DMGI.

DMGI has an Amended and Restated 2005 Stock Plan (the Plan) under which 1,102,000 shares of its common stock have been reserved for issuance at June 30, 2007. All options granted to employees since inception of the Plan have a four-year vesting period. Annual option grants to non-employee directors are automatic pursuant to a formula within the Plan which establishes the number of shares and terms of such grants.

In accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Compensation*, DMGI utilizes the Trinomial Lattice Model to measure the fair value of stock option grants. The following weighted-average assumptions were used in estimating the fair value per share of the options granted under the Plan for the six months ended June 30, 2007 and 2006:

|                            |             |             |
|----------------------------|-------------|-------------|
|                            | <b>2007</b> | <b>2006</b> |
| Risk-free rate of return   | 4.75%       | 4.66%       |
| Expected volatility        | 50.0%       | 35.0%       |
| Expected life (in years)   | 5.0         | 5.3         |
| Suboptimal exercise factor | 2           | 2           |
| Exit rate post-vesting     | 19.9%       | 22.8%       |
| Exit rate pre-vesting      | 15.9%       | 19.0%       |

DMGI calculates the expected volatility for stock-based awards using the historical volatility for its peer group public companies because sufficient historical trading data does not yet exist for DMGI's common stock. DMGI estimates the forfeiture rate for stock-based awards based on historical data. The risk-free rate for stock options granted is determined by using a zero-coupon U.S. Treasury rate for the period that coincides with the expected option terms. It is further assumed that there are no dividend payments.

Stock option activity for the six months ended June 30, 2007 is summarized as follows:

|  |                     |                | Weighted-<br>Average | Remaining<br>Contractual | Aggregate<br>Intrinsic |
|--|---------------------|----------------|----------------------|--------------------------|------------------------|
|  | Number of<br>Shares | Exercise Price | Exercise<br>Price    | Term                     | Value                  |

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|                                  |          |                  |         |      |          |
|----------------------------------|----------|------------------|---------|------|----------|
| Outstanding at December 31, 2006 | 366,500  | \$ 4.02 - \$9.75 |         |      |          |
| Granted                          | 137,500  | \$ 4.02 - \$4.99 |         |      |          |
| Exercised                        |          |                  |         |      |          |
| Forfeited                        | (51,000) | \$ 4.13 - \$9.66 |         |      |          |
| Outstanding at June 30, 2007     | 453,000  | \$ 4.02 - \$9.75 | \$ 7.45 | 7.33 | \$ 1,270 |
| Exercisable at June 30, 2007     | 139,000  | \$ 6.38 - \$9.75 | \$ 9.51 | 7.91 | \$       |

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The aggregate intrinsic value shown in the table above was calculated as the difference between the exercise price of the underlying awards and the quoted price of DMGI's common stock for the 63,500 options that were in-the-money at June 30, 2007. The weighted average estimated grant-date fair value per share for the 1,354 vested and 49,646 unvested options forfeited during the six months ended June 30, 2007 was \$1.17 per share.

Restricted stock activity is summarized as follows:

|                                | Number of | Weighted-Average |
|--------------------------------|-----------|------------------|
|                                | Shares    | Grant-Date       |
|                                |           | Fair Value       |
| Nonvested at December 31, 2006 | 143,334   | \$ 0.68          |
| Issued                         | 30,000    | \$ 4.98          |
| Vested                         | (121,668) | \$ 0.40          |
| Nonvested at June 30, 2007     | 51,666    | \$ 3.83          |

Subsequent to June 30, 2007, 16,666 non-vested restricted shares became vested upon the resignation and termination of the employment of a former executive as required under the restricted stock agreement with such executive.

As of June 30, 2007, the future pre-tax share-based compensation expense for stock option grants is \$540,919 to be recognized in the remainder of 2007 through 2011. Future pre-tax share-based compensation expense for restricted stock is \$156,800 to be recognized in the remainder of 2007 through 2008. However, in the event of a change in control as described in Note 14 below, all of the unvested options would become fully vested and all restrictions on restricted shares would lapse in accordance with the terms of the Plan, and DMGI would recognize all of the future share-based compensation expense.

**13. NET LOSS PER SHARE**

Basic and diluted net loss per share has been computed using the weighted-average number of shares of common stock outstanding for the six months ended June 30, 2007 and 2006 of 9,030,880 and 7,266,804, respectively. As of June 30, 2007, common stock equivalents included outstanding stock options, warrants and non-vested restricted stock totaling 453,000, 423,000 and 35,000 shares, respectively. Common stock equivalents have been excluded from the calculation of the weighted-average number of shares outstanding in all periods presented due to their antidilutive effect. Restricted stock vesting over two years which was issued to three executives in August 2005 were nominal issuances and all such shares are included in basic and diluted weighted-average shares outstanding for the six months ended June 30, 2007 and 2006.

**14. SUBSEQUENT EVENT**

On July 10, 2007, DMGI entered into a merger agreement, which was amended and restated on September 13, 2007 and further amended and restated on October 1, 2007, with The Orchard Enterprises Inc. ( "Orchard" ), a leading global digital distributor and marketer of music, under which Orchard will become a wholly-owned subsidiary of DMGI following the merger. The combined company will be headquartered in New York, New York. The terms of the merger agreement, as amended and restated on September 13, 2007, obligate DMGI to issue in a private placement an aggregate of 9,064,941 shares of common stock of DMGI and 448,833 shares of a newly created series of preferred stock in

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exchange for all outstanding shares of common and preferred stock of Orchard and all outstanding derivative instruments to acquire shares of Orchard. Each share of DMGI preferred stock will be convertible into, and will have voting rights equivalent to, ten shares of DMGI's common stock, with a liquidation preference of \$55.70 per share.

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**DIGITAL MUSIC GROUP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Completion of the merger is subject to customary closing conditions, including, but not limited to, approval by DMGI's and Orchard's shareholders. DMGI is currently preparing a proxy statement that will be filed in preliminary form with the SEC. Once the proxy statement is finalized, it will be presented to shareholders with a request for approval of the merger. DMGI cannot provide any assurance that all conditions to the merger with Orchard will be satisfied or that the merger will be consummated. The merger agreement contains certain restrictions on the operation of the business of each of DMGI and Orchard through the closing. It also contains certain termination rights for DMGI and Orchard, and further provides that if the merger agreement is terminated under certain circumstances, DMGI or Orchard will be required to pay the other a termination fee of up to approximately \$1.6 million.

In connection with the merger, DMGI implemented a retention bonus plan for key employees under which DMGI is obligated to pay up to a total of \$330,000 in one-time retention bonuses to eligible employees who remain continuously employed by DMGI through the closing date of the merger, which is expected to take place in the fourth calendar quarter of 2007.



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**INDEPENDENT AUDITORS REPORT**

To the Board of Directors and Stockholders of

The Orchard Enterprises Inc.:

We have audited the accompanying consolidated balance sheets of The Orchard Enterprises Inc. and subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion such consolidated financial statements present fairly, in all material respects, the financial position of The Orchard Enterprises Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP  
New York, NY  
July 30, 2007 (except for paragraphs 3, 4 and 5  
of Note 15, as to which the date is  
September 13, 2007 and paragraphs 8, 9 and 10  
of Note 15 as to which the date is October 5, 2007)

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|  | December 31, |              |
|--|--------------|--------------|
|  | 2006         | 2005         |
| <b>ASSETS</b>  |              |              |
| <b>CURRENT ASSETS:</b>   |              |              |
| Cash and cash equivalents  | \$ 1,675,889 | \$ 21,866    |
| Accounts receivable net (including amounts from related parties of \$483,037 in 2006 and \$340,483 in 2005)  | 3,126,987    | 1,715,065    |
| Royalty advances   | 585,575      | 207,220      |
| Prepaid expenses and other current assets  | 174,360      | 132,749      |
| Total current assets   | 5,562,811    | 2,076,900    |
| PROPERTY AND EQUIPMENT Net   | 651,405      | 218,855      |
| OTHER ASSETS   | 327,562      | 29,294       |
| TOTAL  | \$ 6,541,778 | \$ 2,325,049 |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIENCY</b>   |              |              |
| <b>CURRENT LIABILITIES:</b>  |              |              |
| Accounts payable   | \$ 249,507   | \$ 955,979   |
| Accrued royalties  | 5,688,066    | 2,985,628    |
| Accrued expenses   | 1,060,792    | 111,527      |
| Note payable   |              | 100,000      |
| Due to affiliated entities   | 46,286       | 23,183       |
| Deferred revenue   | 146,494      |              |
| Accrued interest payable (including amounts to related parties of \$1,227,937 in 2006 and \$707,852 in 2005)   | 1,227,937    | 737,852      |
| Convertible debt payable to a related party  | 6,600,000    | 7,931,000    |
| Total current liabilities  | 15,019,082   | 12,845,169   |
| <b>COMMITMENTS AND CONTINGENCIES</b>   |              |              |
| <b>STOCKHOLDERS DEFICIENCY:</b>  |              |              |
| Series A convertible preferred stock, \$.001 par value 20,000,000 shares authorized, 7,931,000 issued and outstanding as of December 31, 2006; liquidation preference of \$8,386,978   | 7,931        |              |
| Series B convertible preferred stock, \$.001 par value 20,000,000 shares authorized, 7,931,000 issued and outstanding as of December 31, 2006; liquidation preference of \$7,931,000   | 7,931        |              |
| Common stock, \$.001 par value 40,000,000 and 5,000,000 shares authorized as of December 31, 2006 and 2005, respectively; 1,762,444 and 1,477,612 shares issued and outstanding as of December 31, 2006 and 2005, respectively | 1,763        | 1,478        |
| Stock subscription receivable  | (1,478)      | (1,478)      |
| Paid-in capital  | 7,998,593    |              |
| Accumulated deficit  | (16,490,894) | (10,521,934) |
| Accumulated other comprehensive income   | (1,150)      | 1,814        |
| Total stockholders deficiency  | (8,477,304)  | (10,520,120) |
| TOTAL  | \$ 6,541,778 | \$ 2,325,049 |

See notes to consolidated financial statements.

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**THE ORCHARD ENTERPRISES INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

|  | Year ended December 31, |                       |                       |
|--|-------------------------|-----------------------|-----------------------|
|  | 2006                    | 2005                  | 2004                  |
| REVENUES (including amounts from related parties of \$1,783,140 in 2006, \$1,007,814 in 2005, and \$73,313 in 2004)                  | \$ 14,918,135           | \$ 6,820,378          | \$ 1,981,883          |
| COSTS OF REVENUES (including amounts from related parties of \$68,797 in 2006, \$35,830 in 2005, and \$11,759 in 2004)               | 10,717,017              | 5,277,958             | 1,497,430             |
| <b>GROSS PROFIT</b>  | <b>4,201,118</b>        | <b>1,542,420</b>      | <b>484,453</b>        |
| OPERATING EXPENSES:  |                         |                       |                       |
| Product development (including amounts from related parties of \$5,577 in 2006, \$4,307 in 2005, and \$3,152 in 2004)                | 118,943                 | 171,820               | 169,110               |
| Sales and marketing (including amounts from related parties of \$128,274 in 2006, \$53,128 in 2005, and \$33,094 in 2004)            | 3,126,707               | 1,468,261             | 1,114,390             |
| General and administrative (including amounts from related parties of \$1,017,657 in 2006, \$830,247 in 2005, and \$612,946 in 2004) | 6,537,087               | 3,727,066             | 2,544,953             |
| Total operating expenses   | 9,782,737               | 5,367,147             | 3,828,453             |
| <b>LOSS FROM OPERATIONS</b>  | <b>(5,581,619)</b>      | <b>(3,824,727)</b>    | <b>(3,344,000)</b>    |
| OTHER (INCOME) EXPENSE:  |                         |                       |                       |
| Other income   | (130,000)               |                       |                       |
| Interest income  | (2,743)                 | (319)                 |                       |
| Interest expense (including amounts from related parties of \$520,084 in 2006, \$464,261 in 2005, and \$200,709 in 2004)             | 520,084                 | 474,261               | 272,551               |
| Total other (income) expense   | 387,341                 | 473,942               | 272,551               |
| <b>NET LOSS</b>  | <b>\$ (5,968,960)</b>   | <b>\$ (4,298,669)</b> | <b>\$ (3,616,551)</b> |

See notes to consolidated financial statements.

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**THE ORCHARD ENTERPRISES INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS DEFICIENCY**  
**FOR THE YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004**

|   | Series A Preferred |          | Series B Preferred |          | Common Stock |          |            | Accumulated  |                 |                     |                                   |                         |                    |
|---|--------------------|----------|--------------------|----------|--------------|----------|------------|--------------|-----------------|---------------------|-----------------------------------|-------------------------|--------------------|
|   | Shares             | Amount   | Shares             | Amount   | Shares       | Amount   | Receivable | Subscription | Paid-in Capital | Accumulated Deficit | Other Comprehensive Income (Loss) | Stockholders Deficiency | Comprehensive Loss |
| BALANCE January 1, 2004                 |                    | \$       |                    | \$       | 1,477,612    | \$ 1,478 | \$(1,478)  |              |                 | \$ (2,606,714)      |                                   | \$ (2,606,714)          | \$                 |
| Foreign currency translation adjustment |                    |          |                    |          |              |          |            |              |                 |                     | 697                               | 697                     | 697                |
| Net loss                                |                    |          |                    |          |              |          |            |              |                 | (3,616,551)         |                                   | (3,616,551)             | (3,616,551)        |
| BALANCE December 31, 2004               |                    |          |                    |          | 1,477,612    | 1,478    | (1,478)    |              |                 | (6,223,265)         | 697                               | (6,222,568)             | (3,615,854)        |
| Foreign currency translation adjustment |                    |          |                    |          |              |          |            |              |                 |                     | 1,117                             | 1,117                   | 1,117              |
| Net loss                                |                    |          |                    |          |              |          |            |              |                 | (4,298,669)         |                                   | (4,298,669)             | (4,298,669)        |
| BALANCE December 31, 2005               |                    |          |                    |          | 1,477,612    | 1,478    | (1,478)    |              |                 | (10,521,934)        | 1,814                             | (10,520,120)            | (4,297,552)        |
| Issuance of Common Stock                |                    |          |                    |          | 284,832      | 285      |            |              | 83,455          |                     |                                   | 83,740                  |                    |
| Issuance of Preferred Stock             | 7,931,000          | 7,931    | 7,931,000          | 7,931    |              |          |            |              | 7,915,138       |                     |                                   | 7,931,000               |                    |
| Foreign currency translation adjustment |                    |          |                    |          |              |          |            |              |                 |                     | (2,964)                           | (2,964)                 | (2,964)            |
| Net loss                                |                    |          |                    |          |              |          |            |              |                 | (5,968,960)         |                                   | (5,968,960)             | (5,968,960)        |
| BALANCE December 31, 2006               | 7,931,000          | \$ 7,931 | 7,931,000          | \$ 7,931 | 1,762,444    | \$ 1,763 | \$(1,478)  |              | \$ 7,998,593    | \$ (16,490,894)     | \$(1,150)                         | \$( 8,477,304)          | \$( 5,971,924)     |

See notes to consolidated financial statements.

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|  | Year ended December 31, |                |                |
|--|-------------------------|----------------|----------------|
|  | 2006                    | 2005           | 2004           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                         |                |                |
| Net loss   | \$ (5,968,960)          | \$ (4,298,669) | \$ (3,616,551) |
| Adjustments to reconcile net loss to net cash used in operating activities:                |                         |                |                |
| Depreciation and amortization  | 151,311                 | 45,745         | 18,064         |
| Bad debt expense   | 70,000                  |                |                |
| Net loss on sale/disposal of fixed assets  | 39,783                  |                |                |
| Gain on note payable and related accrued interest  | (130,000)               |                |                |
| Stock-based compensation   | 83,740                  |                |                |
| Changes in operating assets and liabilities:   |                         |                |                |
| Accounts receivable  | (1,481,922)             | (1,370,927)    | (335,463)      |
| Royalty advances   | (378,355)               | (175,577)      | (31,643)       |
| Prepaid expenses and other current assets  | (41,611)                | (80,635)       | (1,375)        |
| Other assets   | (298,268)               |                | (11,294)       |
| Accounts payable   | (706,472)               | 716,808        | 185,475        |
| Accrued royalties  | 2,702,438               | 2,068,363      | 731,964        |
| Accrued expenses   | 949,265                 | (89,491)       | (42,415)       |
| Due to affiliated entities   | 23,103                  | 7,012          | 50,383         |
| Deferred revenue   | 146,494                 |                |                |
| Accrued interest payable   | 520,085                 | 474,261        | 210,709        |
| Net cash used in operating activities  | (4,319,369)             | (2,703,110)    | (2,842,146)    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                         |                |                |
| Purchases of property and equipment  | (674,651)               | (141,380)      | (114,411)      |
| Proceeds from the sale of fixed assets   | 51,007                  |                |                |
| Net cash used in investing activities  | (623,644)               | (141,380)      | (114,411)      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                         |                |                |
| Proceeds from issuance of convertible debt payable to a related party                      | 6,600,000               | 2,865,000      | 2,956,000      |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS                               | (2,964)                 | 1,117          | 796            |
| INCREASE IN CASH AND CASH EQUIVALENTS  | 1,654,023               | 21,627         | 239            |
| CASH AND CASH EQUIVALENTS Beginning of year  | 21,866                  | 239            |                |
| CASH AND CASH EQUIVALENTS End of year  | \$ 1,675,889            | \$ 21,866      | \$ 239         |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>                                  |                         |                |                |
| Interest paid  | \$                      | \$             | \$ 61,843      |
| Non-cash financing activities:   |                         |                |                |
| Issuance of preferred stock upon conversion of convertible debt payable to a related party | \$ 7,931,000            | \$             | \$             |

See notes to consolidated financial statements.



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**THE ORCHARD ENTERPRISES INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. ORGANIZATION AND BUSINESS**

The Orchard Enterprises Inc. ( Orchard ) was incorporated in New York in September 2000 and was one of the first distributors of digital music content. Orchard is a global music marketing and distribution company, offering a suite of services to assist music content owners create and sell product digitally across a worldwide network of digital entertainment services.

On April 28, 2003, Dimensional Associates, LLC ( Dimensional ), an entity formed by a group of private investors (the Investor Group ), invested in and acquired operating control of Orchard through the purchase of a convertible debt instrument followed by subsequent periodic fundings under the same terms and conditions as the original convertible debt instrument (see Notes 8, 9 and 15).

**2. BASIS OF PRESENTATION**

The accompanying consolidated financial statements have been prepared assuming Orchard will continue as a going concern. Orchard has incurred losses and negative cash flows from operations since its inception. Orchard incurred a net loss of \$5,968,960 for the year ended December 31, 2006, has incurred operating losses since inception, has a working capital deficiency of \$9,456,271 and an accumulated deficit of \$16,490,894 at December 31, 2006. Orchard's ability to continue operating as a going concern is substantially dependent on its ability to generate operating cash flows through the execution of its business plan or to secure funding sufficient to provide for the working capital needs of its business. Until and unless Orchard's operations generate significant revenues and cash flows, Orchard will continue to attempt to fund operations from cash on hand, through the issuance of debt and through the issuance of preferred or common stock. The Investor Group has committed to fund the operations of Orchard through at least July 31, 2008.

**3. SIGNIFICANT ACCOUNTING POLICIES**

**Consolidation and Basis of Presentation** The consolidated financial statements include the accounts of Orchard and its wholly owned subsidiaries, Orchard Management, Inc., and Orchard EU, Limited. The consolidated accounts include 100% of the assets, liabilities, revenues, expenses, and cash flows of Orchard and all entities in which Orchard has a controlling voting interest that are required to be consolidated in accordance with accounting principles generally accepted in the United States ( U.S. GAAP ). All significant inter-company balances and transactions have been eliminated in consolidation.

**Use of Estimates** The preparation of consolidated financial statements and related disclosures in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the period reported. Actual results could differ from those estimates. The most significant estimates relate to assessing the collectability of accounts receivable, the recoverability of royalty advances, the value of securities underlying stock based compensation, the realization of deferred tax assets, tax contingencies, valuation allowances, and the useful lives and potential impairment of Orchard's property and equipment. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the period that they are determined to be necessary.

**Cash and Cash Equivalents** Cash and cash equivalents include all short-term highly liquid investments that are readily convertible to known amounts of cash and have maturities of three months or less when purchased.



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**Allowance for Doubtful Accounts** Orchard establishes allowances for doubtful accounts based on credit profiles of its retailers, current economic and industry trends, contractual terms and conditions and historic payment experience, as well as for known or expected events. Accordingly, at December 31, 2006 and 2005, Orchard had \$70,000 and \$0 recorded as an allowance for doubtful accounts.

**Fair Value of Financial Instruments** The carrying value of Orchard's short-term financial instruments, including accounts receivable, accounts payable, accrued expenses, and accrued royalties approximates their fair value due to the short-term nature of these items. There is no market value information available for Orchard's convertible debt and a reasonable estimate could not be made without incurring excessive costs (see Note 9).

**Foreign Currency Translation** Orchard has foreign operations where the functional currency has been determined to be the local currency. The functional currency of Orchard's subsidiary in the United Kingdom has been determined to be the British Pound. For operations where the local currency is the functional currency, assets and liabilities are translated using end-of-period exchange rates; revenues, expenses and cash flows are translated using average rates of exchange. For these operations, currency translation adjustments are accumulated in a separate component of stockholders' deficiency. Transaction gains and losses are recognized in the determination of net income or loss.

**Concentrations of Credit Risk** Orchard's customers are primarily commercial organizations headquartered in the United States. Accounts receivable are generally unsecured.

The revenues from two of its customers, iTunes and eMusic, account for a significant portion of Orchard's total revenues. Revenues from iTunes were approximately 51%, 45% and 45% of total revenues and revenues from eMusic were approximately 12%, 14% and 4% of total revenues for the years ended December 31, 2006, 2005, and 2004, respectively. Accounts receivable from iTunes were 35% and 31% of total accounts receivable at December 31, 2006 and 2005, respectively. Accounts receivable from eMusic were 15% and 20% of total accounts receivable at December 31, 2006 and 2005, respectively.

**Due From Digital Service Providers** At December 31, 2006 and 2005, accounts receivable includes \$144,046 and \$332,451, respectively, related to reimbursements to Orchard by its customers, for digital encoding of Orchard's music content so that it can be utilized on the customer's retail website.

**Royalty Advances and Digital Rights** Orchard has paid advance royalties and the cost of acquiring digital rights to certain record labels and artists. Orchard accounts for these advance royalty payments and digital rights acquisition costs pursuant to the provisions of Statement of Financial Accounting Standards (SFAS) No. 50, *Financial Reporting in the Record and Music Industry* (SFAS No. 50). Pursuant to SFAS No. 50, certain advance royalty payments that are believed to be recoverable from future royalties to be earned by the artist or songwriter are capitalized as assets. Royalty advances will be recouped from Orchard's future royalty obligations resulting from the fees it receives from digital entertainment services. Digital rights acquired by Orchard are amortized using the straight-line method over the term of the agreement. Orchard classifies royalty advances as short-term or long-term based on the expectations of when these advances will be recovered. The decision to capitalize an advance to an artist or songwriter as an asset requires significant judgment as to the recoverability of these advances. The recoverability of these assets is assessed upon initial commitment of the advance, based upon Orchard's forecast of anticipated revenues from the sale of future and existing music and publishing-related products. In determining whether these amounts are recoverable, Orchard evaluates the current and past popularity of the artist or songwriter, the initial or expected commercial acceptability of the product, the current and past popularity of the genre of music that the product is designed to appeal to, and other relevant factors. Based upon this information, the portion of such advances that is believed not to be recoverable is expensed. All advances and digital rights acquisition costs are assessed for recoverability periodically, at minimum, on a quarterly basis.

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**THE ORCHARD ENTERPRISES INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Property and Equipment** Property and equipment, consisting primarily of office equipment, computer equipment, and furniture and fixtures, are stated at cost less accumulated depreciation. Depreciation and amortization is determined using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are stated at cost and are amortized using the straight-line method over the lesser of the term of the lease or the estimated useful lives of the assets.

Major renewals and improvements are capitalized and minor replacements, maintenance and repairs are charged to current operations as incurred. Upon retirement or disposal of assets, the cost and related accumulated depreciation are removed from the consolidated balance sheets and any gain or loss is reflected in the consolidated statements of operations.

**Internal-Use Software Development Costs** In accordance with AICPA Statement of Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, Orchard capitalizes certain external and internal computer software costs incurred during the application development stage. The application development stage generally includes software design and configuration, coding, testing, and installation activities. Training and maintenance costs are expensed as incurred, while upgrades and enhancements are capitalized if it is probable that such expenditures will result in additional functionality. Capitalized software costs are depreciated over the estimated useful life of the underlying project on a straight-line basis, generally not exceeding five years. Orchard did not capitalize software costs in any periods presented because in the opinion of management these costs were not considered capitalizable.

**Impairment of Long-Lived Assets** Orchard reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. In connection with this review, Orchard also reevaluates the periods of depreciation and amortization for these assets. Orchard assesses recoverability by determining whether the net book value of the related asset will be recovered through the projected undiscounted future cash flows of the asset. If Orchard determines that the carrying value of the asset may not be recoverable, it measures any impairment based on the projected future discounted cash flows as compared to the asset's carrying value. Through December 31, 2006, Orchard has not recorded any impairment charges on its long-lived assets.

**Revenue Recognition** Orchard follows the provisions of Staff Accounting Bulletin ( SAB ) 104, *Revenue Recognition in Financial Statements* ( SAB 104 ), Emerging Issues Task Force ( EITF ) 00-21 *Revenue Arrangements with Multiple Deliverables* and EITF 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*. In general, Orchard recognizes revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Orchard's distribution revenue from the sale of music recordings through digital distribution channels is recognized when the products are sold by the digital service providers, which provide Orchard with periodic notification of the sales.

For arrangements with multiple obligations (*e.g.*, deliverable and undelivered music content, music publishing information and other services), Orchard allocates revenues to each component of the contract based on objective evidence of its fair value. Orchard recognizes revenues allocated to undelivered products when the criteria for product revenues set forth above are met. If objective and reliable evidence of the fair value of the undelivered obligations is not available, the arrangement consideration allocable to a delivered item is combined with the amount allocable to the undelivered item(s) within the arrangement. Revenues are recognized as the remaining obligations are fulfilled. Revenues from multiple element arrangements were not significant in any of the periods presented.

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**THE ORCHARD ENTERPRISES INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In accordance with industry practice and as is customary in many territories, certain physical products (such as CDs and cassettes) are sold to customers with the right to return unsold items. Net distribution revenues to Orchard from such physical sales are recognized when reported by the retail distributor for the products that are shipped based on gross sales typically less a provision for future estimated returns determined by distributor based on past historical trends. During 2006, 2005, and 2004, revenues from physical sales were 4%, 6%, and 16% of total revenues, respectively.

Reimbursements received by Orchard from its customers for encoding Orchard's music content in the appropriate digital format for use by the customer are recognized under the proportional performance method as revenue in the period that the encoded content is delivered to the customer. Cash received in advance of providing the service is recorded as deferred revenue.

Shipping and handling charges billed to customers are included in revenues and the costs associated with shipping physical products are recorded as costs of revenues. The physical products are the property of the record labels and artists. Revenues and cost from shipping and handling were not significant in 2006, 2005, or 2004.

**Costs of Revenues** Costs of revenues includes the royalty expenses owed to the artists and labels, costs of encoding digital music, shipping charges, and digital delivery costs. Royalties earned by labels, artists, songwriters, co-publishers, and other copyright holders, are recognized as an expense in the period in which the sale of the digital or physical music recordings takes place and are included in cost of revenues in the accompanying consolidated statements of operations.

**Product Development Costs** Costs incurred in connection with product development and testing are expensed as incurred. Products development costs for the years ended December 31, 2006, 2005, and 2004, were \$118,943, \$171,820, and \$169,110, respectively.

**Income Taxes** Orchard uses the asset and liability method to determine its income tax expense. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established when realization of deferred tax assets is not considered more likely than not.

**Comprehensive Income** SFAS No. 130, *Reporting Comprehensive Income*, requires the disclosure of comprehensive income to reflect changes in equity that result from transactions and economic events from non-owner sources. Orchard's comprehensive loss for 2006, 2005, and 2004 consisted of net loss and foreign currency translation adjustments.

**Loss Contingencies** Orchard accrues for costs relating to litigation, claims, and other contingent matters when such liabilities become probable and reasonably estimable. Such estimates may be based on advice from third parties or on management's judgment, as appropriate. Actual amounts paid may differ from amounts estimated, and such differences will be charged to operations in the period in which the final determination of the liability is made.

**Recent Accounting Pronouncements** In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation ( FIN ) No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of*

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*FASB Statement No. 109* ( *FIN 48* ), which clarifies the accounting for uncertainty in income tax positions ( *tax positions* ). *FIN 48* requires that Orchard recognize in its financial statements the impact of a tax position if that tax position is more likely than not of being sustained on audit, based on the technical merits of the tax position. The provisions of *FIN 48* are effective as of the beginning of Orchard's 2007 fiscal year, with the cumulative effect of any change in accounting principle recorded as an adjustment to opening retained earnings. Orchard is currently evaluating the impact of adopting *FIN 48* on its consolidated financial statements.

In September 2006, FASB issued SFAS No. 157, *Fair Value Measurements* ( *SFAS 157* ), which defines fair value, establishes a framework for measuring fair value, and expands required disclosures about fair value measurements. The provisions of SFAS 157 are effective for fiscal years beginning after November 15, 2007. Orchard is currently evaluating the impact of adopting SFAS 157 on its financial statements.

In February 2007, FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( *SFAS 159* ). SFAS 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. Orchard does not currently plan to adopt this pronouncement.

**4. PROPERTY AND EQUIPMENT**

Property and equipment at December 31, 2006 and 2005, consist of the following:

|  | Useful<br>Lives<br>(Years) | 2006       | 2005       |
|--|----------------------------|------------|------------|
| Computer and office equipment                  | 5                          | \$ 557,270 | \$ 191,463 |
| Furniture and fixtures                         | 7                          | 79,624     | 17,768     |
| Leasehold improvements                         | 3                          | 185,758    | 75,714     |
| <br>   |                            |            |            |
| Total cost                                     |                            | 822,652    | 284,945    |
| Less accumulated depreciation and amortization |                            | (171,247)  | (66,090)   |
| <br>   |                            |            |            |
| Property and equipment - net                   |                            | \$ 651,405 | \$ 218,855 |

Depreciation and amortization expense was \$151,311, \$45,745, and \$18,064 for the years ended December 31, 2006, 2005, and 2004, respectively. In 2006, Orchard disposed of certain leasehold improvements and office equipment realizing a net loss on sale/disposal of \$39,783 primarily as a result of Orchard's relocation in 2006. Cost of the equipment and leasehold improvements sold/disposed of were \$136,944 and the related accumulated depreciation was \$46,154.

**5. ACCRUED ROYALTIES**

Orchard's distribution revenue from the sale of music recordings through digital distribution channels is recognized when the products are sold by the digital service providers, which provide Orchard with periodic notification of the sales. Also, net distribution revenues to Orchard from physical sales are recognized when reported by the retail distributor for the products that are shipped based on gross sales typically less a provision for future estimated returns determined by past historical trends.

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Accordingly, royalties earned by labels, artists, songwriters, co-publishers, and other copyright holders are recognized as an expense and a related accrued royalty liability is recognized on the balance sheet in the period in which the sale of the digital or physical music recording takes place. Orchard typically enters into a

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contractual arrangement with the label or artist under which Orchard is obligated to pay royalties to the label or artist based on an agreed upon percentage of the total distribution revenue. Orchard is normally obligated to pay the royalties 45 days after the end of the quarter in which it receives the distribution revenue from the service provider. Accrued royalties amounted to \$5,688,066 and \$2,985,628 at December 31, 2006 and 2005, respectively.

**6. INCOME TAXES**

The following is a summary of Orchard's tax provision for the years ended December 31, 2006, 2005 and 2004.

|                     | Year Ended December 31, |           |             |
|---------------------|-------------------------|-----------|-------------|
|                     | 2006                    | 2005      | 2004        |
| Current             | \$                      | \$        | \$          |
| Deferred            |                         |           |             |
| U.S. Federal        | 2,897,000               | 926,000   | 1,036,000   |
| Foreign             | 60,000                  | 40,000    | 40,000      |
| Subtotal            | 2,957,000               | 966,000   | 1,076,000   |
| Valuation allowance | (2,957,000)             | (966,000) | (1,076,000) |
| Total deferred      |                         |           |             |
| Income tax benefit  | \$                      | \$        | \$          |

The following table presents the principal reasons for the difference between the statutory U.S. federal income tax rate and effective income tax rates for the years ended December 31, 2006, 2005 and 2004, presented as follows:

|   | 2006 | 2005 | 2004 |
|---|------|------|------|
| Income tax benefit at U.S. statutory rate of 35%    | 35%  | 35%  | 35%  |
| State and local income taxes net of federal benefit | 11   | 11   | 11   |
| Effect of permanent differences                     | 1    | 1    | 1    |
| Total   | 47   | 47   | 47   |
| Less valuation allowance                            | (47) | (47) | (47) |
| Effective income tax rate                           | 0%   | 0%   | 0%   |

At December 31, 2006, Orchard had approximately \$15,800,000 of net operating loss carryforwards for U.S. federal income tax purposes which expire in the years 2020 through 2027. Due to the uncertainty of their realization, no income tax benefit has been recorded by Orchard for these net operating loss carryforwards and valuation allowances have been established for any such benefits. The utilization of Orchard's net operating losses may be subject to a substantial limitation due to the change of ownership provisions under Section 382 of the Internal Revenue Code and

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similar state provisions. Such limitation may result in the expiration of the net operating loss carryforwards before their utilization.

At December 31, 2006, Orchard EU, Limited had available approximately \$350,000 of foreign net operating loss carryforwards with no expiration date. At December 31, 2006, Orchard Management, Inc. had available approximately \$30,000 of net operating loss carryforwards which expire in the years 2020 through 2027.

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Significant components of Orchard's deferred tax assets for U.S. federal income taxes as of December 31, 2006 and 2005, are as follows:

|                                  | <b>2006</b>      | <b>2005</b>      |
|----------------------------------|------------------|------------------|
| Net operating loss carryforwards | \$ 5,689,000     | \$ 2,745,000     |
| Other                            | 14,000           | 1,000            |
| <b>Total deferred tax assets</b> | <b>5,703,000</b> | <b>2,746,000</b> |
| Valuation allowance              | (5,703,000)      | (2,746,000)      |
| <b>Net deferred tax assets</b>   | <b>\$</b>        | <b>\$</b>        |

The valuation allowance increased \$2,957,000 and \$966,000, respectively, during the years ended December 31, 2006 and 2005.

**7. NOTE PAYABLE**

Orchard had a promissory note payable to a third party that Orchard was legally obligated to fulfill. The note matured in 2000 and Orchard has disputed whether certain conditions were ever met by the lender. Management is not aware of any collection efforts by the lender and the lender ceased operations in 2001. The principal amount of the debt, \$100,000 and accrued interest of \$30,000 is recorded in current liabilities at December 31, 2005. In February 2006, the statute of limitations for the enforcement of the debt by the lender expired and Orchard recognized the outstanding principle and interest of \$130,000 related to this promissory note in other income.

**8. PLAN OF RECAPITALIZATION**

In May 2006, through written consents of its shareholders and board of directors, Orchard amended and restated its Certificate of Incorporation and authorized (i) 20,000,000 shares of Series A Convertible Preferred Stock ( Series A Preferred Stock ) with a par value of \$.001 (ii) 20,000,000 shares of Series B Convertible Preferred Stock ( Series B Preferred Stock ) with a par value of \$.001 per share, and (iii) 40,000,000 shares of Common Stock with a par value of \$.001 per share (the May 2006 Recapitalization ). In connection with the May 2006 Recapitalization, the shareholders and board of directors also authorized the issuance of (x) 7,931,000 shares of Series A Preferred Stock and (y) 7,931,000 shares of Series B Preferred Stock in exchange for the conversion and cancellation of convertible debt with a principle balance of \$7,931,000 (see Note 9).

Additionally, Orchard authorized the issuance of 284,832 shares of Common Stock to existing common shareholders, of which substantially all were employees of Orchard at the date of issuance. The number of shares of Common Stock issued to a non-employee stockholder were not significant. Orchard recognized \$83,470 of compensation expense in 2006 related to the issuance of these shares of Common Stock based on the estimated fair value of the Common Stock. The estimated fair value was determined by Orchard based on a valuation performed by an independent valuation specialist.

**9. CONVERTIBLE DEBT**

On April 28, 2003, Orchard entered into a loan agreement with Dimensional (the Loan Agreement ) pursuant to which Dimensional agreed to loan Orchard \$700,000. This initial loan was evidenced by a promissory note in the amount of \$700,000 that, by its terms, was convertible into



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that number of shares of Orchard's Series A Preferred Stock determined by dividing the principal balance by a conversion price of \$1.00 per share of Series A Preferred Stock (i) at any time, at Dimensional's sole option or (ii) automatically, upon the

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closing of a sale of 3,000,000 shares of Orchard's Series A Preferred Stock pursuant to a stock purchase agreement between Orchard and Dimensional. The promissory note accrued interest at the prime rate as announced by Citibank N.A. plus 1.0% and was secured by substantially all of Orchard's assets under a security agreement. The accrued interest was due and payable on demand by Dimensional.

During the remainder of 2003 and through December 31, 2005, Dimensional periodically loaned additional amounts to Orchard under the Loan Agreement on substantially the same terms and conditions as the initial \$700,000 loan. This additional convertible debt was not evidenced by any additional promissory notes and was payable on demand by Dimensional. Accordingly, the entire outstanding principal balance and accrued interest at December 31, 2005, was classified as a current liability in the accompanying consolidated balance sheet. At December 31, 2005, the outstanding principal balance of the Dimensional convertible debt was \$7,931,000 and the outstanding balance of the accrued interest was \$707,852. Pursuant to the May 2006 Recapitalization (see Note 8), Dimensional agreed to convert the entire \$7,931,000 outstanding principal balance of the convertible debt into 7,931,000 shares of Series A Preferred Stock and 7,931,000 shares of Series B Preferred Stock. Interest expense on the convertible debt was \$464,261 and \$200,709 for the years ending December 31, 2005 and 2004, respectively.

During 2006, Dimensional periodically loaned additional amounts to Orchard under the Loan Agreement on substantially the same terms and conditions as the initial \$700,000 loan. This additional convertible debt was not evidenced by any additional promissory notes and was payable on demand by Dimensional. Accordingly, the entire outstanding principal balance and accrued interest at December 31, 2006, is classified as a current liability in the accompanying consolidated balance sheet. At December 31, 2006, the outstanding principal balance of the Dimensional convertible debt was \$6,600,000 and the outstanding balance of the accrued interest was \$1,227,937 (which includes both outstanding interest on the \$7,931,000 debt that was converted in the May 2006 Recapitalization (see Note 8) and interest accrued during 2006 on the \$6,600,000 loaned by Dimensional during 2006). Interest expense on the convertible debt was \$520,085 for the year ending December 31, 2006.

In connection with the execution of the Loan Agreement, on April 28, 2003, the shareholders of Orchard entered into a shareholder agreement (the Shareholder Agreement), which provides that the Board of Directors shall consist of five members, three of which will be designated by Dimensional so long as there are any loans outstanding under the Loan Agreement. Additionally, the Shareholder Agreement restricts Orchard's ability to declare dividends, sell assets, incur indebtedness and issue shares of any class or series of capital stock without Dimensional's written consent.

**10. STOCKHOLDERS DEFICIENCY**

***Common Stock and Preferred Stock*** At December 31, 2006, Orchard had authorized the issuance of the following securities:

***Series A Convertible Preferred Stock*** Orchard's Series A Preferred Stock (a) is its most senior class or series of securities, (b) has a liquidation preference of one times the amount of the Original Issue Price of \$1.00 per share plus any unpaid dividends (and then participates with the Common Stock on an as converted basis), (c) earns a cumulative annual dividend equal to the prime rate as announced by CitiBank N.A. plus 1.0% (calculated on a monthly basis), and (d) is convertible into shares of Common Stock with a conversion ratio of one share of Common Stock for each share of Series A Preferred Stock (subject to adjustment in accordance with the anti-dilution provisions in the terms of the Series A Preferred Stock). Dividends are payable when and if declared by Orchard's Board of Directors. The shares of Series A Preferred Stock are automatically converted into shares of Common Stock upon the affirmative election of the holders of at least sixty-six and two-thirds of the outstanding shares of Series A Preferred Stock, or immediately upon the closing of a public offering pursuant

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to an effective registration statement under the Securities Act of 1933, as amended, covering the offer and sale of the Common Stock of Orchard in which the per share price is at least \$4.00 per share and the net proceeds to Orchard are at least \$20,000,000. The shares of Series A Preferred Stock may, at the option of the holder thereof, be converted at any time into shares of Common Stock. The liquidation preference is triggered upon (i) a sale, lease or other disposition of substantially all of Orchard's assets, (ii) transfer of 50% of Orchard's voting power, (iii) consolidation or merger of Orchard resulting in less than 50% ownership by the shareholders. Series A Preferred Stock votes on an as converted basis with the shares of the Common Stock of Orchard. However, certain actions of Orchard require the approval by a majority of the outstanding Series A Preferred Stock such as amendments to the articles of incorporation, acquisitions, involuntary liquidation of Orchard and the payment of dividends.

At December 31, 2006 and 2005, there were 7,931,000 and no shares of Series A Preferred Stock issued and outstanding, respectively.

As of December 31, 2006, the board of directors of Orchard has not declared any dividends on the Series A Preferred Stock, and the shareholders of Series A Preferred Stock were entitled to a cumulative dividend of \$455,978 at December 31, 2006.

*Series B Convertible Preferred Stock* Orchard's Series B Preferred Stock (a) is junior to the Series A Preferred Stock (b) has a liquidation preference of one times the amount of the Original Issue Price of \$1.00 per share plus any unpaid dividends (and then participates with the Common Stock on an as converted basis), and (c) is convertible into shares of Common Stock with a conversion ratio of one share of Common Stock for each share of Series B Preferred Stock. The shares of Series B Preferred Stock are automatically converted into shares of Common Stock upon the affirmative election of the holders of at least 66 2/3% of the outstanding shares of Series B Preferred Stock, or immediately upon the closing of a public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended, covering the offer and sale of the Common Stock of Orchard in which the per share price is at least \$4.00 per share and the net proceeds to Orchard are at least \$20,000,000. The shares of Series B Preferred Stock may, at the option of the holder thereof, be converted at any time into shares of Common Stock. The liquidation preference is triggered upon (i) a sale, lease or other disposition of substantially all of Orchard's assets, (ii) transfer of 50% of Orchard's voting power, or (iii) consolidation or merger of Orchard resulting in less than 50% ownership by the shareholders. Series B Preferred Stock votes on an as converted basis with the shares of the Common Stock of Orchard.

At December 31, 2006 and 2005, there were 7,931,000 and no shares of Series B Preferred Stock issued and outstanding, respectively.

*Common Stock* Orchard's common stock (a) is its most junior class of stock, (b) has no liquidation preference, (c) has no set dividend rights and, (d) is not convertible. At December 31, 2006 and 2005, there were 1,762,444 and 1,477,612 shares of common stock issued and outstanding, respectively. At December 31, 2006, Orchard has reserved 15,862,000 shares of common stock for issuance upon the conversion of the outstanding Series A and Series B Convertible Preferred Stock.

**11. EMPLOYEE BENEFIT PLANS**

*Defined Contribution Plan* During 2005, Orchard implemented a 401(k) profit-sharing plan which is a pretax defined contribution plan. Certain employees have elected to participate in the defined contribution plan. Under the plan, Orchard is permitted but not required to make contributions based on a percentage of the employee elected contributions. Orchard did not make any elective contributions to the plan for the years ended December 31, 2006, 2005 and 2004.

**Table of Contents****Index to Financial Statements****THE ORCHARD ENTERPRISES INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12. GEOGRAPHIC INFORMATION**

Orchard operates in one reportable segment, digital content distribution. Long-lived assets outside of the United States of America are not significant. Revenues by geographic region, based on the country in which the customer is located, for the years ended December 31, 2006, 2005, and 2004, were as follow:

|                          | 2006          | 2005         | 2004         |
|--------------------------|---------------|--------------|--------------|
| U.S. sourced revenue     | \$ 11,423,014 | \$ 5,816,836 | \$ 1,834,980 |
| Non-U.S. sourced revenue | 3,495,121     | 1,003,542    | 146,903      |
| Total revenue            | \$ 14,918,135 | \$ 6,820,378 | \$ 1,981,883 |

**13. RELATED-PARTY TRANSACTIONS**

From time to time Orchard has amounts due to and from companies that have common ownership or are controlled by the Investor Group. These amounts are billed and paid on a regular basis. Net payables to affiliates totaled \$46,286 and \$23,183 at December 31, 2006 and 2005, respectively.

**Management Agreement** During 2004, Orchard entered into a management services agreement with Dimensional Associates, Inc., an entity incorporated and owned by the Investor Group, for ongoing consulting and management advisory services performed by certain key executives employed by Dimensional Associates, Inc. Pursuant to this agreement, Orchard pays a monthly management fee based on a predetermined allocation percentage derived from the time spent by such executives on Orchard's business. The allocation percentage is reviewed periodically by management of the Investor Group, usually semiannually, and the monthly fee is adjusted accordingly. Orchard recognized \$657,000, \$718,000, and \$460,000 during the years ended December 31, 2006, 2005, and 2004, respectively, for management fees which are included in general and administrative expenses in the accompanying consolidated statements of operations.

**Operating Lease With Affiliate** Orchard utilized and paid for certain office space (under a written sublease arrangement) leased from an affiliated entity of the Investor Group through April 2006. Amounts included in operating expenses in connection with this arrangement were \$68,429, \$143,588 and \$78,796 for the years ended December 31, 2006, 2005 and 2004, respectively. Orchard purchased \$48,481 and \$2,233 of leasehold improvements, which have been recorded as fixed assets, from this affiliate during the years ended December 31, 2005 and 2004, respectively. Also, Orchard purchased \$15,565 of furniture during 2005 from this affiliated entity, which is recorded as property and equipment in the accompanying consolidated balance sheet at December 31, 2005. This affiliate and Orchard have common majority ownership.

Beginning in April 2006, Orchard is utilizing space subleased by an affiliated entity, with no formal sublease agreement in place. Orchard pays the lessee directly for the space utilized. In 2006, Orchard incurred expenses of approximately \$266,000 under this arrangement.

**Legal Costs** Orchard has engaged several outside legal firms to represent its general business interests. One such firm employs a family member of one of the senior executives employed by the Investor Group. Amounts included in operating expenses in connection with the services performed by this legal firm were \$158,432, \$26,094 and \$110,396 for the years ended December 31, 2006, 2005, and 2004, respectively.

**Distribution Services With eMusic** eMusic provides digital music distribution services to Orchard under a Digital Music Wholesale Agreement, dated January 1, 2004, as amended on March 31, 2007. eMusic is a majority-owned subsidiary of Dimensional. The agreement grants eMusic worldwide rights, on a non-exclusive basis, to exploit Orchard's master recordings digitally and via the Internet through December 31, 2009. Per the



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agreement, Orchard is entitled to better royalty terms if eMusic allows any other independent record label such better terms during the Term of the agreement ( Most Favored Nation clause). Amounts included in revenues in connection with these services were \$1,783,140, \$981,864, and \$73,313, for the years ended December 31, 2006, 2005, and 2004, respectively. Amounts included in accounts receivable in connection with these services were \$483,037 and \$340,483 at December 31, 2006 and 2005, respectively.

Orchard has distribution agreements with certain labels whereby it is not permitted to charge distribution fees to the label or artist for sales by eMusic. For the years ended December 31, 2006, 2005, and 2004, Orchard received revenues of \$715,384, \$531,333, and \$0, respectively, from eMusic relating to such agreements. These amounts were recorded in revenues and with an equal amount recorded in cost of revenues.

**Consulting Services With Dimensional Music Publishing, LLC** Orchard provided consulting services to Dimensional Music Publishing, LLC during 2005. Dimensional Music Publishing, LLC is owned 100% by the Investor Group. Revenue of \$25,950 was recognized for consulting services during 2005 in the accompanying consolidated statements of operations. No such consulting services were provided in 2006 or 2004.

**Sale of fixed assets to Dimensional Music Publishing, LLC** Orchard sold fixed assets to Dimensional Music Publishing, LLC realizing a loss of \$1,448 in 2006. The cost of the equipment was \$5,650 and the related accumulated depreciation was \$3,202.

**Revenue Sharing Agreement With CGH Ventures, Inc** During 2003 Orchard Management, Inc., a wholly-owned subsidiary of Orchard, entered into a revenue sharing agreement with CGH Ventures, Inc., an entity owned by two stockholders of Orchard. Pursuant to this agreement, Orchard is obligated to pay CGH Ventures, Inc. 80% of the net revenues earned by Orchard Management, Inc. Orchard Management, Inc. provides management services to a recording group. Orchard recorded \$68,797, \$35,830 and \$11,759 during 2006, 2005, and 2004, respectively, as commission expense for CGH s share of the net revenue earned under the management agreement. The commission expense was included in costs of revenues in the accompanying consolidated statement of operations.

**14. COMMITMENTS AND CONTINGENCIES**

**Lease Commitments** Orchard utilized and paid for certain office space (under a written sublease arrangement) leased from an affiliated entity of the Investor Group through April 2006. Commencing April 2006, Orchard is utilizing space subleased by an affiliated entity, with no formal sublease agreement in place. Rent expense was \$487,558, \$271,937 and \$147,388 for the years ended December 31, 2006, 2005, and 2004, respectively.

As such there were no future minimum lease payments under operating leases as of December 31, 2006.

**Litigation and Indemnification** Orchard is a party to litigation matters and claims from time to time in the ordinary course of its operations, including copyright infringement litigation, for which it is entitled to indemnification by content providers. While the results of such litigation and claims cannot be predicted with certainty, Orchard believes that the final outcome of such matters will not have a material adverse impact on its business, financial position, cash flows, or results of operations.

**Contract Dispute** In November 2006, Orchard settled an outstanding dispute with a supplier whereby Orchard paid \$735,000 in full settlement of an obligation for which Orchard had recorded a liability of \$1,137,585. As a result of the settlement, Orchard realized a gain of \$402,585 that has been recorded as a reduction of costs of revenues.

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**Table of Contents****Index to Financial Statements****THE ORCHARD ENTERPRISES INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****15. SUBSEQUENT EVENTS**

***Debt Conversion, Debt Forgiveness and Recapitalization*** In July 2007, through written consents of its shareholders and board of directors, Orchard ratified and confirmed the outstanding convertible debt of Orchard and authorized the conversion of the outstanding principal on such convertible debt owed to Dimensional of \$10,700,000, simultaneous with the authorization for a recapitalization of Orchard (the July 2007 Recapitalization). The July 2007 Recapitalization included amending and restating Orchard's Certificate of Incorporation and authorizing the issuance of (i) 10,700,000 shares of Series A Preferred Stock and (ii) 9,675,295 shares of Series B Preferred Stock and (iii) 2,377,778 shares of Common Stock (which was issued to the original common shareholders). In addition, Dimensional forgave all interest owed and outstanding, including the interest owed and outstanding at December 31, 2006 of \$961,442 related to the debt converted in connection with the May 2006 Recapitalization (see Notes 8 and 9). In connection with the July 2007 Recapitalization, the shareholders amended and restated the Shareholder Agreement, which restated their respective rights and obligations. Pursuant to the July 2007 Recapitalization, Orchard amended and restated its certificate of incorporation to increase its number of authorized shares of capital stock as follows: (i) 30,000,000 shares of Series A Preferred Stock (ii) 30,000,000 shares of Series B Preferred Stock, and (iii) 80,000,000 shares of Common Stock.

In connection with the July 2007 Recapitalization, a senior executive of Orchard and a senior executive of an affiliated company were granted deferred stock awards of 745,240 and 279,465 shares of Series B Preferred Stock, which will be issued upon the occurrence of a liquidity event as defined in the deferred stock award. The award is fully vested and non-forfeitable.

***Merger Agreement*** On July 10, 2007, Orchard entered into an Agreement and Plan of Merger, which was amended and restated on September 13, 2007 and further amended and restated on October 5, 2007 (the Merger Agreement), with Digital Music Group, Inc. (DMGI) and DMGI New York, Inc. (Merger Sub). Under the terms of the Merger Agreement, Merger Sub will merge with and into Orchard, with Orchard continuing as the surviving corporation and as a wholly-owned subsidiary of DMGI.

Orchard's board of directors unanimously approved the Merger Agreement and the transactions contemplated thereby. As a result of the merger, all shares of Orchard capital stock and all deferred stock awards shall be converted into the right to receive 9,064,941 shares of DMGI common stock and 448,833 shares of DMGI preferred stock (the Merger Shares).

The completion of the merger is subject to various customary conditions, including: (i) obtaining the requisite approval of both Orchard's and DMGI's shareholders; (ii) compliance with all applicable waiting periods imposed by the HSR Act and other government entities; (iii) obtaining reasonably satisfactory tax opinions; (iv) authorizing the issuance of the DMGI Series A Preferred Stock and the issuance of the shares of DMGI Common Stock; and (v) execute and deliver various ancillary agreements and other documents, including a registration rights agreement in favor of Orchard's shareholders covering the Merger Shares (and those shares of DMGI Common Stock issuable upon conversion of the DMGI Series A Preferred Stock issued as part of the Merger Shares).

The Merger Agreement also includes customary termination provisions for both Orchard and DMGI, and provides that, in connection with the termination of the Merger Agreement under specified circumstances relating to the receipt by Orchard of an affirmative proposal to the transaction with DMGI, Orchard may be required to pay DMGI a termination fee of \$1.11 million plus DMGI's reasonable costs and expenses incurred in connection with the transaction up to \$500,000.

The proposed merger is expected to be completed in the fourth calendar quarter of 2007.

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**Table of Contents****Index to Financial Statements****THE ORCHARD ENTERPRISES INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Additional Capital Contributions and Recapitalization*** In September 2007, through written consents of its shareholders and board of directors, Orchard ratified and confirmed capital contributions made to Orchard by Dimensional in the amount of \$850,000 between July 3, 2007 and September 28, 2007, simultaneous with the authorization of a recapitalization of Orchard (the September 2007 Recapitalization). The September 2007 Recapitalization included amending and restating Orchard's certificate of incorporation and authorizing the issuance of (i) 803,250 shares of Series B Preferred Stock, (ii) 850,000 shares of Series C Preferred Stock (defined below) and (iii) 4,455,090 shares of Common Stock (which was issued to the original common shareholders). Orchard expects to recognize a significant compensation charge for the nine months ended September 30, 2007 based on the fair value of the Common Stock issued to the original holders of Common Stock. Pursuant to the September 2007 Recapitalization, Orchard amended and restated its certificate of incorporation to (i) increase its number of authorized shares of preferred stock from 60,000,000 to 61,500,000 and (ii) authorize 1,500,000 shares of a new series of preferred stock, the Series C Preferred Stock (defined below).

In connection with the September 2007 Recapitalization, a senior executive of Orchard and a senior executive of an affiliated company were granted deferred stock awards of 34,000 and 12,750 shares of Series B Preferred Stock and 824,593 and 309,222 shares of Common Stock, respectively, which will be issued upon the occurrence of a liquidity event, as defined in their respective deferred stock awards. The awards are fully vested and non-forfeitable. Orchard expects to recognize a compensation charge for the nine months ended September 30, 2007 based on the fair value of the deferred stock awards.

***Series C Convertible Preferred stock*** Orchard's Series C Convertible Preferred Stock (the Series C Preferred Stock) has the following rights and preferences: (a) along with the Series A Preferred Stock, it is Orchard's most senior class or series of securities, (b) has a liquidation preference of one times the amount of the original issue price of \$2.95 per share plus any unpaid dividends on a *pari passu* basis with the holders of Series A Preferred (and then participates with the Common Stock on an as converted basis), (c) earns a cumulative annual dividend equal to the prime rate as announced by CitiBank N.A. plus 1.0% (calculated on a monthly basis), and (d) is convertible into shares of Common Stock with a conversion ratio of one share of Common Stock for each share of Series C Preferred Stock (subject to adjustment in accordance with the anti-dilution provision in the terms of the Series C Preferred Stock). Dividends are payable when and if declared by Orchard's board of directors. The shares of Series C Preferred Stock are automatically converted into shares of Common Stock upon the affirmative election of the holders of at least  $\frac{66}{100}$  of the outstanding shares of Series C Preferred Stock, or immediately upon the closing of a public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended, covering the offer and sale of the Common Stock of Orchard in which the per share price is at least \$4.00 per share and the net proceeds to Orchard are at least \$20,000,000. The shares of the Series C Preferred Stock may, at the option of the holder thereof, be converted at any time into shares of Common Stock. The liquidation preference is triggered upon (i) a sale, lease or other disposition of substantially all of Orchard's assets, (ii) transfer of 50% of Orchard's voting power, (iii) consolidation or merger of Orchard resulting in less than 50% ownership by the shareholders. Series C Preferred Stock votes on an as converted basis with the shares of the Common Stock of Orchard. However, certain actions of Orchard require the approval by a majority of the outstanding Series A Preferred Stock and Series C Preferred Stock, voting together as a single class, such as amendments to the articles of incorporation, acquisitions, involuntary liquidation of Orchard and the payment of dividends.



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**THE ORCHARD ENTERPRISES INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**

|   | June 30, 2007        | December 31, 2006   |
|---|----------------------|---------------------|
| <b>ASSETS</b>   |                      |                     |
| CURRENT ASSETS:   |                      |                     |
| Cash and cash equivalents   | \$ 3,127,145         | \$ 1,675,889        |
| Accounts receivable net (including amounts from related parties of \$642,973 in 2007 and \$483,037 in 2006)   | 4,377,173            | 3,126,987           |
| Royalty advances  | 1,296,779            | 585,575             |
| Prepaid expenses and other current assets   | 282,434              | 174,360             |
| Due from affiliated entities  | 5,339                |                     |
| Total current assets  | 9,088,870            | 5,562,811           |
| PROPERTY AND EQUIPMENT Net  | 896,668              | 651,405             |
| OTHER ASSETS  | 373,129              | 327,562             |
| <b>TOTAL</b>  | <b>\$ 10,358,667</b> | <b>\$ 6,541,778</b> |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIENCY</b>  |                      |                     |
| CURRENT LIABILITIES:  |                      |                     |
| Accounts payable  | \$ 511,479           | \$ 249,507          |
| Accrued royalties   | 7,429,363            | 5,688,066           |
| Accrued expenses  | 490,090              | 1,060,792           |
| Due to affiliated entities  |                      | 46,286              |
| Deferred revenue  | 276,816              | 146,494             |
| Accrued interest payable to a related party   | 1,634,810            | 1,227,937           |
| Convertible debt payable to a related party   | 10,700,000           | 6,600,000           |
| Total current liabilities   | 21,042,558           | 15,019,082          |
| COMMITMENTS AND CONTINGENCIES   |                      |                     |
| STOCKHOLDERS DEFICIENCY:  |                      |                     |
| Series A convertible preferred stock, \$.001 par value 20,000,000 shares authorized, 7,931,000 issued and outstanding; liquidation preference of \$ 8,750,772 | 7,931                | 7,931               |
| Series B convertible preferred stock, \$.001 par value 20,000,000 shares authorized, 7,931,000 issued and outstanding; liquidation preference of \$ 7,931,000 | 7,931                | 7,931               |
| Common stock, \$.001 par value 40,000,000 shares authorized; 1,762,444 shares issued and outstanding  | 1,763                | 1,763               |
| Stock subscription receivable   | (1,478)              | (1,478)             |
| Paid-in capital   | 7,998,593            | 7,998,593           |
| Accumulated deficit   | (18,683,155)         | (16,490,894)        |
| Accumulated other comprehensive income  | (15,476)             | (1,150)             |
| Total stockholders deficiency   | (10,683,891)         | (8,477,304)         |
| <b>TOTAL</b>  | <b>\$ 10,358,667</b> | <b>\$ 6,541,778</b> |

See notes to condensed consolidated financial statements.

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**Table of Contents****Index to Financial Statements****THE ORCHARD ENTERPRISES INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

|   | <b>Six months ended June 30,</b> |                       |
|---|----------------------------------|-----------------------|
|   | <b>2007</b>                      | <b>2006</b>           |
| REVENUES (including amounts from related parties of \$1,316,823 in 2007 and \$922,769 in 2006)              | \$ 11,987,265                    | \$ 6,382,405          |
| COSTS OF REVENUES (including amounts from related parties of \$15,978 in 2007 and \$38,333 in 2006)         | 8,613,787                        | 4,881,882             |
| <b>GROSS PROFIT</b>   | <b>3,373,478</b>                 | <b>1,500,523</b>      |
| <b>OPERATING EXPENSES:</b>  |                                  |                       |
| Product development (including amounts from related parties of \$5,288 in 2007 and \$2,486 in 2006)         | 106,966                          | 72,837                |
| Sales and marketing (including amounts from related parties of \$63,459 in 2007 and \$57,176 in 2006)       | 1,979,020                        | 1,630,922             |
| General and administrative (including amounts from related parties \$102,740 in 2007 and \$431,612 in 2006) | 3,072,880                        | 2,597,232             |
| Total operating expenses  | 5,158,866                        | 4,300,991             |
| <b>LOSS FROM OPERATIONS</b>   | <b>(1,785,388)</b>               | <b>(2,800,468)</b>    |
| <b>OTHER (INCOME) EXPENSE:</b>  |                                  |                       |
| Other income  |                                  | (130,000)             |
| Interest income   |                                  | (2,425)               |
| Interest expense from a related party   | 406,873                          | 315,343               |
| Total other expense   | 406,873                          | 182,918               |
| <b>NET LOSS</b>   | <b>\$ (2,192,261)</b>            | <b>\$ (2,983,386)</b> |

See notes to condensed consolidated financial statements.

**Table of Contents****Index to Financial Statements****THE ORCHARD ENTERPRISES INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|   | <b>Six months ended June 30,</b> |                |
|---|----------------------------------|----------------|
|   | <b>2007</b>                      | <b>2006</b>    |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                |                                  |                |
| Net loss  | \$ (2,192,261)                   | \$ (2,983,386) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                                  |                |
| Depreciation and amortization   | 129,825                          | 61,766         |
| Bad debt expense  | 5,387                            |                |
| Loss on sale/disposal of fixed assets                                       |                                  | 41,461         |
| Gain on note payable and related accrued interest                           |                                  | (130,000)      |
| Stock-based compensation  |                                  | 83,740         |
| Changes in operating assets and liabilities:                                |                                  |                |
| Accounts receivable   | (1,255,574)                      | (379,989)      |
| Royalty advances  | (711,204)                        | (284,596)      |
| Prepaid expenses and other current assets                                   | (108,074)                        | (244,586)      |
| Other assets  | (47,914)                         | (166,576)      |
| Accounts payable  | 261,972                          | 380,606        |
| Accrued royalties   | 1,741,297                        | 693,993        |
| Accrued expenses  | (570,702)                        | 291,548        |
| Due to affiliated entities  | (51,625)                         | (26,762)       |
| Deferred revenue  | 130,322                          | 10,953         |
| Accrued interest payable  | 406,873                          | 315,343        |
| Net cash used in operating activities                                       | (2,261,678)                      | (2,336,485)    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                |                                  |                |
| Purchases of property and equipment   | (372,741)                        | (616,085)      |
| Proceeds from the sale of fixed assets                                      |                                  | 11,836         |
| Net cash used in investing activities                                       | (372,741)                        | (604,249)      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                 |                                  |                |
| Proceeds from issuance of convertible debt payable to a related party       | 4,100,000                        | 3,050,000      |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS                | (14,325)                         | (155)          |
| <b>INCREASE IN CASH AND CASH EQUIVALENTS</b>                                | <b>1,451,256</b>                 | <b>109,111</b> |
| CASH AND CASH EQUIVALENTS Beginning of period                               | 1,675,889                        | 21,866         |
| CASH AND CASH EQUIVALENTS End of period                                     | \$ 3,127,145                     | \$ 130,977     |

See notes to condensed consolidated financial statements.



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**THE ORCHARD ENTERPRISES INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. ORGANIZATION AND BUSINESS**

Orchard Enterprises Inc. ( Orchard ) was incorporated in New York in September 2000 and was one of the first distributors of digital music content. Orchard is a global music marketing and distribution company, offering a suite of innovative services to assist music content owners create and sell product digitally across a worldwide network of digital entertainment services.

On April 28, 2003, Dimensional Associates, LLC ( Dimensional ), an entity formed by a group of private investors (the Investor Group ), invested in and acquired operating control of Orchard through the purchase of a convertible debt instrument followed by subsequent periodic fundings under the same terms and conditions as the original convertible debt instrument (see Note 5 and 8). During 2006, convertible debt principal of \$7,931,000 was cancelled and exchanged for 7,931,000 shares of Orchard s Series A Convertible Preferred Stock and 7,931,000 shares of Orchard s Series B Convertible Preferred Stock (See Notes 6 and 7). In July of 2007 an additional \$10,700,000 of convertible debt was cancelled and exchanged for 10,700,000 shares of shares of Orchard s Series A Convertible Preferred Stock and 9,675,295 shares of Orchard s Series B Convertible Preferred Stock (See Note 12).

**2. BASIS OF PRESENTATION**

The accompanying condensed consolidated financial statements have been prepared pursuant to the rules of the Securities and Exchange Commission (the SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to SEC rules. These financial statements should be read in conjunction with Orchard s financial statements for the year ended December 31, 2006.

In the opinion of management, the financial statements as of June 30, 2007 and for the six month periods ended June 30, 2007 and 2006 include all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of the consolidated financial position, results of operations and cash flows for the periods presented. The results of operations for the six months ended June 30, 2007 and 2006 are not necessarily indicative of the results to be expected for the full year.

The condensed consolidated financial statements have been prepared assuming Orchard will continue as a going concern. Orchard has incurred losses and negative cash flows from operations since its inception. Orchard incurred a net loss of \$2,192,261 for the six months ended June 30, 2007, has incurred operating losses since inception, has a working capital deficiency of \$11,953,688 and an accumulated deficit of \$18,683,155 at June 30, 2007. Orchard s ability to continue operating as a going concern is substantially dependent on its ability to generate operating cash flows through the execution of its business plan or to secure funding sufficient to provide for the working capital needs of its business. Until and unless Orchard s operations generate significant revenues and cash flows, Orchard will continue to attempt to fund operations from cash on hand, through the issuance of debt and through the issuance of preferred or common stock. The Investor Group has committed to fund the operations of Orchard through at least October 1, 2008.

**3. SIGNIFICANT ACCOUNTING POLICIES**

**Consolidation and Basis of Presentation** The condensed consolidated financial statements include the accounts of Orchard and its wholly owned subsidiaries, Orchard Management, Inc., and Orchard EU, Limited. The consolidated accounts include 100% of the assets, liabilities, revenues, expenses, and cash flows of Orchard and all entities in which Orchard has a controlling voting interest that are required to be consolidated in

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accordance with accounting principles generally accepted in the United States ( U.S. GAAP ). All significant inter-company balances and transactions have been eliminated in consolidation.

**Use of Estimates** The preparation of condensed consolidated financial statements and related disclosures in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the period reported. Actual results could differ from those estimates. The most significant estimates relate to assessing the collectability of accounts receivable, the recoverability of royalty advances, the value of securities underlying stock based compensation, the realization of deferred tax assets, tax contingencies, valuation allowances, and the useful lives and potential impairment of Orchard's property and equipment. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the period that they are determined to be necessary.

**Cash and Cash Equivalents** Cash and cash equivalents include all short-term highly liquid investments that are readily convertible to known amounts of cash and have maturities of three months or less when purchased.

**Allowance for Doubtful Accounts** Orchard establishes allowances for doubtful accounts based on credit profiles of its retailers, current economic and industry trends, contractual terms and conditions and historic payment experience, as well as for known or expected events. Accordingly, at June 30, 2007 and December 31, 2006, Orchard had \$75,387 and \$70,000, respectively, recorded as an allowance for doubtful accounts.

**Fair Value of Financial Instruments** The carrying value of Orchard's short-term financial instruments, including accounts receivable, accounts payable, accrued expenses, and accrued royalties approximates their fair value due to the short-term nature of these items. There is no market value information available for Orchard's convertible debt and a reasonable estimate could not be made without incurring excessive costs (see Note 7).

**Foreign Currency Translation** Orchard has foreign operations where the functional currency has been determined to be the local currency. The functional currency of Orchard's subsidiary in the United Kingdom has been determined to be the British Pound. For operations where the local currency is the functional currency, assets and liabilities are translated using end-of-period exchange rates; revenues, expenses and cash flows are translated using average rates of exchange. For these operations, currency translation adjustments are accumulated in a separate component of stockholders' deficiency. Transaction gains and losses are recognized in the determination of net income or loss.

**Concentrations of Credit Risk** Orchard's customers are primarily commercial organizations headquartered in the United States. Accounts receivable are generally unsecured.

The revenues from two of its customers, iTunes and eMusic account for a significant portion of Orchard's total revenues. Revenues from iTunes were approximately 53% and 52% of total revenues and revenues from eMusic were approximately 11% and 14% of total revenues for the six months ended June 30, 2007 and 2006, respectively. Accounts receivable from iTunes were 28% and 35% of total accounts receivable at June 30, 2007 and December 31, 2006, respectively. Accounts receivable from eMusic were 15% of total accounts receivable at June 30, 2007 and December 31, 2006.

**Due From Digital Service Providers** At June 30, 2007 and December 31, 2006, accounts receivable includes \$361,080 and \$144,046, respectively, related to reimbursements to Orchard by its customers for digital encoding of Orchard's music content so that it can be utilized on the customer's retail website.

**Royalty Advances and Digital Rights** Orchard has paid advance royalties and the cost of acquiring digital rights to certain content owners. Orchard accounts for these advance royalty payments and digital rights acquisition costs pursuant to the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 50, *Financial Reporting in the Record and Music Industry* ( SFAS No. 50 ). Pursuant to SFAS No. 50, certain

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advance royalty payments that are believed to be recoverable from future royalties to be earned by the artist or songwriter are capitalized as assets. Royalty advances will be recouped from Orchard's future royalty obligations resulting from the fees it receives from digital entertainment services. Digital rights acquired by Orchard are amortized using the straight-line method over the term of the agreement. Orchard classifies royalty advances as short-term or long-term based on the expectations of when these advances will be recovered. The decision to capitalize an advance to an artist or songwriter as an asset requires significant judgment as to the recoverability of these advances. The recoverability of these assets is assessed upon initial commitment of the advance, based upon Orchard's forecast of anticipated revenues from the sale of future and existing music and publishing-related products. In determining whether these amounts are recoverable, Orchard evaluates the current and past popularity of the artist or songwriter, the initial or expected commercial acceptability of the product, the current and past popularity of the genre of music that the product is designed to appeal to, and other relevant factors. Based upon this information, the portion of such advances that is believed not to be recoverable is expensed. All advances and digital rights acquisition costs are assessed for recoverability periodically, at minimum, on a quarterly basis.

**Property and Equipment** Property and equipment, consisting primarily of office equipment, computer equipment, and furniture and fixtures, are stated at cost less accumulated depreciation. Depreciation and amortization is determined using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are stated at cost and are amortized using the straight-line method over the lesser of the term of the lease or the estimated useful lives of the assets.

Major renewals and improvements are capitalized and minor replacements, maintenance and repairs are charged to current operations as incurred. Upon retirement or disposal of assets, the cost and related accumulated depreciation are removed from the consolidated balance sheets and any gain or loss is reflected in the consolidated statements of operations.

**Internal-Use Software Development Costs** In accordance with AICPA Statement of Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, Orchard capitalizes when necessary certain external and internal computer software costs incurred during the application development stage. The application development stage generally includes software design and configuration, coding, testing and installation activities. Training and maintenance costs are expensed as incurred, while upgrades and enhancements are capitalized if it is probable that such expenditures will result in additional functionality. Capitalized software costs are depreciated over the estimated useful life of the underlying project on a straight-line basis, generally not exceeding five years. During the six month periods ended June 30, 2007 and 2006, Orchard capitalized \$129,825 and \$0 of internal-use software development costs.

**Impairment of Long-Lived Assets** Orchard reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. In connection with this review, Orchard also reevaluates the periods of depreciation and amortization for these assets. Orchard assesses recoverability by determining whether the net book value of the related asset will be recovered through the projected undiscounted future cash flows of the asset. If Orchard determines that the carrying value of the asset may not be recoverable, it measures any impairment based on the projected future discounted cash flows as compared to the asset's carrying value. As of June 30, 2007, Orchard has not recorded any impairment charges on its long-lived assets.

**Revenue Recognition** Orchard follows the provisions of Staff Accounting Bulletin (SAB) 104, *Revenue Recognition in Financial Statements* (SAB 104), Emerging Issues Task Force (EITF) 00-21, *Revenue Arrangements with Multiple Deliverables*, and EITF 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent* (EITF 99-19). In general, Orchard recognizes revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.



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The Orchard's distribution revenue from the sale of recorded music products through digital distribution channels is recognized when the products are sold by the digital service providers who provide Orchard with periodic notification of the sales.

For arrangements with multiple obligations (e.g., deliverable and undelivered music content, music publishing information and other services), Orchard allocates revenues to each component of the contract based on objective evidence of its fair value. Orchard recognizes revenues allocated to undelivered products when the criteria for product revenues set forth above are met. If objective and reliable evidence of the fair value of the undelivered obligations is not available, the arrangement consideration allocable to a delivered item is combined with the amount allocable to the undelivered item(s) within the arrangement. Revenues are recognized as the remaining obligations are fulfilled. Revenues from multiple element arrangements were not significant for the six months ended June 30, 2007 or 2006.

In accordance with industry practice and as is customary in many territories, certain physical products (such as CDs and cassettes) are sold to customers with the right to return unsold items. Net distribution revenues to Orchard from such physical sales are recognized when reported by the retail distributor for the products that are shipped based on gross sales typically less a provision for future estimated returns determined by distributors based on past historical trends. For the six months ended June 30, 2007 and 2006, revenues from physical sales were approximately 1% and 5% of total revenues, respectively.

Reimbursements received by Orchard from its customers for encoding Orchard's music content in the appropriate digital format for use by the customer are recognized under the proportional performance method as revenue in the period that the encoded content is delivered to the customer. Cash received in advance of providing the service is recorded as deferred revenue.

Shipping and handling charges billed to customers are included in revenues and the costs associated with shipping physical products are recorded as cost of revenues. The physical products are the property of the recording labels and artists. Revenues and cost from shipping and handling were not significant during the six months ended June 30, 2007 and 2006.

**Costs of Revenues** Costs of revenues includes the royalty expenses owed to the artists and labels, costs of encoding digital music, shipping charges, and digital delivery costs. Royalties earned by labels, artists, songwriters, co-publishers, and other copyright holders, are recognized as an expense in the period in which the sale of the digital or physical music takes place and is included in cost of revenues in the accompanying condensed consolidated statements of operations.

**Product Development Costs** Costs incurred in connection with product development and testing are expensed as incurred. Product development costs for the six months ended June 30, 2007 and 2006, were \$106,966 and \$72,837, respectively.

**Income Taxes** Orchard uses the asset and liability method to determine its income tax expense. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established when realization of deferred tax assets is not considered more likely than not.

Effective January 1, 2007, the Orchard adopted the provisions of the Financial Accounting Standards Board ( FASB ) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ) an interpretation of SFAS No. 109, *Accounting for Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109 and prescribes a recognition

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threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As of January 1, 2007, Orchard had no significant unrecognized tax benefits. During the six months ended June 30, 2007, Orchard recognized no adjustments for uncertain tax benefits. Orchard is subject to U.S. federal and state examinations by tax authorities for all years since its inception. Orchard does not expect any significant changes to its unrecognized tax positions during the next twelve months.

Orchard recognizes interest and penalties related to uncertain tax positions in income tax expense. No interest and penalties related to uncertain tax positions were accrued at June 30, 2007.

Orchard maintains a full valuation allowance on its deferred tax assets. Accordingly, Orchard has not recorded a benefit for income taxes.

**Comprehensive Income** SFAS No. 130, *Reporting Comprehensive Income*, requires the disclosure of comprehensive income to reflect changes in equity that result from transactions and economic events from non-owner sources. Orchard's comprehensive loss for the six months ended June 30, 2007 and 2006 consisted of net loss and foreign currency translation adjustments.

The components of comprehensive loss are as follows:

|   | <b>Six months ended June 30,</b> |                       |
|---|----------------------------------|-----------------------|
|   | <b>2007</b>                      | <b>2006</b>           |
| Net loss                                | \$ (2,192,261)                   | \$ (2,983,386)        |
| Foreign currency translation adjustment | (14,326)                         | (155)                 |
| <b>Comprehensive loss</b>               | <b>\$ (2,206,587)</b>            | <b>\$ (2,983,541)</b> |

**Loss Contingencies** Orchard accrues for costs relating to litigation, claims and other contingent matters when such liabilities become probable and reasonably estimable. Such estimates may be based on advice from third parties or on management's judgment, as appropriate. Actual amounts paid may differ from amounts estimated, and such differences will be charged to operations in the period in which the final determination of the liability is made.

**Recent Accounting Pronouncements** In September 2006, FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value, and expands required disclosures about fair value measurements. The provisions of SFAS 157 are effective for fiscal years beginning after November 15, 2007. Orchard is currently evaluating the impact of adopting SFAS 157 on its financial statements.

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( SFAS 159 ). SFAS 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. Orchard does not currently plan to adopt this pronouncement.

**4. ACCRUED ROYALTIES**

Orchard's distribution revenue from the sale of music recordings through digital distribution channels is recognized when the products are sold by the digital service providers who provide Orchard with periodic notification of the sales. Also, net distribution revenues to Orchard from physical sales are recognized when reported by the retail distributor for the products that are shipped based on gross sales typically less a provision for future estimated returns determined by past historical trends.

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Accordingly, royalties earned by labels, artists, songwriters, co-publishers, other copyright holders are recognized as an expense and a related accrued royalty liability is recognized on the balance sheet in the period in which the sale of the digital or physical music recording takes place. Orchard typically enters into a contractual arrangement with the label or artist under which Orchard is obligated to pay royalties to the label or artist based on an agreed upon percentage of the total distribution revenue. Orchard is normally obligated to pay the royalties 45 days after the end of the quarter in which it receives the distribution revenue from the service provider. Accrued royalties amounted to \$7,429,363 and \$5,688,066 at June 30, 2007 and December 31, 2006, respectively.

**5. NOTE PAYABLE**

Orchard had a promissory note payable to a third party that Orchard was legally obligated to fulfill. The note matured in 2000 and Orchard has disputed whether certain conditions were ever met by the lender. Management is not aware of any collection efforts by the lender and the lender ceased operations in 2001. In February of 2006, the statute of limitations for the enforcement of the debt by the lender expired and Orchard has recognized the outstanding principle and interest of \$130,000 related to this promissory note in Other Income.

**6. PLAN OF RECAPITALIZATION**

In May 2006, through written consents of its shareholders and board of directors, Orchard amended and restated its Certificate of Incorporation and authorized (i) 20,000,000 shares of Series A Convertible Preferred Stock ( Series A Preferred Stock ) with a par value of \$.001 (ii) 20,000,000 shares of Series B Convertible Preferred Stock ( Series B Preferred Stock ) with a par value of \$.001 per share, and (iii) 40,000,000 shares of Common Stock with a par value of \$.001 per share (the May 2006 Recapitalization ). In connection with the May 2006 Recapitalization, the shareholders and board of directors also authorized the issuance of (x) 7,931,000 shares of Series A Preferred Stock and (y) 7,931,000 shares of Series B Preferred Stock in exchange for the conversion and cancellation of convertible debt with a principle balance of \$7,931,000 (see Note 7).

Additionally, Orchard authorized the issuance of 284,832 shares of common stock to existing common shareholders, of which substantially all were employees of Orchard at the date of issuance. The number of shares of common stock issued to a non-employee stockholder were not significant. Orchard recognized \$83,470 of compensation expense in the six months ended June 30, 2006 related to the issuance of these shares of common stock based on the estimated fair value of the common stock. The estimated fair value was determined by Orchard based on a valuation performed by an independent valuation specialist.

**7. CONVERTIBLE DEBT**

On April 28, 2003, Orchard entered into a loan agreement with Dimensional (the Loan Agreement ) pursuant to which Dimensional agreed to loan Orchard \$700,000. This initial loan was evidenced by a promissory note in the amount of \$700,000 that, by its terms, was convertible into that number of shares of Orchard's Series A Preferred Stock determined by dividing the principal balance by a conversion price of \$1.00 per share of Series A Preferred Stock (i) at any time, at Dimensional's sole option or (ii) automatically, upon the closing of a sale of 3,000,000 shares of Orchard's Series A Preferred Stock pursuant to a stock purchase agreement between Orchard and Dimensional. The promissory note accrued interest at the prime rate as announced by Citibank N.A. plus 1.0% and was secured by substantially all of Orchard's assets under a security agreement. The accrued interest was due and payable on demand by Dimensional.

During the remainder of 2003 and through December 31, 2005, Dimensional periodically loaned additional amounts to Orchard under the Loan Agreement on substantially the same terms and conditions as the initial \$700,000 loan. This additional convertible debt was not evidenced by any additional promissory notes and was payable on demand by Dimensional. Accordingly, the entire outstanding principal balance and accrued interest at December 31, 2005, was classified as a current liability in the accompanying consolidated balance sheet. At

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December 31, 2005, the outstanding principal balance of the Dimensional convertible debt was \$7,931,000 and the outstanding balance of the accrued interest was \$707,852. Pursuant to the May 2006 Recapitalization (see Note 6), Dimensional agreed to convert the entire \$7,931,000 outstanding principal balance of the convertible debt into 7,931,000 shares of Series A Preferred Stock and 7,931,000 shares of Series B Preferred Stock.

During 2007 and 2006, Dimensional has periodically loaned additional amounts to Orchard under the Loan Agreement on substantially the same terms and conditions as the initial \$700,000 loan. This additional convertible debt was not evidenced by any additional promissory notes and was payable on demand by Dimensional. Accordingly, the entire outstanding principal balance and accrued interest at June 30, 2007 and December 31, 2006, is classified as a current liability in the accompanying condensed consolidated balance sheet. At June 30, 2007 and December 31, 2006, the outstanding principal balance of the Dimensional convertible debt was \$10,700,000 and \$6,600,000 and the outstanding balance of the accrued interest was \$1,634,810 and \$1,227,937 (which includes both outstanding interest on the \$7,931,000 debt that was converted in the May 2006 Recapitalization (see Note 6) and interest accrued during 2007 and 2006 on the \$10,700,000 loaned by Dimensional during 2007 and 2006). Interest expense on the convertible debt was \$406,873 and \$315,343 for the six months ended June 30, 2007 and 2006.

In connection with the execution of the Loan Agreement, on April 28, 2003, the shareholders of Orchard entered into a shareholder agreement (the Shareholder Agreement), which provides that the Board of Directors shall consist of five members, three of which will be designated by Dimensional so long as there are any loans outstanding under the Loan Agreement. Additionally, the Shareholder Agreement restricts Orchard's ability to declare dividends, sell assets, incur indebtedness and issue shares of any class or series of capital stock without Dimensional's written consent.

**8. STOCKHOLDERS DEFICIENCY**

**Common Stock and Preferred Stock** At June 30, 2007, Orchard had authorized the issuance of the following securities:

**Series A Convertible Preferred Stock** Orchard's Series A Preferred Stock (a) is its most senior class or series of securities, (b) has a liquidation preference of one times the amount of the Original Issue Price of \$1.00 per share plus any unpaid dividends (and then participates with the Common Stock on an as converted basis), (c) earns a cumulative annual dividend equal to the prime rate as announced by CitiBank N.A. plus 1.0% (calculated on a monthly basis), and (d) is convertible into shares of Common Stock with a conversion ratio of one share of Common Stock for each share of Series A Preferred Stock (subject to adjustment in accordance with the anti-dilution provision in the terms of the Series A Preferred Stock) Dividends are payable when and if declared by Orchard's Board of Directors. The shares of Series A Preferred Stock are automatically converted into shares of Common Stock upon the affirmative election of the holders of at least 66<sup>2</sup>/<sub>3</sub> of the outstanding shares of Series A Preferred Stock, or immediately upon the closing of a public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended, covering the offer and sale of the Common Stock of Orchard in which the per share price is at least \$4.00 per share and the net proceeds to Orchard are at least \$20,000,000. The shares of the Series A Preferred Stock may, at the option of the holder thereof, be converted at any time into shares of Common Stock. The liquidation preference is triggered upon (i) a sale, lease or other disposition of substantially all of Orchard's assets, (ii) transfer of 50% of Orchard's voting power, (iii) consolidation or merger of Orchard resulting in less than 50% ownership by the shareholders. Series A Preferred Stock votes on an as converted basis with the shares of the Common Stock of Orchard. However, certain actions of Orchard require the approval by a majority of the outstanding Series A Preferred Stock such as amendments to the articles of incorporation, acquisitions, involuntary liquidation of Orchard and the payment of dividends.

At June 30, 2007 and December 31, 2006, there were 7,931,000 shares of Series A Preferred Stock issued and outstanding.

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As of June 30, 2007, the board of directors of Orchard has not declared any dividends on the Series A Preferred Stock and the shareholders of Series A Preferred Stock were entitled to a cumulative dividend of \$819,772 at June 30, 2007.

*Series B Convertible Preferred Stock* Orchard's Series B Preferred Stock (a) is junior to the Series A Preferred Stock (b) has a liquidation preference of one times the amount of the Original Issue Price of \$1.00 per share plus any unpaid dividends (and then participates with the Common Stock on an as converted basis), and (c) is convertible into shares of Common Stock with a conversion ratio of one share of Common Stock for each share of Series B Preferred Stock. The shares of Series B Preferred Stock are automatically converted into shares of Common Stock upon the affirmative election of the holders of at least 66 2/3 of the outstanding shares of Series B Preferred Stock, or immediately upon the closing of a public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended, covering the offer and sale of the Common Stock of Orchard in which the per share price is at least \$4.00 per share and the net proceeds to Orchard are at least \$20,000,000. The shares of Series B Preferred Stock may, at the option of the holder thereof, be converted at any time into shares of Common Stock. The liquidation preference is triggered upon (i) a sale, lease or other disposition of substantially all of Orchard's assets, (ii) transfer of 50% of Orchard's voting power, or (iii) consolidation or merger of Orchard resulting in less than 50% ownership by the shareholders. Series B Preferred Stock votes on an as converted basis with the shares of the Common Stock of Orchard.

At June 30, 2007 and December 31, 2006, there were 7,931,000 shares of Series B Preferred Stock issued and outstanding.

*Common Stock* Orchard's common stock (a) is its most junior class of stock, (b) has no liquidation preference, (c) has no set dividend rights and (d) is not convertible. At June 30, 2007 and December 31, 2006, there were 1,762,444 shares of common stock issued and outstanding. At June 30, 2007, Orchard has 15,862,000 shares of common stock reserved for issuance upon the conversion of the outstanding Series A and Series B Convertible Preferred Stock.

**9. GEOGRAPHIC INFORMATION**

Orchard operates in one reportable segment, digital music content distribution. Long-lived assets outside of the United States of America are not significant. Revenues by geographic region, based on the country in which the customer is located for the six months ended June 30, 2007 and 2006, are as follow:

|                          | <b>Six months ended June 30,</b> |                     |
|--------------------------|----------------------------------|---------------------|
|                          | <b>2007</b>                      | <b>2006</b>         |
| U.S. sourced revenue     | \$ 9,054,301                     | \$ 4,979,049        |
| Non-U.S. sourced revenue | 2,932,964                        | 1,403,356           |
| <b>Total revenue</b>     | <b>\$ 11,987,265</b>             | <b>\$ 6,382,405</b> |

**10. RELATED-PARTY TRANSACTIONS**

From time to time Orchard has amounts due to and from companies that have common ownership or are controlled by the Investor Group. These amounts are billed and paid on a regular basis. Net receivable (payables) to affiliates totaled \$5,339 and (\$46,286) at June 30, 2007 and December 31, 2006, respectively.

*Management Agreement* During 2004 Orchard entered into a management services agreement with Dimensional, an entity incorporated and owned by the Investor Group, for ongoing consulting and management advisory services performed by certain key executives employed by Dimensional. Pursuant to this agreement, Orchard paid a monthly management fee based on a predetermined allocation percentage derived from the time

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spent by such executives on Orchard's business. As of January 1, 2007 employees devoting substantially all of their time on Orchard business were hired by Orchard and the management fee was suspended. Orchard recognized \$306,000 during the six months ended June 30, 2006, for management fees which are included in general and administrative expenses in the accompanying condensed consolidated statements of operations.

***Operating Lease With Affiliate*** Orchard utilized and paid for certain office space (under a written sublease arrangement) leased from an affiliated entity of the Investor Group through April 2006. Amounts included in operating expenses in connection with this arrangement were \$52,356 for the six months ended June 30, 2006.

In January 2006, Orchard began utilizing space subleased by an affiliated entity, with no formal sublease agreement in place. Orchard pays the lessee directly for the space utilized. For the six months ended June 30, 2007 and 2006, Orchard incurred expenses of approximately \$169,225 and \$96,800, respectively, under this arrangement. In August 2007, the sublease to this space was assigned by the affiliate to Orchard. The lease expires in January 2009.

***Legal Costs*** Orchard has engaged several outside legal firms to represent its general business interests. One such firm employs a family member of one of the senior executives employed by the Investor Group. Amounts included in operating expenses in connection with the services performed by this legal firm were \$2,263 and \$34,670 for the six months ended June 30, 2007 and 2006, respectively.

***Distribution Services With eMusic*** eMusic provides digital music distribution services to Orchard under a Digital Music Wholesale Agreement, dated January 1, 2004, as amended on March 31, 2007. eMusic is a majority owned subsidiary of Dimensional. The agreement grants eMusic worldwide rights, on a non-exclusive basis, to exploit Orchard's master recordings digitally and via the Internet through December 31, 2009. Per the agreement, Orchard is entitled to better royalty terms if eMusic allows any other independent record label such better terms during the Term of the agreement (Most Favored Nation clause). Amounts included in revenues in connection with these services were \$1,316,823 and \$922,769, for the six months ended June 30, 2007 and 2006, respectively. Amounts included in accounts receivable in connection with these services were \$642,973 and \$483,087 at June 30, 2007 and December 31, 2006, respectively.

Orchard has distribution agreements with certain labels whereby it is not permitted to charge distribution fees to the label or artist for sales by eMusic. For the six months ended June 30, 2007 and 2006, Orchard received revenues of \$380,699 and \$386,565, respectively, from eMusic relating to such agreements. These amounts were recorded in revenues and with an equal amount recorded in costs of revenues.

***Sale of fixed assets to Dimensional Music Publishing, LLC*** Orchard sold fixed assets to Dimensional Music Publishing, LLC realizing a loss of \$1,448 for the six months ended June 30 2006. The cost of the equipment was \$5,650 and the related accumulated depreciation was \$3,202.

***Revenue Sharing Agreement With CGH Ventures, Inc*** During 2003 Orchard Management, Inc., a wholly-owned subsidiary of Orchard, entered into a revenue sharing agreement with CGH Ventures, Inc., an entity owned by two stockholders of Orchard. Pursuant to this agreement, Orchard is obligated to pay CGH Ventures, Inc. 80% of the net revenues earned by Orchard Management Inc. Orchard Management Inc. provides management services to a recording group. Orchard recorded \$15,978 and \$38,333 for the six months ended June 30, 2007 and 2006, respectively as commission expense for CGH's share of the net revenue earned under the management agreement. The commission expense was included in costs of revenues in the accompanying condensed consolidated statements of operations.

**11. COMMITMENTS AND CONTINGENCIES**

***Litigation and Indemnification*** Orchard is a party to litigation matters and claims from time to time in the ordinary course of its operations, including copyright infringement litigation, for which it is entitled to

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indemnification by content providers. While the results of such litigation and claims cannot be predicted with certainty, Orchard believes that the final outcome of such matters will not have a material adverse impact on its business, financial position, cash flows, or results of operations.

**12. SUBSEQUENT EVENTS**

***Debt Conversion, Debt Forgiveness and Recapitalization*** In July 2007, through written consents of its shareholders and Board of Directors, Orchard ratified and confirmed the outstanding convertible debt of Orchard and authorized the conversion of the outstanding principal on such convertible debt owed to Dimensional of \$10,700,000, simultaneous with the authorization for a recapitalization of Orchard (the July 2007 Recapitalization). The July 2007 Recapitalization included amending and restating Orchard's Certificate of Incorporation and authorizing the issuance of (i) 10,700,000 shares of Series A Preferred Stock and (ii) 9,675,295 shares of Series B Preferred Stock and (iii) 2,377,778 shares of Common Stock (which was issued to the original common shareholders). Orchard expects to recognize a significant compensation charge for the nine months ended September 30, 2007 based on the fair value of common stock issued to the original shareholders. In addition, Dimensional forgave all interest owed and outstanding, including the interest owed and outstanding at December 31, 2006, related to the debt converted in connection with the May 2006 Recapitalization (see Notes 8 and 9). The forgiveness of interest owed will be reflected in other income for the quarter ended September 30, 2007. In connection with the July 2007 Recapitalization, the shareholders amended and restated the Shareholder Agreement, which restated their respective rights and obligations. Pursuant to the July 2007 Recapitalization, Orchard amended and restated its certificate of incorporation to increase its number of authorized shares of capital stock as follows: (i) 30,000,000 shares of Series A Preferred Stock (ii) 30,000,000 shares of Series B Preferred Stock, and (iii) 80,000,000 shares of Common Stock.

In connection with the July 2007 Recapitalization, a senior executive of Orchard and a senior executive of an affiliated company were granted deferred stock awards of 745,240 and 279,465 shares of Series B Preferred Stock, which will be issued upon the occurrence of a liquidity event, as defined in the deferred stock award. The award is fully vested and non-forfeitable. Orchard expects to recognize a compensation charge for the nine months ended September 30, 2007 based on the fair value of the deferred stock awards.

***Merger Agreement*** On July 10, 2007, Orchard entered into an Agreement and Plan of Merger, which was amended and restated on September 13, 2007 and further amended and restated on October 5, 2007 (the Merger Agreement), with Digital Music Group, Inc. (DMGI) and DMGI New York, Inc. (Merger Sub). Under the terms of the Merger Agreement, Merger Sub will merge with and into Orchard, with Orchard continuing as the surviving corporation (the Surviving Corporation) and as a wholly-owned subsidiary of DMGI.

Orchard's board of directors unanimously approved the Merger Agreement and the transactions contemplated thereby. As a result of the merger, all shares of Orchard capital stock and all deferred stock awards shall be converted into the right to receive 9,064,941 shares of DMGI Common Stock and 448,833 shares of DMGI Series A Preferred Stock (the Merger Shares).

The completion of the merger is subject to various customary conditions, including: (i) obtaining the requisite approval of both Orchard's and DMGI's shareholders; (ii) compliance with all applicable waiting periods imposed by the HSR Act and other government entities; (iii) obtaining reasonably satisfactory tax opinions; (iv) authorizing the issuance of the DMGI Series A Preferred Stock and the issuance of the shares of DMGI Common Stock; and (v) execute and deliver various ancillary agreements and other documents, including a registration rights agreement in favor of Orchard's shareholders covering the Merger Shares (and those shares of DMGI Common Stock issuable upon conversion of the DMGI Series A Preferred Stock issued as part of the Merger Shares).

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The Merger Agreement also includes customary termination provisions for both Orchard and DMGI, and provides that, in connection with the termination of the Merger Agreement under specified circumstances relating to the receipt by Orchard of an affirmative proposal to the transaction with DMGI, Orchard may be required to pay DMGI a termination fee of \$1.11 million plus DMGI's reasonable costs and expenses incurred in connection with the transaction up to \$500,000.

The proposed merger is expected to be completed in the fourth calendar quarter of 2007.

***Additional Capital Contributions and Recapitalization*** In September 2007, through written consents of its shareholders and board of directors, Orchard ratified and confirmed capital contributions made to Orchard by Dimensional in the amount of \$850,000 between July 3, 2007 and September 28, 2007, simultaneous with the authorization of a recapitalization of Orchard (the September 2007 Recapitalization). The September 2007 Recapitalization included amending and restating Orchard's certificate of incorporation and authorizing the issuance of (i) 803,250 shares of Series B Preferred Stock, (ii) 850,000 shares of Series C Preferred Stock (defined below) and (iii) 4,455,090 shares of Common Stock (which was issued to the original common shareholders). Orchard expects to recognize a significant compensation charge for the nine months ended September 30, 2007 based on the fair value of the Common Stock issued to the original holders of Common Stock. Pursuant to the September 2007 Recapitalization, Orchard amended and restated its certificate of incorporation to (i) increase its number of authorized shares of preferred stock from 60,000,000 to 61,500,000 and (ii) authorize 1,500,000 shares of a new series of preferred stock, the Series C Preferred Stock (defined below).

In connection with the September 2007 Recapitalization, a senior executive of Orchard and a senior executive of an affiliated company were granted deferred stock awards of 34,000 and 12,750 shares of Series B Preferred Stock and 824,593 and 309,222 shares of Common Stock, respectively, which will be issued upon the occurrence of a liquidity event, as defined in their respective deferred stock awards. The awards are fully vested and non-forfeitable. Orchard expects to recognize a compensation charge for the nine months ended September 30, 2007 based on the fair value of the deferred stock awards.

***Series C Convertible Preferred stock*** Orchard's Series C Convertible Preferred Stock (the Series C Preferred Stock) has the following rights and preferences: (a) along with the Series A Preferred Stock, it is Orchard's most senior class or series of securities, (b) has a liquidation preference of one times the amount of the original issue price of \$2.95 per share plus any unpaid dividends on a *pari passu* basis with the holders of Series A Preferred (and then participates with the Common Stock on an as converted basis), (c) earns a cumulative annual dividend equal to the prime rate as announced by CitiBank N.A. plus 1.0% (calculated on a monthly basis), and (d) is convertible into shares of Common Stock with a conversion ratio of one share of Common Stock for each share of Series C Preferred Stock (subject to adjustment in accordance with the anti-dilution provision in the terms of the Series C Preferred Stock). Dividends are payable when and if declared by Orchard's board of directors. The shares of Series C Preferred Stock are automatically converted into shares of Common Stock upon the affirmative election of the holders of at least 66 2/3 of the outstanding shares of Series C Preferred Stock, or immediately upon the closing of a public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended, covering the offer and sale of the Common Stock of Orchard in which the per share price is at least \$4.00 per share and the net proceeds to Orchard are at least \$20,000,000. The shares of the Series C Preferred Stock may, at the option of the holder thereof, be converted at any time into shares of Common Stock. The liquidation preference is triggered upon (i) a sale, lease or other disposition of substantially all of Orchard's assets, (ii) transfer of 50% of Orchard's voting power, (iii) consolidation or merger of Orchard resulting in less than 50% ownership by the shareholders. Series C Preferred Stock votes on an as converted basis with the shares of the Common Stock of Orchard. However, certain actions of Orchard require the approval by a majority of the outstanding Series A Preferred Stock and Series C Preferred Stock, voting together as a single class, such as amendments to the articles of incorporation, acquisitions, involuntary liquidation of Orchard and the payment of dividends.

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**DIGITAL MUSIC GROUP, INC.**

**INTRODUCTION TO UNAUDITED PRO FORMA CONDENSED**

**COMBINED FINANCIAL STATEMENTS**

The following unaudited pro forma condensed combined financial statements give effect to the proposed merger of Digital Music Group Inc. ( DMGI ) and The Orchard Enterprises Inc. ( Orchard ). For accounting purposes, Orchard is considered to be acquiring DMGI. Accordingly, the purchase price is allocated among the fair values of the assets and liabilities of DMGI, while the historical results of Orchard are reflected in the results of the combined company. The transaction will be accounted for under the purchase method of accounting in accordance with Statement of Financial Accounting Standards No 141, *Business Combinations*. Under the purchase method of accounting, the estimated purchase price, calculated as described in Note 2 to these unaudited pro forma condensed combined financial statements, is allocated to the tangible and intangible assets acquired and liabilities assumed in connection with the transaction, based on their estimated fair values at the time the merger is consummated.

For purposes of these unaudited pro forma condensed combined financial statements, DMGI has made preliminary allocations of the estimated purchase price to the assets to be acquired and liabilities to be assumed based on preliminary estimates of their fair values. A final determination of the estimated fair values, will be made subsequent to the completion of the merger based on the actual purchase price and the actual assets and liabilities of DMGI that exist as of the date of completion of the merger. The actual amounts recorded at the completion of the merger may differ materially from the information presented in these unaudited pro forma condensed combined financial statements as a result of:

net cash used in DMGI's and Orchard's operations between the dates of the pro forma financial statements and the closing of the merger;

other changes in DMGI's and Orchard's assets and liabilities that occur prior to completion of the merger;

the timing of completion of the merger; and

other changes in estimated costs and fair values, which could cause material differences in the information presented below.

The unaudited pro forma condensed combined financial statements presented below are based on the historical financial statements of DMGI and Orchard, adjusted to give effect to the acquisition of DMGI by Orchard for accounting purposes. The pro forma adjustments are described in the accompanying notes.

The unaudited pro forma condensed combined balance sheet as of June 30, 2007 gives effect to the proposed merger as if it occurred on June 30, 2007, and combines the historical balance sheets of DMGI and Orchard as of June 30, 2007, as included elsewhere in this proxy statement.

The unaudited pro forma condensed combined statement of operations for the six months ended June 30, 2007 is presented as if the merger was consummated on January 1, 2006, and combines the historical results of DMGI and Orchard for the six months ended June 30, 2007, as included herein. The unaudited pro forma condensed combined statement of operations for the year ended December 31, 2006 is presented as if the merger was consummated on January 1, 2006, and combines the historical results of Orchard and DMGI for the year ended December 31, 2006, and also gives effect to DMGI's acquisition of Digital Musicworks International, Inc. ( DMI ) and certain assets of Rio Bravo Entertainment LLC ( Rio Bravo ) on February 6, 2006 and DMGI's acquisition of Digital Rights Agency LLC ( DRA ) on September 8, 2006, as if these acquisitions also occurred on January 1, 2006. The historical results of DMGI and Orchard for the year ended December 31, 2006 were derived from their audited consolidated statements of operations included elsewhere in this proxy statement, and the pre-acquisition pro forma results for companies acquired by DMGI during 2006 were derived from Note 3 to DMGI's consolidated financial statements for the year ended December 31, 2006, also included elsewhere in this proxy statement.



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**DIGITAL MUSIC GROUP, INC.**

**INTRODUCTION TO UNAUDITED PRO FORMA CONDENSED**

**COMBINED FINANCIAL STATEMENTS (Continued)**

These unaudited pro forma condensed combined financial statements have been prepared for illustrative purposes only and are not indicative of the consolidated financial position or results of operations in future periods or the results that actually would have been realized had DMGI and Orchard been a combined company during the periods presented. The pro forma adjustments are based on the preliminary information available at the time of the preparation of this proxy statement and are subject to change. These unaudited pro forma condensed combined financial statements, including the notes thereto, are qualified in their entirety by reference to, and should be read in conjunction with, the historical financial statements of DMGI and Orchard included elsewhere in this proxy statement.

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**Table of Contents****Index to Financial Statements****DIGITAL MUSIC GROUP, INC.****UNAUDITED PRO FORMA CONDENSED COMBINED BALANCE SHEET****June 30, 2007**

|   | Digital<br>Music<br>Group, Inc.<br>Historical | The<br>Orchard<br>Enterprises<br>Inc.<br>Historical | Pro Forma<br>Adjustments | Pro Forma<br>Digital<br>Music<br>Group, Inc. |
|---|---|---|--------------------------|--|
| <b>ASSETS</b>   |   |   |                          |  |
| Current assets:   |   |   |                          |  |
| Cash and cash equivalents   | \$ 13,968,883                                 | \$ 3,127,145  |                          | \$ 17,096,028                                |
| Accounts receivable, net  | 1,835,638                                     | 4,377,173   |                          | 6,212,811                                    |
| Current portion of royalty advances   | 1,983,679                                     | 1,296,779   |                          | 3,280,458                                    |
| Prepaid expenses and other current assets   | 601,844                                       | 287,773   |                          | 889,617                                      |
| Total current assets  | 18,390,044                                    | 9,088,870   |                          | 27,478,914                                   |
| Furniture and equipment, net  | 1,020,541                                     | 896,668   | \$ (520,541)(e)          | 1,396,668                                    |
| Digital rights, net   | 3,546,393                                     |   | 1,453,607 (e)            | 5,000,000                                    |
| Master recordings, net  | 2,122,843                                     |   | 2,157 (e)                | 2,125,000                                    |
| Royalty advances, less current portion  | 7,205,769                                     | 229,701   | 19,231 (e)               | 7,454,701                                    |
| Goodwill  | 5,355,944                                     |   | 9,382,304 (e)            | 14,738,248                                   |
| Other assets  | 42,563  | 143,428   | (42,563)(e)              | 143,428                                      |
| Total assets  | \$ 37,684,097                                 | \$ 10,358,667                                       | \$ 10,294,195            | \$ 58,336,959                                |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)</b>  |   |   |                          |  |
| Current liabilities:  |   |   |                          |  |
| Accounts payable and accrued liabilities  | \$ 1,369,197                                  | \$ 1,001,569  |                          | \$ 2,370,766                                 |
| Royalties payable   | 2,204,311                                     | 7,429,363   |                          | 9,633,674                                    |
| Deferred revenue  |   | 276,816   |                          | 276,816                                      |
| Current portion of capital lease obligations  | 34,090  |   |                          | 34,090                                       |
|   |   |   | \$ 1,584,693 (a)         |  |
| Merger-related liabilities  |   |   | 1,922,500 (e)            | 3,507,193                                    |
| Accrued interest payable to a related party   |   | 1,634,810   | (1,634,810)(c)           |  |
| Convertible debt payable to a related party   |   | 10,700,000  | (10,700,000)(c)          |  |
| Total current liabilities   | 3,607,598                                     | 21,042,558  | (8,827,617)              | 15,822,539                                   |
| Long-term liabilities:  |   |   |                          |  |
| Capital lease obligations, less current portion   | 1,719   |   |                          | 1,719  |
| Other long-term liabilities   | 89,285  |   |                          | 89,285                                       |
| Total liabilities   | 3,698,602                                     | 21,042,558  | (8,827,617)              | 15,913,543                                   |
| Commitments and contingencies   |   |   |                          |  |
| Stockholders' equity (deficit):   |   |   |                          |  |
| Orchard Series A convertible preferred stock  |   | 7,931   | (7,931)(c)               |  |
| Orchard Series B convertible preferred stock  |   | 7,931   | (7,931)(c)               |  |
| Preferred stock, \$.01 par value, 1,000,000 shares authorized: pro forma<br>448,833 shares issued and outstanding |   |   | 4,488 (d)                | 4,488  |
| Orchard Common stock  |   | 1,763   | (1,763)(c)               |  |
| Common stock subscription receivable  |   | (1,478)   | 1,478 (c)                |  |

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|  |               |               |                 |               |
|--|---------------|---------------|-----------------|---------------|
| Common stock, \$.01 par value, 30,000,000 shares authorized: pro forma<br>18,186,880 shares issued and outstanding |               |               | (91,219)(b)     |               |
|  | 91,219        |               | 181,868 (d)     | 181,868       |
|  |               |               | (40,564,757)(b) |               |
|  |               |               | 12,350,957 (c)  |               |
|  |               |               | (186,356)(d)    |               |
| Additional paid-in capital   | 40,564,757    | 7,998,593     | 40,772,497 (e)  | 60,935,691    |
|  |               |               | (1,774,329)(a)  |               |
| Accumulated deficit  | (6,670,481)   | (18,683,155)  | 8,444,810 (b)   | (18,683,155)  |
| Accumulated other comprehensive income   |               | (15,476)      |                 | (15,476)      |
| Total stockholders' equity (deficit)   | 33,985,495    | (10,683,891)  | 19,121,812      | 42,423,416    |
| Total liabilities and stockholders' equity (deficit)   | \$ 37,684,097 | \$ 10,358,667 | \$ 10,294,195   | \$ 58,336,959 |

The accompanying notes are an integral part of these unaudited pro forma condensed combined financial statements.

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## DIGITAL MUSIC GROUP, INC.

## UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS

For the Six Months Ended June 30, 2007

|  | Digital Music Group, Inc. Historical | The Orchard Enterprises Inc. Historical | Pro Forma Adjustments | Pro Forma Digital Music Group, Inc. |
|--|--------------------------------------|---|-----------------------|-------------------------------------|
| Revenue  | \$ 6,543,811                         | \$ 11,987,265                           |                       | \$ 18,531,076                       |
| Cost of revenue:                               |                                      |   |                       |                                     |
| Royalties and payments to content owners       | 4,593,191                            | 8,611,463                               | \$ (394,451)(f)       | 13,204,654                          |
| Amortization                                   | 394,451                              | 2,324                                   | 463,393 (g)           | 465,717                             |
| Gross profit                                   | 1,556,169                            | 3,373,478                               | (68,942)              | 4,860,705                           |
|  |                                      |   | (176,219)(f)          |                                     |
| Operating, general and administrative expenses | 3,482,509                            | 5,158,866                               | 83,333 (g)            | 8,548,489                           |
| Merger-related expenses                        | 328,844                              |   | (328,844)(a)          |                                     |
| Loss from operations                           | (2,255,184)                          | (1,785,388)                             | 352,788               | (3,687,784)                         |
| Interest income                                | 441,516                              |   |                       | 441,516                             |
| Interest expense                               | (3,924)                              | (406,873)                               | 406,873 (i)           | (3,924)                             |
| Other expense                                  | (27,443)                             |   |                       | (27,443)                            |
| Loss before taxes                              | (1,845,035)                          | (2,192,261)                             | 759,661               | (3,277,635)                         |
| Income taxes                                   | (800)                                |   |                       | (800)                               |
| Net loss                                       | \$ (1,845,835)                       | \$ (2,192,261)                          | \$ 759,661            | \$ (3,278,435)                      |
| Loss per share:                                |                                      |   |                       |                                     |
| Basic  | \$ (0.20)                            |   |                       | \$ (0.18)                           |
| Diluted  | \$ (0.20)                            |   |                       | \$ (0.18)                           |
| Weighted average shares outstanding:           |                                      |   |                       |                                     |
| Basic  | 9,030,880                            |   |                       | 18,095,821                          |
| Diluted  | 9,030,880                            |   |                       | 18,095,821                          |

The accompanying notes are an integral part of these unaudited pro forma condensed combined financial statements.

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## DIGITAL MUSIC GROUP, INC.

## UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS

For the Year Ended December 31, 2006

|  | Digital Music Group, Inc. Historical | Digital Music Group, Inc. (prior to acquisition) | Rio Bravo Entertainment LLC Carve Out Segment (prior to acquisition) | Digital Rights Agency LLC (prior to acquisition) | The Orchard Enterprises Inc. Historical | Pro Forma Adjustments | Pro Forma Digital Music Group, Inc. |
|--|--------------------------------------|--|--|--|---|-----------------------|-------------------------------------|
| Revenue  | \$ 5,564,949                         | \$   | \$ 63,196  | \$ 4,572,956                                     | \$ 14,918,135                           |                       | \$ 25,119,236                       |
| Cost of revenue:                               |                                      |  |  |  |   |                       |                                     |
| Royalties and payments to content owners       | 3,329,698                            |  | 50,556   | 3,880,289  | 10,709,853                              |                       | 17,970,396                          |
|  |                                      |  |  |  |   | \$ 86,118 (h)         |                                     |
|  |                                      |  |  |  |   | (508,607)(f)          |                                     |
| Amortization                                   | 422,489                              |  |  |  | 7,164                                   | 926,786 (g)           | 933,950                             |
| Gross profit                                   | 1,812,762                            |  | 12,640   | 692,667  | 4,201,118                               | (504,297)             | 6,214,890                           |
|  |                                      |  |  |  |   | 9,194 (h)             |                                     |
|  |                                      |  |  |  |   | (166,034)(f)          |                                     |
| Operating, general and administrative expenses | 5,655,161                            | 10,000   | 624  | 733,800  | 9,782,737                               | 166,667 (g)           | 16,192,149                          |
| Income (loss) from operations                  | (3,842,399)                          | (10,000)   | 12,016   | (41,133)   | (5,581,619)                             | (514,124)             | (9,977,259)                         |
| Interest income                                | 1,251,396                            |  |  | 5,923  | 2,743                                   |                       | 1,260,062                           |
| Interest expense                               | (13,649)                             | (4,667)  |  | (1,538)  | (520,084)                               | 520,084 (i)           | (19,854)                            |
| Other income (expense)                         | (16,982)                             |  |  |  | 130,000                                 |                       | 113,018                             |
| Income (loss) before taxes                     | (2,621,634)                          | (14,667)   | 12,016   | (36,748)   | (5,968,960)                             | 5,960                 | (8,624,033)                         |
| Income taxes                                   | (800)                                |  |  |  |   |                       | (800)                               |
| Net income (loss)                              | \$ (2,622,434)                       | \$ (14,667)                                      | \$ 12,016  | \$ (36,748)                                      | \$ (5,968,960)                          | \$ 5,960              | \$ (8,624,833)                      |
| Loss per share:                                |                                      |  |  |  |   |                       |                                     |
| Basic  | \$ (0.32)                            |  |  |  |   |                       | \$ (0.49)                           |
| Diluted  | \$ (0.32)                            |  |  |  |   |                       | \$ (0.49)                           |
| Weighted average shares outstanding:           |                                      |  |  |  |   |                       |                                     |
| Basic  | 8,071,393                            |  |  |  |   |                       | 17,737,222                          |
| Diluted  | 8,071,393                            |  |  |  |   |                       | 17,737,222                          |

The accompanying notes are an integral part of these unaudited pro forma condensed combined financial statements.





Table of ContentsIndex to Financial Statements**DIGITAL MUSIC GROUP, INC.****NOTES TO THE UNAUDITED PRO FORMA CONDENSED****COMBINED FINANCIAL STATEMENTS****1. The Merger and Basis of Presentation**

On July 10, 2007, DMGI and Orchard entered into a merger agreement, which was amended and restated on September 13, 2007, and further amended and restated on October 5, 2007, under which a wholly-owned subsidiary of DMGI, DMGI New York, Inc. ( DMGI NY ), will merge with and into Orchard, with Orchard continuing as the surviving company and becoming a wholly-owned subsidiary of DMGI. Pursuant to the merger agreement, DMGI will issue an aggregate maximum of 9,064,941 shares of common stock of DMGI, par value \$0.01 per share, and 448,883 shares of a newly created series of preferred stock or the right to receive such shares, as applicable, par value \$0.01 per share, in exchange for all outstanding shares of common and preferred stock of Orchard and deferred stock awards (as adjusted to reflect the reverse stock split, if any). Each share of the preferred stock of DMGI will be convertible into, and will have voting rights equivalent to, ten shares of DMGI common stock, with a liquidation preference of \$55.70 per share.

Because Orchard stockholders will own a majority of the voting stock of the combined company upon closing of the merger, Orchard is deemed to be the acquiring company for accounting purposes and the transaction will be accounted for as a reverse acquisition in accordance with Statement of Financial Accounting Standards No 141, *Business Combinations*. Accordingly, the assets and liabilities of DMGI will be recorded as of the merger closing date at their estimated fair value.

The accompanying pro forma condensed combined financial statements do not give effect to any cost savings or revenue synergies which are expected to result from the merger of DMGI and Orchard. Further, these pro forma condensed combined financial statements will change, perhaps materially, based on facts and circumstances as of the closing of the merger.

**2. Preliminary Purchase Price Allocation**

The preliminary estimated purchase price is as follows:

|   |               |
|---|---------------|
| Fair value of DMGI outstanding common stock             | \$ 38,749,997 |
| Estimated fair value of DMGI stock options and warrants | 100,000       |
| Direct merger-related costs                             | 1,922,500     |
| Total estimated purchase price                          | \$ 40,772,497 |

On July 10, 2007, DMGI had 9,121,939 shares of common stock outstanding and has not issued any additional shares since this time. The fair value of DMGI common stock used in determining the purchase price was \$4.248 per share based on its average closing price on NASDAQ for the two days prior to through the two days subsequent to the merger announcement date of July 11, 2007. The fair value of DMGI's stock options and warrants is a preliminary estimate. The final estimated fair value will be determined using the Trinomial Lattice Model based on the number of DMGI stock options and warrants outstanding on the merger closing date.

Orchard's merger-related costs include approximately \$1,072,500 in legal, accounting and other direct costs and approximately \$850,000 in employee termination, relocation, lease cancellation and other costs to be incurred in connection with integrating and consolidating the DMGI and Orchard operations.



**Table of Contents****Index to Financial Statements****DIGITAL MUSIC GROUP, INC.****NOTES TO THE UNAUDITED PRO FORMA CONDENSED****COMBINED FINANCIAL STATEMENTS (Continued)**

Under the purchase method of accounting, the total purchase price is allocated to the acquired tangible and intangible assets and assumed liabilities of DMGI based on their estimated fair values as of the merger closing date. The excess of the purchase price over the fair value of assets acquired and liabilities assumed is allocated to goodwill. A preliminary allocation of the preliminary estimated purchase price, as shown above, to the acquired tangible and intangible assets and assumed liabilities of DMGI based on the estimated fair values as of June 30, 2007, is as follows:

|  |               |
|--|---------------|
| Cash and cash equivalents                                  | \$ 13,968,883 |
| Accounts receivable and other current assets               | 2,437,482     |
| Royalty advances   | 9,208,679     |
| Furniture and equipment                                    | 500,000       |
| Digital rights   | 5,000,000     |
| Master recordings  | 2,125,000     |
| Goodwill   | 14,738,248    |
| Assumed liabilities  | (3,698,602)   |
| Integration and other merger related costs, including DMGI | (3,507,193)   |
| Net assets acquired  | \$ 40,772,497 |

The final determination of the purchase price allocation will be based on the estimated fair values of the tangible and intangible assets acquired and liabilities assumed at the date of the closing of the merger and will be made as soon as practicable after the closing. The purchase price allocation will remain preliminary until DMGI completes its valuation of the tangible and intangible assets acquired and liabilities assumed. The final amounts allocated to assets acquired and liabilities assumed could differ significantly from the amounts presented in these pro forma financial statements.

**3. Pro Forma Adjustments**

(a) To record DMGI's change of control bonuses and other employee-related obligations that become due as a result of the merger in the estimated amount of approximately \$657,000 and estimated costs to be incurred by DMGI to consummate the merger totaling approximately \$927,000. Merger-related costs include fees payable for investment banking, legal and accounting services, NASDAQ and other regulatory fees, printing, proxy solicitation and other costs, including \$328,844 incurred prior to June 30, 2007, which is eliminated through this pro forma adjustment.

(b) To eliminate DMGI's historical stockholders' equity accounts.

(c) To reflect the conversion of Orchard's convertible debt, accrued interest and Orchard preferred stock as additional paid-in capital as if Orchard's debt conversion, debt forgiveness and recapitalization, as described in Note 12 to Orchard's unaudited consolidated financial statements for the period ended June 30, 2007 included elsewhere in this proxy statement, had occurred on June 30, 2007.

(d) To reflect 9,121,939 shares of DMGI common stock outstanding at the date of the merger announcement and to record the conversion of all classes of Orchard equity for 9,064,941 shares of DMGI common stock and 448,833 shares of DMGI preferred stock, each with a par value of \$.01 per share (without giving effect to the reverse stock split, if any).

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(e) To record the preliminary purchase price of DMGI totaling \$40,772,497 by adjusting the historical value of DMGI's assets and liabilities to their estimated fair values as described in Note 2 above.

(f) To eliminate DMGI's historical depreciation and amortization expense.

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(g) To record DMGI's pro forma depreciation and amortization expense based on the preliminary estimated fair value of the underlying assets.

(h) To record the amortization and depreciation of the fair value of the assets of DRA and Rio Bravo as if they were acquired at the beginning of the period.

(i) To eliminate interest expense associated with Orchard's convertible debt to reflect Orchard's debt conversion, debt forgiveness and recapitalization, as described in Note 12 to Orchard's unaudited consolidated financial statements for the period ended June 30, 2007 included elsewhere in this proxy statement, as if it had occurred as of the beginning of the period.

**4. Pro Forma Loss Per Share**

Weighted average shares outstanding for the six months ended June 30, 2007 include DMGI's historical weighted average shares outstanding plus the 9,064,941 shares of DMGI common stock to be issued in connection with the merger.

Weighted average shares outstanding for the year ended December 31, 2006 include:

|  |            |
|--|------------|
| DMGI shares outstanding prior to its IPO   | 2,425,000  |
| DMGI shares attributable to the acquisition of DMI   | 2,249,941  |
| DMGI shares attributable to the acquisition of certain assets of Rio Bravo   | 25,000     |
| DMGI shares attributable to the acquisition of DRA   | 476,998    |
| DMGI common shares to be issued in connection with the merger  | 9,064,941  |
| DMGI shares issued in connection with its IPO in the amount of 3,900,000, outstanding for the period from February 7, 2006 through December 31, 2006 | 3,495,342  |
|  | 17,737,222 |

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ANNEX A

**SECOND AMENDED AND RESTATED AGREEMENT AND PLAN OF MERGER**

**by and among**

**DIGITAL MUSIC GROUP, INC.**

**DMGI NEW YORK, INC.**

**and**

**THE ORCHARD ENTERPRISES INC.**

**DATED AS OF OCTOBER 5, 2007**

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**AMENDED AND RESTATED AGREEMENT AND PLAN OF MERGER**

SECOND AMENDED AND RESTATED AGREEMENT AND PLAN OF MERGER, dated as of October , 2007 (this Agreement ), by and among The Orchard Enterprises Inc., a New York corporation (the Orchard ), Digital Music Group, Inc., a Delaware corporation ( DMGI ), and DMGI New York, Inc., a New York corporation ( Merger Sub ).

**WITNESSETH:**

WHEREAS, the Boards of Directors of the Orchard, DMGI and Merger Sub have determined that it is in the best interests of their respective companies and their stockholders to consummate the strategic business combination transaction provided for herein, pursuant to which Merger Sub will, subject to the terms and conditions set forth herein, merge with and into the Orchard (the Merger ), so that the Orchard is the surviving corporation (hereinafter sometimes referred to in such capacity as the Surviving Corporation ) in the Merger; and

WHEREAS, to that end, the parties entered into that certain Agreement and Plan of Merger dated as of July 10, 2007 (the Execution Date ), as amended by that certain Amended and Restated Agreement and Plan of Merger, dated as of September 13, 2007 (collectively, the Old Agreement ); and

WHEREAS, the parties now desire to further change certain provisions of the Old Agreement and to amend and restate the Old Agreement in its entirety as set forth herein; and

WHEREAS, for Federal income tax purposes, it is intended by the Orchard, DMGI and Merger Sub that the Merger shall qualify as a reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended (the Code ), and this Agreement shall constitute a plan of reorganization within the meaning of Treasury Regulation Section 1.368-2(g); and

WHEREAS, the parties desire to make certain representations, warranties and agreements in connection with the Merger and also to prescribe certain conditions to the Merger.

NOW, THEREFORE, in consideration of the mutual covenants, representations, warranties and agreements contained herein, and other good and valuable consideration, the receipt and adequacy of which are hereby acknowledged, and intending to be legally bound hereby, the parties agree as follows:

**ARTICLE I**

**THE MERGER**

1.1 *The Merger.* Subject to the terms and conditions of this Agreement, in accordance with the New York Business Corporation Law (the NYBCL ), at the Effective Time ( Effective Time ), Merger Sub shall merge with and into the Orchard. The Orchard shall be the Surviving Corporation in the Merger, and shall continue its corporate existence under the laws of the State of New York. Upon consummation of the Merger, the separate corporate existence of Merger Sub shall terminate.

1.2 *Effective Time.* The Merger shall become effective as set forth in the certificate of merger (the Certificate of Merger ) to be filed with the Department of State of the State of New York (the New York Department ), on the Closing Date. The term Effective Time shall be the date and time when the Merger becomes effective, as set forth in the Certificate of Merger.

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1.3 *Effects of the Merger.* At and after the Effective Time, the Merger shall have the effects set forth in Section 906 of the NYBCL.

1.4 *Conversion of the Orchard Stock.* At the Effective Time, by virtue of the Merger and without any action on the part of Merger Sub, DMGI, the Orchard or the holder of any of the following securities:

(a) Subject to Article II, each share of (x) Series A preferred stock, par value \$0.001, of the Orchard (the Orchard Senior Preferred Stock ) and (y) Series C Preferred Stock, par value \$0.001, of the Orchard (the Series C Preferred Stock, and together with the Series A Preferred Stock, the Orchard Senior Preferred Stock ) issued and outstanding immediately prior to the Effective Time except for shares of the Orchard Senior Preferred Stock owned by the Orchard as treasury stock or owned, directly or indirectly, by the Orchard or any of its wholly-owned Subsidiaries, shall be converted into the right to receive:

(i) that number of shares of the Series A preferred stock, par value \$0.001 per share of DMGI (the DMGI Series A Preferred Stock ) equal to the quotient of (A) the sum of (1) the applicable liquidation preference on such share of Orchard Senior Preferred Stock plus (2) all accrued but unpaid dividends on such share of Orchard Senior Preferred Stock (collectively, the Orchard Senior Preferred Preference ), divided by (B) \$55.70; provided that the aggregate number of shares of DMGI Series A Preferred Stock issuable pursuant to this Section 1.4 shall not exceed 448,833 (the DMGI Preferred Limit ); and

(ii) to the extent that the aggregate number of shares of DMGI Series A Preferred Stock issuable pursuant to Section 1.4(a)(i) would exceed the DMGI Preferred Limit, then, in lieu thereof, any share of Orchard Senior Preferred Stock (or portion thereof) that otherwise would have converted into shares of DMGI Series A Preferred Stock shall instead convert into that number of shares of the common stock, par value \$0.001 per share, of DMGI (the DMGI Common Stock ) equal to the quotient of (A) the applicable Orchard Senior Preferred Preference, divided by (B) the DMGI Stock Price.

For the avoidance of doubt, to the extent that the aggregate Orchard Senior Preferred Preference exceeds \$25,000,000, the holders of Orchard Senior Preferred Stock shall be allocated shares of DMGI Series A Preferred Stock and DMGI Common Stock to be issued pursuant to this Section 1.4(a) on a pro rata basis. For purposes of this Agreement, the term DMGI Stock Price shall mean the closing price of DMGI Common Stock as quoted on the NASDAQ Global Market System (or such other exchange, index, bulletin board or over the counter trading system on which the DMGI Common Stock may then be traded, quoted or listed) for the business day immediately preceding the Effective Time.

(b) Subject to Article II, each share of Series B preferred stock, par value \$0.001, of the Orchard issued and outstanding immediately prior to the Effective Time (the Series B Preferred Stock ), except for shares of the Series B Preferred Stock owned by the Orchard as treasury stock or owned, directly or indirectly, by the Orchard or any of its wholly-owned Subsidiaries, shall be converted into the right to receive:

(i) that number of shares of DMGI Series A Preferred Stock equal to the quotient of (A) the \$1.00 liquidation preference on such share of Series B Preferred Stock (the Series B Preference ), divided by (B) \$55.70; provided that the aggregate number of shares of DMGI Series A Preferred Stock issuable pursuant to this Section 1.4(b)(i) shall not exceed an amount equal to (a) 448,833 minus (b) the number of shares of DMGI Series A Preferred Stock issuable pursuant to Section 1.4(a)(i) (the Junior DMGI Preferred Limit ); and

(ii) to the extent that the aggregate number of shares of DMGI Series A Preferred Stock issuable pursuant to Section 1.4(b)(i) would exceed the Junior DMGI Preferred Limit, then, in lieu thereof, any share of Series B Preferred Stock (or portion thereof) that otherwise would have converted into shares of DMGI Series A Preferred Stock shall instead convert into that number of shares of DMGI Common Stock equal to the quotient of (A) the Series B Preference, divided by (B) the DMGI Stock Price.

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For the avoidance of doubt, solely for purposes of calculating the total number of shares of Series B Preferred Stock issued and outstanding immediately prior to the Effective Time, all Deferred B Shares shall be deemed to be issued and outstanding; provided, however, that any shares of DMGI Series A Preferred Stock and DMGI Common Stock that would otherwise be issuable at the Effective Time pursuant to this Section 1.4 in consideration of such Deferred B Shares shall not be issued and instead, shall be reserved for issuance pursuant to Section 6.21. For the further avoidance of doubt, to the extent that the aggregate Series B Preference (including the Series B Preference on any Deferred B Shares) exceeds the Series B Remainder, the holders of Series B Preferred Stock shall be allocated shares of DMGI Series A Preferred Stock and DMGI Common Stock to be issued pursuant to this Section 1.4(b) on a pro rata basis. As used herein, Series B Remainder means an amount equal to the product of (i) the Junior DMGI Preferred Limit and (ii) \$55.70. For purposes of this Agreement, Deferred B Shares means any shares of Series B Preferred Stock that either (x) have been issued pursuant to the terms of the Deferred Stock Awards but are still held by the Orchard or (y) are issuable (but not actually issued) pursuant to the Deferred Stock Awards.

(c) Subject to Article II, each share of common stock, par value \$0.001, of the Orchard issued and outstanding immediately prior to the Effective Time the ( Common Stock ), except for shares of the Common Stock owned by the Orchard as treasury stock or owned, directly or indirectly, by the Orchard or any of its wholly-owned Subsidiaries, shall be converted into the right to receive that number of shares of DMGI Common Stock equal to the product of (i) the Common Stock Ratio, times (ii) the Remaining DMGI Common Stock.

In no event shall DMGI be obligated to issue more than 9,064,941 shares of DMGI Common Stock pursuant to this Agreement or the Deferred Stock Awards (the DMGI Common Limit ). For purposes of this Agreement, the Common Stock Ratio shall mean the quotient of (x) one, divided by (y) the total number of shares of Common Stock (including any Deferred Common Shares and any shares of common stock issuable upon conversion of Series A Preferred Stock, Series B Preferred Stock (including any Deferred B Shares) and Series C Preferred Stock (in each case, to the extent applicable)). For purposes of this Agreement, the Remaining DMGI Common Stock shall mean the difference of (1) 9,064,941 and (2) the number of shares of DMGI Common Stock issuable pursuant to Sections 1.4(a) and (b). For purposes of this Agreement, Deferred Common Shares means any shares of Orchard Common Stock that either (x) have been issued pursuant to the terms of the Deferred Stock Awards but are still held by the Orchard or (y) are issuable (but not actually issued) pursuant to the Deferred Stock Awards.

(d) All of the shares of the Orchard Capital Stock converted into the right to receive DMGI Capital Stock pursuant to this Article I shall no longer be outstanding and shall automatically be cancelled and shall cease to exist as of the Effective Time, and each certificate (each a Certificate ) previously representing any such shares of the Orchard Capital Stock shall thereafter represent only the right to receive (i) a certificate representing the number of whole shares of DMGI Capital Stock and (ii) cash in lieu of fractional shares into which the shares of the Orchard Capital Stock represented by such Certificates have been converted pursuant to this Section 1.4 and Article II. Certificates previously representing shares of the Orchard Capital Stock shall be exchanged for certificates representing whole shares of DMGI Capital Stock and cash in lieu of fractional shares issued in consideration therefor upon the surrender of such Certificates in accordance with Article II, without any interest thereon. If, prior to the Effective Time, the outstanding shares of DMGI Capital Stock or the Orchard Capital Stock shall have been increased, decreased, changed into or exchanged for a different number or kind of shares or securities as a result of a reorganization, recapitalization, reclassification, stock dividend, stock split, reverse stock split, or other similar change in capitalization, or there shall be any extraordinary dividend or distribution, an appropriate and proportionate adjustment shall be made to the exchange ratios set forth in Section 1.4(a), Section 1.4(b) and/or Section 1.4(c), as applicable.

(e) Notwithstanding anything in the Agreement to the contrary, at the Effective Time, all shares of the Orchard Capital Stock that are owned, directly or indirectly, by the Orchard or any of its wholly-owned Subsidiaries shall be cancelled and shall cease to exist and no stock of DMGI or other consideration shall be delivered in exchange therefor.



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1.5 *Merger Sub Stock*. At the Effective Time, by virtue of the Merger and without any action on the part of Merger Sub, DMGI, the Orchard or the holder of any of the following securities:

(a) Each share of common stock, par value \$1.00 per share, of Merger Sub issued and outstanding immediately prior to the Effective Time ( *Merger Sub Common Stock* ), except for shares of the Merger Sub Common Stock owned by Merger Sub as treasury stock, shall be converted into one (1) share of the common stock, par value \$0.001 per share, of the Surviving Corporation (the *Surviving Corporation Common Stock* ).

(b) Each certificate previously representing any such shares of Merger Sub Common Stock shall thereafter be deemed to be a certificate representing the number of whole shares of Surviving Corporation Common Stock represented by such certificate converted pursuant to this Section 1.4.

1.6 *DMGI Stock*. At and after the Effective Time, except as set forth in Section 1.6 of the DMGI Disclosure Schedule, each share of DMGI Common Stock and each option granted and warrant issued by DMGI to purchase shares of DMGI Common Stock ( *DMGI Options* ) issued and outstanding immediately prior to the Effective Time shall remain issued and outstanding and shall not be affected by the Merger.

1.7 *Certificate of Incorporation of the Orchard*. At the Effective Time, the Certificate of Incorporation of the Orchard (the *Orchard Articles* ), as in effect at the Effective Time, shall be the Certificate of Incorporation of the Surviving Corporation, except that the Orchard Articles shall be amended, effective as of the Effective Time, to change the name of the Surviving Corporation as contemplated by Section 1.10(ii) below.

1.8 *Bylaws of the Orchard*. At the Effective Time, the Bylaws of the Orchard, as in effect immediately prior to the Effective Time, shall be the Bylaws of the Surviving Corporation, until thereafter amended in accordance with applicable law.

1.9 *Tax Consequences*. It is intended that the Merger shall constitute a reorganization within the meaning of Section 368(a) of the Code and that this Agreement shall constitute a plan of reorganization within the meaning of Treasury Regulation Section 1.368-2(g).

1.10 *Name of Surviving Corporation*. From and after the Effective Time, the name of the Surviving Corporation shall be The Orchard NY, Inc.

**ARTICLE II**

**EXCHANGE OF CERTIFICATES**

2.1 *Exchange Procedures*. At the Closing, upon surrender of Certificates for cancellation to DMGI, DMGI shall deliver certificates representing shares of DMGI Capital Stock to each holder of record of a Certificate or Certificates that immediately prior to the Effective Time represented outstanding shares of Orchard Capital Stock whose shares were converted into the right to receive shares of DMGI Capital Stock pursuant to Section 1.4. The holders of such Certificates shall only be entitled to receive certificates representing the number of whole shares of DMGI Capital Stock (after aggregating all Certificates surrendered by such holder) into which such holder is entitled, and the Certificates so surrendered shall forthwith be canceled. Until so surrendered, outstanding Certificates will be deemed from and after the Effective Time, for all corporate purposes, to evidence only the right to receive upon surrender thereof the number of whole shares of DMGI Capital Stock to which such holder is entitled pursuant to Section 1.4.

2.2 *Lost, Stolen or Destroyed Certificates*. In the event that any Certificates shall have been lost, stolen or destroyed, DMGI shall issue, upon the making of an affidavit of that fact and personal indemnity by the holder thereof, certificates representing the shares of DMGI Capital Stock into which the shares of Orchard Capital Stock represented by such lost, stolen or destroyed Certificates were converted pursuant to Section 1.4.

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2.3 *No Further Ownership Rights in Stock.* All shares of DMGI Capital Stock issued in accordance with the terms hereof shall be deemed to have been issued in full satisfaction of all rights pertaining to such shares of Orchard Capital Stock, and there shall be no further registration of transfers on the records of the Orchard of shares of Orchard Capital Stock that were outstanding immediately prior to the Effective Time. If after the Effective Time Certificates are presented to DMGI for any reason, they shall be canceled and exchanged as provided in this Article II.

**ARTICLE III**

**REPRESENTATIONS AND WARRANTIES OF THE ORCHARD**

Except as disclosed in the disclosure schedule delivered by the Orchard to DMGI concurrently herewith (the Orchard Disclosure Schedule ), the Orchard hereby represents and warrants to DMGI and Merger Sub as follows:

3.1 *Corporate Organization.* (a) The Orchard is a corporation duly organized, validly existing and in good standing under the laws of the State of New York. The Orchard has the corporate power and authority to own or lease all of its properties and assets and to carry on its business as it is now being conducted, and is duly licensed or qualified to do business in each jurisdiction in which the nature of the business conducted by it or the character or location of the properties and assets owned or leased by it makes such licensing or qualification necessary, except where the failure to be so licensed or qualified would not, either individually or in the aggregate, reasonably be expected to have a Material Adverse Effect on the Orchard. As used in this Agreement, the term Material Adverse Effect means, with respect to DMGI, the Orchard or the Surviving Corporation, as the case may be, a material adverse effect on (i) the business, results of operations or financial condition of such party and its Subsidiaries taken as a whole (provided, however, that, with respect to this clause (i), Material Adverse Effect shall not include effects resulting from (A) changes, after the Execution Date, in U.S. generally accepted accounting principles ( GAAP ), (B) changes, after the Execution Date, in laws, rules or regulations of general applicability or interpretations thereof by courts or Governmental Entities, (C) changes, after the Execution Date, in global, national or regional political conditions (including the outbreak of war or acts of terrorism) or in economic or market conditions generally affecting companies engaged in the music aggregation, music distribution or music business in general, except to the extent that any such changes have a materially disproportionate adverse effect on such party, or (D) public disclosure of the transactions contemplated hereby or actions expressly permitted or required by this Agreement or that are taken with the prior written consent of the other party in contemplation of the transactions contemplated hereby) or (ii) the ability of such party to timely consummate the transactions contemplated hereby. True and complete copies of the Certificate of Incorporation of the Orchard and the Bylaws of the Orchard, as in effect as of the Execution Date, have previously been made available by the Orchard to DMGI.

(b) Each Orchard Subsidiary ( Orchard Subsidiary ) (i) is duly organized and validly existing under the laws of its jurisdiction of organization, (ii) is duly qualified to do business and, where such concept is recognized under applicable law, in good standing in all jurisdictions (whether federal, state, local or foreign) where its ownership or leasing of property or the conduct of its business requires it to be so qualified and in which the failure to be so qualified would reasonably be expected to have a Material Adverse Effect on the Orchard and (iii) has all requisite corporate power and authority to own or lease its properties and assets and to carry on its business as now conducted. True and correct copies of the Certificate of Incorporation and the bylaws of each Orchard Subsidiary, as in effect as of the Execution Date, have previously been made available by the Orchard to DMGI.

As used in this Agreement, the word Subsidiary when used with respect to any party, means any corporation, partnership, limited liability company, or other organization, whether incorporated or unincorporated, which is consolidated with such party for financial reporting purposes.

3.2 *Capitalization.* (a) The authorized capital stock of the Orchard consists of (i) 80,000,000 shares of the Orchard Common Stock, of which, as of the date hereof, 4,456,090 shares are issued and outstanding and none of which are held in treasury, the record holders of which are listed in Schedule 3.2(a) of the Orchard

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Disclosure Schedule, (ii) 30,000,000 shares of Series A Preferred Stock, of which, as of the date hereof, 18,631,000 shares are issued and outstanding and none of which are held in treasury, the record holders of which are listed in Schedule 3.2(a) of the Orchard Disclosure Schedule, (iii) 30,000,000 shares of Series B Preferred Stock, of which, as of the date hereof, 18,409,545 shares are issued and outstanding and none of which are held in treasury, the record holders of which are listed in Schedule 3.2(a) of the Orchard Disclosure Schedule and (iv) 1,500,000 shares of Series C Preferred Stock, par value \$0.001, of the Orchard, of which, as of the date hereof, 850,000 are issued and outstanding and none of which are held in the treasury, the record holders of which are listed in Schedule 3.2(a) of the Orchard Disclosure Schedule. All of the issued and outstanding shares of the Orchard Capital Stock have been duly authorized and validly issued and are fully paid, nonassessable and free of preemptive rights, with no personal liability attaching to the ownership thereof. None of the outstanding shares of Orchard Capital Stock or any other equity securities of the Orchard have been issued in violation of the Securities Act of 1933, as amended (the Securities Act). The Orchard does not have and is not bound by any outstanding subscriptions, options, warrants, calls, commitments or agreements of any character calling for the purchase or issuance of any shares of the Orchard Capital Stock or any other equity securities of the Orchard or any securities representing the right to purchase or otherwise receive any shares of the Orchard Capital Stock (collectively, the Orchard Rights). As of the date hereof, no shares of the Orchard Capital Stock were reserved for issuance. Since March 31, 2007, the Orchard has not issued any shares of Orchard Capital Stock.

(b) The Orchard owns, directly or indirectly, all of the issued and outstanding shares of capital stock or other equity ownership interests of each of the Orchard Subsidiaries, free and clear of any liens, pledges, charges, encumbrances and security interests whatsoever ( Liens ), and all of such shares or equity ownership interests are duly authorized and validly issued and are fully paid, nonassessable and free of preemptive rights, with no personal liability attaching to the ownership thereof. No Orchard Subsidiary has or is bound by any outstanding subscriptions, options, warrants, calls, commitments or agreements of any character calling for the purchase or issuance of any shares of capital stock or any other equity security of such Subsidiary or any securities representing the right to purchase or otherwise receive any shares of capital stock or any other equity security of such Subsidiary. Section 3.2(b) of the Orchard Disclosure Schedule sets forth a list of the material investments of the Orchard in corporations, joint ventures, partnerships, limited liability companies and other entities other than its Subsidiaries (each a Non-Subsidiary Affiliate ).

*3.3 Authority; No Violation.* (a) The Orchard has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly approved by the Board of Directors of the Orchard. The Board of Directors of the Orchard has directed that this Agreement and the transactions contemplated hereby be submitted to the Orchard's stockholders for approval at a meeting of such stockholders and, except for the approval of this Agreement by the affirmative vote of the holders of a majority of the outstanding shares of the Orchard Capital Stock, no other corporate proceedings on the part of the Orchard are necessary to approve this Agreement or to consummate the transactions contemplated hereby. This Agreement has been duly and validly executed and delivered by the Orchard and (assuming due authorization, execution and delivery by DMGI) constitutes a valid and binding obligation of the Orchard, enforceable against the Orchard in accordance with its terms, subject to any applicable bankruptcy and insolvency laws affecting generally the enforceability of creditors' rights from time to time in effect.

(b) Neither the execution and delivery of this Agreement by the Orchard nor the consummation by the Orchard of the transactions contemplated hereby, nor compliance by the Orchard with any of the terms or provisions hereof, will (i) violate any provision of the Orchard Articles or Bylaws or (ii) assuming that the consents and approvals referred to in Section 3.4 are duly obtained, (x) violate any statute, code, ordinance, rule, regulation, judgment, order, writ, decree or injunction applicable to the Orchard, any of its Subsidiaries or its Non-Subsidiary Affiliates or any of their respective properties or assets or (y) violate, conflict with, result in a breach of any provision of or the loss of any benefit under, constitute a default (or an event which, with notice or lapse of time, or both, would constitute a default) under, result in the termination of or a right of termination or cancellation under, accelerate the performance required by, or result in the creation of any

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Lien upon any of the respective properties or assets of the Orchard, any of its Subsidiaries or Non-Subsidiary Affiliates under, any of the terms, conditions or provisions of any note, bond, mortgage, indenture, deed of trust, license, permit, lease, agreement or other instrument or obligation to which the Orchard, any of its Subsidiaries or its Non-Subsidiary Affiliates is a party, or by which they or any of their respective properties or assets may be bound or affected, except for such violations, conflicts, breaches or defaults which, either individually or in the aggregate, would not reasonably be expected to have a Material Adverse Effect on the Orchard.

3.4 *Consents and Approvals.* Except for (i) the filing of any required applications or notices with any state or foreign agencies and approval of such applications and notices (the State and Foreign Approvals ), (ii) the filing of the Certificate of Merger with the New York Department pursuant to the NYBCL (iii) the filings required by the Hart-Scott-Rodino Antitrust Improvements Act, of 1976, as amended, and the rules and regulations promulgated thereunder (the HSR Act ) and (iv) the approval of this Agreement by the requisite vote of the stockholders of the Orchard, no consents or approvals of or filings or registrations with any court, administrative agency or commission or other governmental authority or instrumentality (each a Governmental Entity ) are necessary in connection with (A) the execution and delivery by the Orchard of this Agreement and (B) the consummation by the Orchard of the Merger and the other transactions contemplated hereby.

3.5 *Financial Statements.* (a) Each of (i) the audited consolidated balance sheets of the Orchard and its Subsidiaries as of December 31, 2004 and December 31, 2005, respectively, and the related audited consolidated statements of operations, shareholders equity and cash flows of the Orchard and its Subsidiaries for the years then ended, including the notes thereto (collectively, the Audited Financial Statements ), (ii) the unaudited consolidated balance sheet of the Orchard and its Subsidiaries as of December 31, 2006 and the related unaudited consolidated statements of operations, shareholders equity and cash flows of the Orchard and its Subsidiaries for the year then ended, including the condensed, consolidated footnotes thereto (collectively, the Unaudited Financial Statements ), and (iii) the management prepared draft consolidated balance sheet of the Orchard and its Subsidiaries as of March 31, 2007 and the related management prepared draft consolidated statements of operations, shareholders equity and cash flows of the Orchard and its Subsidiaries for the period then ended (the Draft Quarterly Statements ), (x) have been prepared from, and are in accordance with, the books and records of the Orchard and its Subsidiaries, (y) fairly present in all material respects the consolidated results of operations, cash flows, changes in shareholders equity and consolidated financial position of the Orchard and its Subsidiaries for the respective fiscal periods or as of the respective dates therein set forth (subject in the case of Draft Quarterly Statements to recurring year-end audit adjustments normal in nature and amount) and (z) have been prepared in accordance with GAAP consistently applied during the periods involved, except, in each case, as indicated in such statements or in the notes thereto. The books and records of the Orchard and its Subsidiaries have been, and are being, maintained in all material respects in accordance with GAAP and any other applicable legal and accounting requirements and reflect only actual transactions. Deloitte & Touche LLP has not resigned or been dismissed as independent public accountants of the Orchard as a result of or in connection with any disagreements with the Orchard on a matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure.

(b) Neither the Orchard nor any of its Subsidiaries has any material liability of any nature whatsoever (whether absolute, accrued, contingent or otherwise and whether due or to become due), except for (i) those liabilities that are reflected or reserved against on the consolidated balance sheet of the Orchard for the quarter ended March 31, 2007 (including any condensed, consolidated footnotes thereto), (ii) current liabilities incurred in the ordinary course of business consistent with past practice since March 31, 2007 or in connection with this Agreement and the transactions contemplated hereby; and (iii) contingent liabilities that would not reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on the Orchard.

(c) The records, systems, controls, data and information of the Orchard and its Subsidiaries are recorded, stored, maintained and operated under means (including any electronic, mechanical or photographic process, whether computerized or not) that are under the exclusive ownership and direct

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control of the Orchard or its Subsidiaries or accountants (including all means of access thereto and therefrom), except for any non-exclusive ownership and non-direct control that would not reasonably be expected to have a Material Adverse Effect on the Orchard. The Orchard maintains accounting records which fairly and accurately reflect, in all material respects, its transactions, and the Orchard has devised and maintains accounting controls sufficient to provide reasonable assurances that such transactions are (i) executed in accordance with management's general or specific authorization and (ii) recorded as necessary to permit the preparation of its financial statements in accordance with GAAP.

(d) Since March 31, 2007, (i) neither the Orchard nor any of its Subsidiaries has received or otherwise had or obtained knowledge of any material complaint, allegation, assertion or claim, whether written or oral, regarding the accounting or auditing practices, procedures, methodologies or methods of the Orchard or any of its Subsidiaries or their respective internal accounting controls, including any material complaint, allegation, assertion or claim that the Orchard or any of its Subsidiaries has engaged in questionable accounting or auditing practices, and (ii) no attorney representing the Orchard or any of its Subsidiaries, whether or not employed by the Orchard or any of its Subsidiaries, has reported evidence of a breach of fiduciary duty or similar violation by the Orchard or any of its officers, directors, employees or agents to the Board of Directors of the Orchard or any committee thereof or to any director or officer of the Orchard.

**3.6 Receivables.** All accounts receivable reflected on the consolidated balance sheet included in the Reviewed Quarterly Statements, and created since March 31, 2007, represent valid obligations of customers of Orchard arising from bona fide transactions entered into in the ordinary course of business consistent with past practices.

**3.7 Broker's Fees.** Neither the Orchard nor any Orchard Subsidiary nor any of their respective officers or directors has employed any broker or finder or incurred any liability for any broker's fees, commissions or finder's fees in connection with the Merger or related transactions contemplated by this Agreement.

**3.8 Absence of Certain Changes or Events.** (a) Since March 31, 2007, no event or events have occurred that have had or would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on the Orchard.

(b) Since March 31, 2007, the Orchard and its Subsidiaries have carried on their respective businesses in all material respects in the ordinary course consistent with past practices, including the timely payment of vendors, Content owners, employee payrolls and other liabilities as and when due. As of the Execution Date, other than in the ordinary course of business consistent with past practices, there are no material past-due obligations of the Orchard.

(c) Since March 31, 2007, neither the Orchard nor any of its Subsidiaries has (i) except for normal increases and normal severance and termination payments made in the ordinary course of business consistent with past practice, or as required by applicable law or as otherwise expressly contemplated by this Agreement, increased the wages, salaries, compensation, pension, or other fringe benefits or perquisites payable to any executive officer, employee or director from the amount thereof in effect as of March 31, 2007, granted any severance or termination pay, entered into any contract to make or grant any severance or termination pay, or paid any bonus other than the customary year-end bonuses for fiscal year 2006 in amounts consistent with past practice, (ii) granted any stock appreciation or similar rights or granted any rights to acquire any shares of its capital stock, or issued any shares of its capital stock, to any executive officer, director or employee other than grants made prior to the Execution Date in the ordinary course of business consistent with past practice, (iii) suffered any strike, work stoppage, slow-down, or other labor disturbance or (iv) repurchased any shares of the Orchard Capital Stock.

**3.9 Legal Proceedings.** (a) Neither the Orchard nor any of its Subsidiaries is a party to any, and there are no pending or, to the Knowledge of the Orchard, threatened, legal, administrative, arbitral or other proceedings, claims, actions or governmental or regulatory investigations of any nature against the Orchard or any of its

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Subsidiaries, except as would not reasonably be expected to result in a Material Adverse Effect on the Orchard, or challenging the validity or propriety of the transactions contemplated by this Agreement.

(b) There is no injunction, order, judgment, decree, or regulatory restriction imposed upon the Orchard, any of its Subsidiaries or the assets of the Orchard or any of its Subsidiaries that has had, or would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on the Orchard or the Surviving Corporation.

As used in this Agreement, the term Knowledge of the Orchard shall mean all information actually known by (i) Danny Stein, (ii) Greg Scholl, (iii) Stanley Schneider, (iv) Tom Etergino, (v) Brad Navin, or (vi) Jeff Nimerofsky.

3.10 *Taxes and Tax Returns.* (a) Each of the Orchard and its Subsidiaries has duly and timely filed (including all applicable extensions) all material Tax Returns required to be filed by it (all such Tax Returns being accurate and complete in all material respects), has timely paid all Taxes shown thereon as due and payable and has duly and timely paid all material Taxes that are otherwise due and payable or claimed or asserted to be due and payable from it by federal, state, foreign or local taxing authorities other than Taxes that are being contested in good faith, which have not been finally determined, and have been adequately reserved against in accordance with GAAP on the consolidated balance sheet of the Orchard and its Subsidiaries as of December 31, 2006 included in the Unaudited Financial Statements.

Each of the Orchard and its Subsidiaries has in all material respects withheld, collected and paid over to the appropriate Taxing Authority, or is in all material respects properly holding for such payments, all Taxes required by law to be withheld or collected, and each of the Orchard and its Subsidiaries has complied in all material respects with all information reporting and backup withholding requirements under all applicable legal requirements, including maintenance of required records with respect thereto. Neither the Orchard nor any of its Subsidiaries has granted any waiver of the statute of limitations in respect of Taxes or agreed to any extension of time with respect to a Tax assessment or deficiency that remains in effect.

There are no disputes, audits, examinations or proceedings related to Taxes or Tax Returns of the Orchard or any of its Subsidiaries currently being conducted, pending or, to the Knowledge of the Orchard, threatened, and there are no pending or, to the Knowledge of the Orchard, threatened claims by any Taxing Authority for Taxes or assessments, upon the Orchard or any of its Subsidiaries for which the Orchard does not have reserves that are adequate under GAAP on the unaudited consolidated balance sheet of the Orchard and its Subsidiaries as of December 31, 2006 included in the Unaudited Financial Statements. There is no deficiency for any Tax, claim for additional Taxes or other dispute or claim concerning any Tax liability, of either the Orchard or any of its Subsidiaries claimed, issued or raised by any Taxing Authority in writing. No claim is currently pending that has been made in writing by a Taxing Authority in a jurisdiction where the Orchard or any of its Subsidiaries does not file a Tax Return that the Orchard or any of its Subsidiaries is or may be subject to taxation by that jurisdiction. No issues related to Taxes of Orchard or any of its Subsidiaries were raised in writing by any Taxing Authority in any completed audit or examination that can reasonably be expected to recur in a later taxable period. There are no Liens for any Taxes upon any of the assets, income or operations of the Orchard or any of its Subsidiaries, other than statutory Liens for Taxes not yet due and payable. The Orchard has made available to DMGI true and complete copies of any private letter ruling requests, closing agreements or gain recognition agreements with respect to Taxes requested or executed in the last six years. Neither the Orchard nor any of its Subsidiaries is a party to or is bound by any Tax sharing, allocation or indemnification agreement or similar contract or arrangement (a Tax Sharing Agreement), whether written or unwritten.

Neither the Orchard nor any of its Subsidiaries (A) has been a member of an affiliated group filing a consolidated federal income Tax Return (other than a group the common parent of which was the Orchard) or (B) has any liability for the Taxes of any person (other than the Orchard or any of its Subsidiaries or any of its or their predecessors) by reason of contract, agreement (including any Tax Sharing Agreement), assumption, transferee, successor or similar liability, operation of law, or under Treasury Regulation Section 1.1502-6 (or any

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predecessor or successor thereof or any similar or analogous provision of state, local or foreign Law). Neither the Orchard nor any of its Subsidiaries has been, within the past two years or otherwise as part of a plan (or series of related transactions) within the meaning of Section 355(e) of the Code of which the Merger is also a part, a distributing corporation or a controlled corporation (within the meaning of Section 355(a)(1)(A) of the Code) in a distribution of stock intending to qualify for tax-free treatment under Section 355 of the Code. Neither the Orchard nor any of its Subsidiaries has entered into any transaction identified by the Internal Revenue Service as of the Execution Date as a listed transaction for purposes of Treasury Regulations Section 1.6011-4(b)(2) or 301.6111-2(b)(2), or any other reportable transaction within the meaning of Treasury Regulations Section 1.6011-4(b)(1) that required or will require the filing of an IRS Form 8886. At no time during the past five years has the Orchard been a United States real property holding corporation within the meaning of Section 897(c)(2) of the Code.

(b) As used in this Agreement:

(i) the term Tax or Taxes means all federal, state, local and foreign income, excise, gross receipts, ad valorem, profits, gains, property, capital, sales, transfer, use, license, payroll, employment, social security, severance, unemployment, withholding, duties, excise, windfall profits, intangibles, franchise, backup withholding, value added, alternative or add-on minimum, estimated and any other taxes, charges, levies, customs, duties, governmental fees or like assessments or charge of any kind whatsoever, together with all penalties and additions to tax and interest thereon, whether disputed or not, imposed by any Governmental Entity;

(ii) the term Tax Return means any return, declaration, report, claim for refund, or information return or similar statement relating to Taxes, including any schedule or attachment thereto, and including any claim for refund or amendment thereof, or declaration of estimated tax, supplied or required to be supplied to a Governmental Entity; and

(iii) as used in this Agreement, the term Taxing Authority means any governmental authority, domestic or foreign, having jurisdiction over the assessment, determination, collection, or other imposition of any Taxes.

(c) Neither the Orchard nor any of its Subsidiaries has taken or agreed to take any action, has failed to take any action or knows of any fact, agreement, plan or other circumstance that is reasonably likely to prevent the Merger from qualifying as a reorganization within the meaning of Section 368(a) of the Code.

3.11 *Employees.* (a) Section 3.11 of the Orchard Disclosure Schedule sets forth a true and complete list of all material pension, retirement, profit-sharing, deferred compensation, stock option, employee stock ownership, severance pay, vacation, bonus, or other incentive plan, all other employee programs, arrangements, agreements, or payroll practices, qualified or nonqualified, all medical, vision, dental, or other health plans, all life insurance plans, and all other employee benefit plans or fringe benefit plans, including without limitation, any employee benefit plan as that term is defined in Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended ( ERISA ), providing benefits to any current or former employees of the Orchard or any of its Subsidiaries, whether or not incorporated, or any trade or business of the Orchard or any of its Subsidiaries (an Orchard ERISA Affiliate ) (collectively, the Orchard Benefit Plans ).

(b) For each Orchard Benefit Plan, the Orchard has heretofore made available to DMGI true and complete copies of the following (to the extent applicable): (i) the plan documents, summary plan descriptions and any summaries of material modifications; (ii) the three most recent annual reports (Form 5500 and all schedules and attachments thereto) filed with the Department of Labor, and any audited financial statements or actuarial reports; (iii) the most recent determination letter or opinion letter received from the IRS for such Orchard Benefit Plan; (iv) all related trust agreements, insurance contracts, or other funding agreements; and (v) any material written correspondence from any Governmental Entity relating to such Orchard Benefit Plan.

(c)(i) Each of the Orchard Benefit Plans has been operated and administered in all material respects in compliance with applicable laws, including, but not limited to, ERISA and the Code, and has been

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administered and operated in all material respects in accordance with its terms; (ii) each of the Orchard Benefit Plans that is intended to be qualified within the meaning of Section 401(a) of the Code has received, or has requested, a favorable determination letter, and to the Knowledge of Orchard, there are no existing circumstances or any events that have occurred that will, or could reasonably, adversely affect the qualified status of any such Orchard Benefit Plan, (iii) no Orchard Benefit Plan provides benefits, including, without limitation, death or medical benefits (whether or not insured), with respect to current or former employees or directors of the Orchard or its Subsidiaries beyond their retirement or other termination of service, other than (A) coverage mandated by applicable law, including 4980B of the Code regarding COBRA continuation coverage and applicable state insurance laws, (B) death benefits or retirement benefits under any employee pension plan (as such term is defined in Section 3(2) of ERISA), (C) deferred compensation benefits accrued as liabilities on the books of the Orchard or its Subsidiaries or (D) benefits the full cost of which is borne by the current or former employee or director (or his beneficiary), (iv) no Orchard Benefit Plan is (A) subject to Section 302 of ERISA, Title IV of ERISA, or Section 412 of the Code, (B) a multiemployer pension plan (as such term is defined in Section 3(37) of ERISA), or (C) a multiple employer plan within the meaning of Section 4063 of ERISA, nor has the Orchard, its Subsidiaries or Orchard ERISA Affiliates at any time contributed to or been obligated to contribute to any multiemployer plan or multiple employer plan, (v) all contributions or other amounts payable by the Orchard or its Subsidiaries as of the Effective Time with respect to each Orchard Benefit Plan in respect of current or prior plan years have been paid or accrued in accordance with GAAP, (vi) none of the Orchard, its Subsidiaries or any other person, including any fiduciary, has engaged in a transaction in connection with which the Orchard, its Subsidiaries or any Orchard Benefit Plan will be subject to either a material civil penalty assessed pursuant to Section 409 or 502(i) of ERISA or a material tax imposed pursuant to Section 4975 or 4976 of the Code, (vii) there are no pending or, to the Knowledge of the Orchard, threatened or anticipated claims (other than routine claims for benefits) by, on behalf of or against any of Orchard Benefit Plans or any trusts related thereto that would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on the Orchard; and (viii) each Orchard Benefit Plan may be amended or terminated at any time at the sole discretion of the sponsor thereof without liability other than for benefits accrued prior to such amendment or termination, subject only to such constraints as imposed by applicable law.

(d) There are no pending or, to the Knowledge of the Orchard, threatened material labor grievances or material unfair labor practice claims or charges against the Orchard or any of its Subsidiaries, or any strikes or other material labor disputes against the Orchard or any of its Subsidiaries. Neither the Orchard nor its Subsidiaries are party to or bound by any collective bargaining or similar agreement with any labor organization, or work rules or practices agreed to with any labor organization or employee association applicable to employees of the Orchard or its Subsidiaries and, to the Knowledge of the Orchard, there are no organizing efforts by any union or other group seeking to represent any employees of the Orchard or any of its Subsidiaries.

(e) None of the execution and delivery of this Agreement, the approval of this Agreement by the Orchard's stockholders or the consummation of the transactions contemplated hereby will (either alone or in conjunction with any other event) (i) result in any payment (including, without limitation, severance, unemployment compensation, excess parachute payment (within the meaning of Section 280G of the Code), forgiveness of indebtedness or otherwise) becoming due to any director or any employee of the Orchard or any of its affiliates from the Orchard, DMGI or any of their respective affiliates under any Orchard Benefit Plan or otherwise, (ii) increase any benefits otherwise payable under any Orchard Benefit Plan or (iii) result in any acceleration of the time of payment or vesting of any such benefits.

(f) Neither the Orchard nor any of its Subsidiaries or Orchard ERISA Affiliates maintains or contributes to a rabbi trust or similar funding vehicle, and the Merger and other transactions contemplated by this Agreement shall not cause or require the Orchard or any of its Orchard ERISA Affiliates to establish or make any contribution to a rabbi trust or similar funding vehicle.



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3.12 *SEC Reports.* The Orchard has not previously filed a registration statement pursuant to the Securities Act, and is not subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act ).

3.13 *Compliance with Applicable Law.* The Orchard and each of its Subsidiaries hold all licenses, franchises, permits and authorizations necessary for the lawful conduct of their respective businesses under and pursuant to each, except where neither the cost of failure to hold nor the cost of obtaining and holding such license, franchise, permit or authorization would, either individually or in the aggregate, reasonably be expected to have a Material Adverse Effect on the Orchard. The Orchard and each of its Subsidiaries have complied with and are not in default under any applicable law, statute, order, rule, regulation, policy and/or guideline of any Governmental Entity relating to the Orchard or any of its Subsidiaries, except where neither the cost of such noncompliance or default nor the cost of compliance or cure of default would, either individually or in the aggregate, reasonably be expected to have a Material Adverse Effect on the Orchard. Without limitation, during the three (3) years prior to the Execution Date, none of the Orchard, and of its Subsidiaries, or any director, officer, employee, agent or other person acting on behalf of the Orchard or any of its Subsidiaries has to the Knowledge of the Orchard, directly or indirectly, (i) used any funds of the Orchard or any of its Subsidiaries for unlawful contributions, unlawful gifts, unlawful entertainment or other expenses relating to political activity; (ii) made any unlawful payment to foreign or domestic governmental officials or employees or to foreign or domestic political parties or campaigns from funds of the Orchard or any of its Subsidiaries; (iii) violated any provision that would result in the violation of the Foreign Corrupt Practices Act of 1977, as amended, or any similar law; (iv) established or maintained any unlawful fund of monies or other assets of the Orchard or any of its Subsidiaries; (v) made any fraudulent entry on the books or records of the Orchard or any of its Subsidiaries; or (vi) made any unlawful bribe, unlawful rebate, unlawful payoff, unlawful influence payment, unlawful kickback or other unlawful payment to any person, private or public, regardless of form, whether in money, property or services, to obtain favorable treatment in securing business to obtain special concessions for the Orchard or any of its Subsidiaries, to pay for favorable treatment for business secured or to pay for special concessions already obtained for the Orchard or any of its Subsidiaries.

3.14 *Certain Contracts.* (a) Neither the Orchard nor any of its Subsidiaries is a party to or bound by any contract, arrangement, commitment or understanding (whether written or oral) (i) with respect to the employment of any directors, officers or employees, other than in the ordinary course of business consistent with past practice, (ii) which, upon the execution or delivery of this Agreement, stockholder approval of this Agreement or the consummation of the transactions contemplated by this Agreement will (either alone or upon the occurrence of any additional acts or events) result in any payment (whether of severance pay or otherwise) becoming due from DMGI, the Orchard, the Surviving Corporation, or any of their respective Subsidiaries to any officer or employee thereof, (iii) which materially restricts the conduct of any line of business by the Orchard or any of its Subsidiaries or upon consummation of the Merger will materially restrict the ability of the Surviving Corporation to engage in any line of business, (iv) with or to a labor union or guild (including any collective bargaining agreement) or (v) (including any stock option plan, stock appreciation rights plan, restricted stock plan or stock purchase plan) any of the benefits of which will be increased, or the vesting of the benefits of which will be accelerated, by the occurrence of the execution and delivery of this Agreement, stockholder approval of this Agreement or the consummation of any of the transactions contemplated by this Agreement, or the value of any of the benefits of which will be calculated on the basis of any of the transactions contemplated by this Agreement. Each contract, arrangement, commitment or understanding to which the Orchard or any of its Subsidiaries is a party or by which its assets or properties are bound, whether or not set forth in the Orchard Disclosure Schedule, is referred to herein as an Orchard Contract, and to the Knowledge of the Orchard, there are not nor has the Orchard received notice of, any violations of any Orchard Contract by any of the other parties thereto which would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect in the Orchard.

(b)(i) Each Orchard Contract is valid and binding on the Orchard or any of its Subsidiaries, as applicable, and, to the Knowledge of the Orchard, is in full force and effect, (ii) the Orchard and each of its

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Subsidiaries has in all material respects performed all obligations required to be performed by it through the Execution Date under each the Orchard Contract, except where such noncompliance, either individually or in the aggregate, would not reasonably be expected to have a Material Adverse Effect on the Orchard, (iii) to the Knowledge of the Orchard, each third-party counterparty to each Orchard Contract has in all material respects performed all obligations required to be performed by it through the Execution Date under such Orchard Contract, and (iv) no event or condition exists which constitutes or, after notice or lapse of time or both, will constitute, a material default on the part of the Orchard or any of its Subsidiaries under any such the Orchard Contract, except where such default, either individually or in the aggregate, would not reasonably be expected to have a Material Adverse Effect on the Orchard.

(c) Section 3.14 of the Orchard Disclosure Schedule identifies all of the libraries or collections of Content of the Orchard and any of its Subsidiaries. As used in this Agreement, (i) Content means any digital music tracks or other digital media content owned, licensed or distributed by a party for purposes of sale or license or purchase by consumers through Channel Outlets or otherwise and (ii) Channel Outlets means online music, mobile and video stores and other sellers and distributors of digital media content to consumers by means of electronic transmission, mobiletones and streaming, and any other persons or entities licensed to use the Content.

(d) Subject to the rights of the Content owners, the Orchard or its Subsidiaries have valid rights to license, distribute and sell all of the Content through the Orchard's Channel Outlets to consumers. After the consummation of the transactions contemplated by this Agreement, the rights to license, distribute and sell all of the Content shall be retained by the Surviving Corporation without restriction and without payment of any kind to any third party.

(e) Neither the Orchard nor any of its Subsidiaries has transferred ownership of or granted any right to sell, license, use or distribute the Content other than to consumers through the Orchard's Channel Outlets in the ordinary course of business.

(f) Excluding third-party, peer-to-peer file sharing, peer-to-peer providers, device distributions, illegal pay sites, unlicensed video content providers and other systematic infringers, neither the Orchard nor its Subsidiaries has received written notice of any person violating, infringing or misappropriating any rights with respect to the Content.

(g) Since March 31, 2007, no Content owner, Channel Outlet, vendor or supplier of the Orchard or its Subsidiaries has cancelled or otherwise modified its relationship with the Orchard or any of its Subsidiaries, as applicable, in a manner adverse to the Orchard and its Subsidiaries, taken as a whole, and no such person has, to the Knowledge of the Orchard, communicated in writing to the Orchard or its Subsidiaries any intention to do so.

3.15 *Environmental Liability.* There are no legal, administrative, arbitral or other proceedings, claims, actions, causes of action, private environmental investigations or remediation activities or governmental investigations of any nature seeking to impose, or that could reasonably result in the imposition, on the Orchard of any liability or obligation arising under common law or under any local, state or federal environmental statute, regulation or ordinance including, without limitation, the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended ( CERCLA ), pending or, to the Knowledge of the Orchard, threatened against the Orchard, which liability or obligation would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on the Orchard. To the Knowledge of the Orchard, there is no reasonable basis for any such proceeding, claim, action or governmental investigation that would impose any liability or obligation on the Orchard or any Orchard Subsidiary that would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on the Orchard. The Orchard is not subject to any agreement, order, judgment, decree, letter or memorandum by or with any court, governmental authority, regulatory agency or third party imposing any liability or obligation with respect to the foregoing that would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on the Orchard.

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3.16 *Property*. The Orchard or an Orchard Subsidiary (a) has good title to all the properties and assets reflected in the consolidated balance sheet of Orchard and the Orchard Subsidiaries included in the Reviewed Quarterly Statements or acquired after the date thereof (except properties sold or otherwise disposed of since the date thereof in the ordinary course of business) (the Orchard Owned Properties ), free and clear of all material Liens, except (i) statutory Liens securing payments not yet due, (ii) Liens for Taxes not yet due and payable, (iii) easements, rights of way, and other similar encumbrances that do not materially affect the use of the properties or assets subject thereto or affected thereby or otherwise materially impair business operations at such properties and (iv) such imperfections or irregularities of title or Liens as do not materially affect the use of the properties or assets subject thereto or affected thereby or otherwise materially impair business operations at such properties (collectively, Permitted Encumbrances ), and (b) is the lessee of all leasehold estates reflected in the Unaudited Financial Statements or acquired after the date thereof (except for leases that have expired by their terms or leased property that has been disposed of in accordance with terms of its lease and in the ordinary course of business since the date thereof) (the Orchard Leased Properties and, collectively with the Orchard Owned Properties, the Orchard Real Property ), free and clear of all material Liens, except for Permitted Encumbrances, and is in possession of the properties purported to be leased thereunder, and each such lease is a valid obligation of the Orchard or an Orchard Subsidiary without default thereunder by the lessee or, to the Knowledge of the Orchard, the lessor.

3.17 *Intellectual Property*. The Orchard or each of its Subsidiaries owns, or is licensed to use (in each case, free and clear of any material Liens), all Intellectual Property used in or necessary for the conduct of its business as currently conducted. The use of any Intellectual Property by the Orchard and its Subsidiaries does not, to the Knowledge of the Orchard, infringe on or otherwise violate the rights of any person and is in accordance with any applicable license pursuant to which the Orchard or any Orchard Subsidiary acquired the right to use any Intellectual Property. To the Knowledge of the Orchard, no person is challenging, or to the Knowledge of the Orchard infringing on or otherwise violating, any right of the Orchard or any of its Subsidiaries with respect to any Intellectual Property owned by and/or licensed to the Orchard or its Subsidiaries. Neither the Orchard nor any Orchard Subsidiary has received any written notice of any pending claim with respect to any Intellectual Property used by the Orchard or any Orchard Subsidiary which would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on the Orchard. For purposes of this Agreement, Intellectual Property means trademarks, service marks, brand names, certification marks, trade dress and other indications of origin, the goodwill associated with the foregoing and registrations in any jurisdiction of, and applications in any jurisdiction to register, the foregoing, including any extension, modification or renewal of any such registration or application; inventions, discoveries and ideas, whether patentable or not, in any jurisdiction; patents, applications for patents (including divisions, continuations, continuations in part and renewal applications), and any renewals, extensions or reissues thereof, in any jurisdiction; nonpublic information, trade secrets and confidential information and rights in any jurisdiction to limit the use or disclosure thereof by any person; writings and other works, whether copyrightable or not, in any jurisdiction; and registrations or applications for registration of copyrights in any jurisdiction, and any renewals or extensions thereof; and any similar intellectual property or proprietary rights.

3.18 *State Takeover Laws*. (a) The Board of Directors of the Orchard has unanimously approved this Agreement and the transactions contemplated hereby as required to render inapplicable to such agreements and transactions Section 912 of the NYBCL and, to the Knowledge of the Orchard, any similar moratorium, control share, fair price, takeover or interested stockholder law (any such laws, Takeover Statutes

(b) The Orchard has taken all action, if any, necessary or appropriate so that the entering into of this Agreement and the consummation of the transactions contemplated hereby, does not and will not result in the ability of any person to exercise or acquire any Orchard Rights.

3.19 *The Orchard Information*. The information relating to the Orchard and its Subsidiaries which is provided by the Orchard or its representatives for inclusion in the Proxy Statement, or in any other document filed with any other Governmental Entity in connection herewith, will not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements therein, in light of the circumstances in which they are made, not misleading.

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**ARTICLE IV**

**REPRESENTATIONS AND WARRANTIES OF DMGI AND MERGER SUB**

Except as disclosed in the disclosure schedule delivered by DMGI and Merger Sub to the Orchard concurrently herewith (the DMGI Disclosure Schedule ), DMGI and Merger Sub, jointly and severally represent and warrant to the Orchard as follows:

4.1 *Corporate Organization.* (a) DMGI is a corporation duly organized, validly existing and in good standing under the laws of the State of Delaware. DMGI has the corporate power and authority to own or lease all of its properties and assets and to carry on its business as it is now being conducted, and is duly licensed or qualified to do business in each jurisdiction in which the nature of the business conducted by it or the character or location of the properties and assets owned or leased by it makes such licensing or qualification necessary, except where the failure to be so licensed or qualified would not, either individually or in the aggregate, reasonably be expected to have a Material Adverse Effect on DMGI. True and complete copies of the Certificate of Incorporation of DMGI (the DMGI Articles ) and Bylaws of DMGI, as in effect as of the Execution Date, have previously been made available by DMGI to the Orchard.

(b) Each DMGI Subsidiary, including Merger Sub (i) is duly organized and validly existing under the laws of its jurisdiction of organization, (ii) is duly qualified to do business and, where such concept is recognized under applicable law, in good standing in all jurisdictions (whether Federal, state, local or foreign) where its ownership or leasing of property or the conduct of its business requires it to be so qualified and in which the failure to be so qualified would reasonably be expected to have a Material Adverse Effect on DMGI, and (iii) has all requisite corporate power and authority to own or lease its properties and assets and to carry on its business as now conducted. True and correct copies of the Certificate of Incorporation and the bylaws of each DMGI Subsidiary, as in effect as of the Execution Date have previously been made available by DMGI to the Orchard.

4.2 *Capitalization.* (a) The authorized capital stock of DMGI consists of (i) 30,000,000 shares of DMGI Common Stock, of which, as of the Execution Date, 9,121,939 shares were issued and outstanding and none of which were held in treasury and (ii) 1,000,000 shares of preferred stock, of which, as of the Execution Date, no shares were issued and outstanding. All of the issued and outstanding shares of DMGI Capital Stock have been duly authorized and validly issued and are fully paid, nonassessable and free of preemptive rights, with no personal liability attaching to the ownership thereof. None of the outstanding shares of DMGI Capital Stock or any other equity securities of DMGI have been issued in violation of the Securities Act. Except for this Agreement or pursuant to the terms of options issued (or to be issued in accordance with Section 5.2(b)) pursuant to the DMGI Stock Plans or as disclosed in the DMGI Reports, DMGI does not have and is not bound by any outstanding subscriptions, options, warrants, calls, commitments or agreements of any character calling for the purchase or issuance of any shares of DMGI Capital Stock or any other equity securities of DMGI or any securities representing the right to purchase or otherwise receive any shares of DMGI Capital Stock (collectively, DMGI Rights ). At and after the Effective Time each of the DMGI Options issued and outstanding immediately prior to the Effective Time shall remain issued and outstanding and shall not be affected by the Merger. As of the Execution Date, no shares of DMGI Common Stock were reserved for issuance, except for (i) 453,000 shares reserved for issuance upon exercise of options issued pursuant to employee and director stock plans of DMGI in effect as of the Execution Date (the DMGI Stock Plans ) or (ii) as disclosed in the DMGI Reports. Since March 31, 2007, DMGI has not issued any shares of DMGI Capital Stock or any DMGI Rights, other than as permitted by Section 5.2(b) in the case of grants made following the Execution Date pursuant to the exercise of stock options granted prior to such date.

(b) DMGI owns, directly or indirectly, all of the issued and outstanding shares of capital stock or other equity ownership interests of each of the DMGI Subsidiaries, including Merger Sub, free and clear of any Liens, and all of such shares or equity ownership interests are duly authorized and validly issued and are fully paid, nonassessable and free of preemptive rights, with no personal liability attaching to the ownership thereof. No DMGI Subsidiary has or is bound by any outstanding subscriptions, options, warrants, calls,

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commitments or agreements of any character calling for the purchase or issuance of any shares of capital stock or any other equity security of such Subsidiary or any securities representing the right to purchase or otherwise receive any shares of capital stock or any other equity security of such Subsidiary. Section 4.2(b) of the DMGI Disclosure Schedule sets forth a list of the material investments of DMGI in Non-Subsidiary Affiliates.

4.3 *Authority; No Violation.* (a) Each of DMGI and Merger Sub has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly approved by the Board of Directors of each of DMGI and Merger Sub. The Board of Directors of each of DMGI and Merger Sub has directed that this Agreement and the transactions contemplated hereby be submitted to DMGI's stockholders and DMGI, as sole shareholder of Merger Sub, for approval at a meeting of such stockholders and, except for the approval of this Agreement by the affirmative vote of the holders of a majority of the outstanding shares of DMGI Common Stock and DMGI, as sole shareholder of Merger Sub, no other corporate proceedings on the part of DMGI are necessary to approve this Agreement or to consummate the transactions contemplated hereby. This Agreement has been duly and validly executed and delivered by each of DMGI and Merger Sub and (assuming due authorization, execution and delivery by the Orchard) constitutes a valid and binding obligation of each of DMGI and Merger Sub, enforceable against DMGI and Merger Sub in accordance with its terms, subject to any applicable bankruptcy and insolvency laws affecting generally the enforceability of creditors' rights from time to time in effect.

(b) Neither the execution and delivery of this Agreement by each of DMGI and Merger Sub, nor the consummation by each of DMGI and Merger Sub of the transactions contemplated hereby, nor compliance by each of DMGI and Merger Sub with any of the terms or provisions hereof, will (i) violate any provision of the DMGI Articles or Bylaws, (ii) violate any provision of the Certificate of Incorporation or Bylaws of Merger Sub or (iii) assuming that the consents and approvals referred to in Section 4.4 are duly obtained, (x) violate any statute, code, ordinance, rule, regulation, judgment, order, writ, decree or injunction applicable to DMGI, any of its Subsidiaries or Non-Subsidiary Affiliates or any of their respective properties or assets or (y) violate, conflict with, result in a breach of any provision of or the loss of any benefit under, constitute a default (or an event which, with notice or lapse of time, or both, would constitute a default) under, result in the termination of or a right of termination or cancellation under, accelerate the performance required by, or result in the creation of any Lien upon any of the respective properties or assets of DMGI, any of its Subsidiaries or its Non-Subsidiary Affiliates under, any of the terms, conditions or provisions of any note, bond, mortgage, indenture, deed of trust, license, permit, lease, agreement or other instrument or obligation to which DMGI, any of its Subsidiaries or Non-Subsidiary Affiliates is a party, or by which they or any of their respective properties or assets may be bound or affected, except for such violations, conflicts, breaches or defaults which either individually or in the aggregate would not reasonably be expected to have a Material Adverse Effect on DMGI.

4.4 *Consents and Approvals.* Except for (i) the State and Foreign Approvals, (ii) the filing with the SEC of the Proxy Statement and any other form or schedule required by the Exchange Act, (iii) the filing of the Certificate of Merger with the New York Department pursuant to the NYBCL, (iv) the filings required by the HSR Act, (v) such filings and approvals as are required to be made or obtained under the securities or Blue Sky laws of various states in connection with the issuance of the shares of DMGI Capital Stock pursuant to this Agreement and (vi) the approval of this Agreement by the requisite vote of the stockholders of DMGI and DMGI, as sole shareholder of Merger Sub, no consents or approvals of or filings or registrations with any Governmental Entity are necessary in connection with (A) the execution and delivery by each of DMGI and Merger Sub of this Agreement and (B) the consummation by each of DMGI and Merger Sub of the Merger and the other transactions contemplated hereby.

4.5 *Financial Statements.* (a) The financial statements of DMGI and its Subsidiaries included (or incorporated by reference) in the DMGI's annual report on Form 10-K for the year ended December 31, 2006

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and quarterly report on Form 10-Q for the quarter ended March 31, 2007 (including the related notes, where applicable) (i) have been prepared from, and are in accordance with, the books and records of DMGI and its Subsidiaries, (ii) fairly present in all material respects the consolidated results of operations, cash flows, changes in shareholders' equity (but solely with respect to the annual report on Form 10-K) and consolidated financial position of DMGI and its Subsidiaries for the respective fiscal periods or as of the respective dates therein set forth (subject in the case of unaudited statements to recurring year-end audit adjustments normal in nature and amount), and (iii) have been prepared in accordance with GAAP consistently applied during the periods involved, except, in each case, as indicated in such statements or in the notes thereto. The books and records of DMGI and its Subsidiaries have been, and are being, maintained in all material respects in accordance with GAAP and any other applicable legal and accounting requirements and reflect only actual transactions. Perry-Smith LLP has not resigned or been dismissed as independent public accountants of DMGI as a result of or in connection with any disagreements with DMGI on a matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure.

(b) Neither DMGI nor any of its Subsidiaries has any material liability of any nature whatsoever (whether absolute, accrued, contingent or otherwise and whether due or to become due), except for (i) those liabilities that are reflected or reserved against on the consolidated balance sheet of DMGI included in its Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2007 (or disclosed in the notes thereto), (ii) current liabilities incurred in the ordinary course of business consistent with past practice since March 31, 2007 or in connection with this Agreement and the transactions contemplated hereby, and (iii) contingent liabilities that would not reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on DMGI.

(c) The records, systems, controls, data and information of DMGI and its Subsidiaries are recorded, stored, maintained and operated under means (including any electronic, mechanical or photographic process, whether computerized or not) that are under the exclusive ownership and direct control of DMGI or its Subsidiaries or accountants (including all means of access thereto and therefrom), except for any non-exclusive ownership and non-direct control that would not reasonably be expected to have a Material Adverse Effect on DMGI. DMGI maintains accounting records which fairly and accurately reflect, in all material respects, its transactions, and DMGI has devised and maintains accounting controls sufficient to provide reasonable assurances that such transactions are (i) executed in accordance with management's general or specific authorization and (ii) recorded as necessary to permit the preparation of its financial statements in accordance with GAAP.

(d) Since March 31, 2007, (i) neither DMGI nor any of its Subsidiaries has received or otherwise had or obtained knowledge of any material complaint, allegation, assertion or claim, whether written or oral, regarding the accounting or auditing practices, procedures, methodologies or methods of DMGI or any of its Subsidiaries or their respective internal accounting controls, including any material complaint, allegation, assertion or claim that DMGI or any of its Subsidiaries has engaged in questionable accounting or auditing practices and (ii) no attorney representing DMGI or any of its Subsidiaries, whether or not employed by DMGI or any of its Subsidiaries, has reported evidence of a material violation of securities laws, breach of fiduciary duty or similar violation by DMGI or any of its officers, directors, employees or agents to the Board of Directors of DMGI or any committee thereof or to any director or officer of DMGI.

*4.6 Broker's Fees.* With the exception of the engagement of SMH Capital, neither DMGI nor any DMGI Subsidiary nor any of their respective officers or directors has employed any broker or finder or incurred any liability for any broker's fees, commissions or finder's fees in connection with the Merger or related transactions contemplated by this Agreement. DMGI has provided the Orchard with a correct and complete copy of any engagement letter or other contract between DMGI and SMH Capital relating to the Merger and the other transactions contemplated hereunder.

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4.7 *Absence of Certain Changes or Events.* (a) Except as publicly disclosed in the DMGI Reports filed prior to the Execution Date, since March 31, 2007, no event or events have occurred that have had or would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on DMGI.

(b) Except as publicly disclosed in DMGI Reports filed prior to the Execution Date, since March 31, 2007, DMGI and its Subsidiaries have carried on their respective businesses in all material respects in the ordinary course consistent with past practices, including the timely payment of vendors, Content owners, employee payrolls and other liabilities as and when due. As of the Execution Date, except in the ordinary course of business consistent with past practices, there are no material past-due obligations of DMGI.

(c) Since March 31, 2007, neither DMGI nor any of its Subsidiaries has (i) except for normal increases and normal severance and termination payments made in the ordinary course of business consistent with past practice or as required by applicable law, or as otherwise expressly contemplated by this Agreement, increased the wages, salaries, compensation, pension, or other fringe benefits or perquisites payable to any executive officer, employee, or director from the amount thereof in effect as of March 31, 2007, granted any severance or termination pay, entered into any contract to make or grant any severance or termination pay, or paid any bonus other than the customary year-end bonuses for fiscal year 2006 in amounts consistent with past practice, (ii) granted any stock appreciation or similar rights or granted any rights to acquire any shares of its capital stock, or issued any shares of its capital stock, to any executive officer, director or employee other than grants (A) publicly disclosed in the DMGI Reports filed on or prior to the Execution Date and (B) in the case of grants made following the Execution Date as permitted by Section 5.2(b)(iii) or (iv), (iii) suffered any strike, work stoppage, slow-down, or other labor disturbance or (iv) repurchased any shares of DMGI Capital Stock.

4.8 *Legal Proceedings.* (a) Neither DMGI nor any of its Subsidiaries is a party to any, and there are no pending or, to the Knowledge of DMGI, threatened, legal, administrative, arbitral or other proceedings, claims, actions or governmental or regulatory investigations of any nature against DMGI or any of its Subsidiaries, except as would not reasonably be expected to result in a Material Adverse Effect on DMGI, or challenging the validity or propriety of the transactions contemplated by this Agreement.

(b) There is no injunction, order, judgment, decree, or regulatory restriction imposed upon DMGI, any of its Subsidiaries or the assets of DMGI or any of its Subsidiaries that has had or would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on DMGI or the Surviving Corporation.

As used in this Agreement, the term Knowledge of DMGI shall mean all information actually known by (i) Mitchell Koulouris, (ii) Karen Davis, (iii) Tuhin Roy, and (iv) Clayton Trier.

4.9 *Taxes and Tax Returns.* (a) Each of DMGI and its Subsidiaries has duly and timely filed (including all applicable extensions) all material Tax Returns required to be filed by it (all such Tax Returns being accurate and complete in all material respects), has timely paid all Taxes shown thereon as due and payable and has duly and timely paid all material Taxes that are otherwise due and payable or claimed or asserted to be due and payable from it by federal, state, foreign or local taxing authorities other than Taxes that are being contested in good faith, which have not been finally determined, and have been adequately reserved against in accordance with GAAP on the latest financial statements contained in the DMGI Reports.

Each of DMGI and its Subsidiaries has in all material respects withheld, collected and paid over to the appropriate Taxing Authority, or is in all material respects properly holding for such payments, all Taxes required by Law to be withheld or collected, and each of DMGI and its Subsidiaries has complied in all material respects with all information reporting and backup withholding requirements under all applicable legal requirements, including maintenance of required records with respect thereto. Neither DMGI nor any of its Subsidiaries has granted any waiver of the statute of limitations in respect of Taxes or agreed to any extension of time with respect to a Tax assessment or deficiency that remains in effect.

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There are no disputes, audits, examinations or proceedings related to Taxes or Tax Returns of DMGI or any of its Subsidiaries currently being conducted, pending or, to the Knowledge of DMGI, threatened, and there are no pending or, to the Knowledge of DMGI, threatened claims by any Taxing Authority for Taxes or assessments, upon DMGI or any of its Subsidiaries for which DMGI does not have reserves that are adequate under GAAP on the financial statements included in the DMGI Reports. There is no deficiency for any Tax, claim for additional Taxes or other dispute or claim concerning any Tax liability, of either DMGI or any of its Subsidiaries claimed, issued or raised by any Taxing Authority in writing. No claim is currently pending that has been made in writing by a Taxing Authority in a jurisdiction where DMGI or any of its Subsidiaries does not file a Tax Return that DMGI or any of its Subsidiaries is or may be subject to taxation by that jurisdiction. There are no Liens for any Taxes upon any of the assets, income or operations of DMGI or any of its Subsidiaries, other than statutory Liens for Taxes not yet due and payable. No issues related to Taxes of DMGI were raised in writing by any Taxing Authority in any completed audit or examination that can reasonably be expected to recur in a later taxable period. DMGI has made available to the Orchard true and complete copies of any private letter ruling requests, closing agreements or gain recognition agreements with respect to Taxes requested or executed in the last six years. Neither DMGI nor any of its Subsidiaries is a party to or is bound by any Tax Sharing, Agreement, whether written or unwritten.

Neither DMGI nor any of its Subsidiaries (A) has been a member of an affiliated group filing a consolidated federal income Tax Return (other than a group the common parent of which was DMGI) or (B) has any liability for the Taxes of any person (other than DMGI or any of its Subsidiaries or any of its or their predecessors) by reason of contract, agreement (including any Tax Sharing Agreement), assumption, transferee, successor or similar liability, operation of law, or under Treasury Regulation Section 1.1502-6 (or any predecessor or successor thereof or any similar or analogous provision of state, local or foreign Law). Neither DMGI nor any of its Subsidiaries has been, within the past two years or otherwise as part of a plan (or series of related transactions) within the meaning of Section 355(e) of the Code of which the Merger is also a part, a distributing corporation or a controlled corporation (within the meaning of Section 355(a)(1)(A) of the Code) in a distribution of stock intending to qualify for tax-free treatment under Section 355 of the Code. Neither DMGI nor any of its Subsidiaries has entered into any transaction identified by the Internal Revenue Service as of the Execution Date as a listed transaction for purposes of Treasury Regulations Section 1.6011-4(b)(2) or 301.6111-2(b)(2), or any other reportable transaction within the meaning of Treasury Regulations Section 1.6011-4(b)(1) that required or will require the filing of an IRS Form 8886. At no time during the past five years has DMGI been a United States real property holding corporation within the meaning of Section 897(c)(2) of the Code.

(b) Neither DMGI nor any of its Subsidiaries has taken or agreed to take any action, has failed to take any action or knows of any fact, agreement, plan or other circumstance that is reasonably likely to prevent the Merger from qualifying as a reorganization within the meaning of Section 368(a) of the Code.

4.10 *Employees.* (a) Section 4.10 of the DMGI Disclosure Schedule sets forth a true and complete list of all material pension, retirement, profit-sharing, deferred compensation, stock option, employee stock ownership, severance pay, vacation, bonus, or other incentive plan, all other employee programs, arrangements, agreements, or payroll practices, qualified or nonqualified, all medical, vision, dental, or other health plans, all life insurance plans, and all other employee benefit plans or fringe benefit plans, including without limitation, any employee benefit plan as that term is defined in Section 3(3) of ERISA, providing benefits to any current or former employees of DMGI or any of its Subsidiaries, whether or not incorporated, or any trade or business of DMGI or any of its Subsidiaries (a DMGI ERISA Affiliate) (collectively, the DMGI Benefit Plans).

(b) For each DMGI Benefit Plan, DMGI has heretofore made available to the Orchard true and complete copies of the following (to the extent applicable): (i) the plan documents, summary plan descriptions, and any summaries of material modifications; (ii) the three most recent annual reports (Form 5500 and all schedules and attachments thereto) filed with the Department of Labor, and any audited financial statements or actuarial reports; (iii) the most recent determination letter or opinion letter received from the IRS for such DMGI Benefit Plan; (iv) all related trust agreements, insurance contracts, or other funding agreements; and (v) any material written correspondence from any Governmental Entity relating to such DMGI Benefit Plan.



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(c)(i) Each of the DMGI Benefit Plans has been operated and administered in all material respects in compliance with applicable laws, including, but not limited to, ERISA and the Code and has been administered and operated in all material respects in accordance with its terms; (ii) each of the DMGI Benefit Plans that is intended to be qualified within the meaning of Section 401(a) of the Code has received, or has requested, a favorable determination letter, and to the Knowledge of DMGI there are no existing circumstances or any events that have occurred that will, or could reasonably, adversely affect the qualified status of any such DMGI Benefit Plan, (iii) no DMGI Benefit Plan provides benefits, including, without limitation, death or medical benefits (whether or not insured), with respect to current or former employees or directors of DMGI or its Subsidiaries beyond their retirement or other termination of service, other than (A) coverage mandated by applicable law, including 4980B of the Code regarding COBRA continuation coverage and applicable state insurance laws, (B) death benefits or retirement benefits under any employee pension plan (as such term is defined in Section 3(2) of ERISA), (C) deferred compensation benefits accrued as liabilities on the books of DMGI or its Subsidiaries or (D) benefits the full cost of which is borne by the current or former employee or director (or his beneficiary), (iv) no DMGI Benefit Plan is (A) subject to Section 302 of ERISA, Title IV of ERISA, or Section 412 of the Code, (B) a multiemployer pension plan (as such term is defined in Section 3(37) of ERISA), or (C) a multiple employer plan within the meaning of Section 4063 of ERISA, nor has DMGI, its Subsidiaries or DMGI ERISA Affiliates at any time contributed to or been obligated to contribute to any multiemployer plan or multiple employer plan, (v) all contributions or other amounts payable by DMGI or its Subsidiaries as of the Effective Time with respect to each DMGI Benefit Plan in respect of current or prior plan years have been paid or accrued in accordance with GAAP, (vi) none of DMGI, its Subsidiaries or any other person, including any fiduciary, has engaged in a transaction in connection with which DMGI, its Subsidiaries or any DMGI Benefit Plan will be subject to either a material civil penalty assessed pursuant to Section 409 or 502(i) of ERISA or a material tax imposed pursuant to Section 4975 or 4976 of the Code, (vii) to the Knowledge of DMGI there are no pending, threatened or anticipated claims (other than routine claims for benefits) by, on behalf of or against any of DMGI Benefit Plans or any trusts related thereto that would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on DMGI, and (viii) each DMGI Benefit Plan may be amended or terminated at any time at the sole discretion of the sponsor thereof without liability other than for benefits accrued prior to such amendment or termination, subject only to such constraints as imposed by applicable law.

(d) There are no pending or, to the Knowledge of DMGI, threatened material labor grievances or material unfair labor practice claims or charges against DMGI or any of its Subsidiaries, or any strikes or other material labor disputes against DMGI or any of its Subsidiaries. Neither DMGI nor its Subsidiaries are party to or bound by any collective bargaining or similar agreement with any labor organization, or work rules or practices agreed to with any labor organization or employee association applicable to employees of DMGI or its Subsidiaries and, to the Knowledge of DMGI, there are no organizing efforts by any union or other group seeking to represent any employees of DMGI or any of its Subsidiaries.

(e) None of the execution and delivery of this Agreement, the approval of this Agreement by DMGI's stockholders or the consummation of the transactions contemplated hereby will (either alone or in conjunction with any other event) (i) result in any payment (including, without limitation, severance, unemployment compensation, excess parachute payment (within the meaning of Section 280G of the Code), forgiveness of indebtedness or otherwise) becoming due to any director or any employee of DMGI or any of its affiliates from DMGI, the Orchard or any of their respective affiliates under any DMGI Benefit Plan or otherwise, (ii) increase any benefits otherwise payable under any DMGI Benefit Plan or (iii) result in any acceleration of the time of payment or vesting of any such benefits.

(f) Neither DMGI nor any of its DMGI ERISA Affiliates maintains or contributes to a rabbi trust or similar funding vehicle, and the Merger and other transactions contemplated by this Agreement shall not cause or require DMGI or its any of its DMGI ERISA Affiliates to establish or make any contribution to a rabbi trust or similar funding vehicle.

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4.11 *SEC Reports.* DMGI has previously made available to the Orchard an accurate and complete copy of each (a) final registration statement, prospectus, report, schedule and definitive proxy statement filed since September 29, 2005 by DMGI with the SEC pursuant to the Securities Act or the Exchange Act (the "DMGI Reports") and prior to the Execution Date and (b) communication mailed by DMGI to its stockholders since September 29, 2005 and prior to the Execution Date, and no such DMGI Report or communication, as of the date thereof, contained any untrue statement of a material fact or omitted to state any material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances in which they were made, not misleading, except that information as of a later date (but before the Execution Date) shall be deemed to modify information as of an earlier date. Since September 29, 2005, as of their respective dates, all DMGI Reports filed under the Securities Act and the Exchange Act complied in all material respects with the published rules and regulations of the SEC with respect thereto.

4.12 *Compliance with Applicable Law.* DMGI and each of its Subsidiaries hold all licenses, franchises, permits and authorizations necessary for the lawful conduct of their respective businesses under and pursuant to each, except where neither the cost of failure to hold nor the cost of obtaining and holding such license, franchise, permit or authorization would, either individually or in the aggregate, reasonably be expected to have a Material Adverse Effect on DMGI. DMGI and each of its Subsidiaries have complied with and are not in default under any, applicable law, statute, order, rule, regulation, policy and/or guideline of any Governmental Entity relating to DMGI or any of its Subsidiaries, except where neither the cost of such noncompliance or default nor the cost of compliance or cure of default would, either individually or in the aggregate, reasonably be expected to have a Material Adverse Effect on DMGI. Without limitation, during the three (3) years prior to the Execution Date, none of DMGI, and of its Subsidiaries, or any director, officer, employee, agent or other person acting on behalf of DMGI or any of its Subsidiaries has, to the Knowledge of DMGI directly or indirectly, (i) used any funds of DMGI or any of its Subsidiaries for unlawful contributions, unlawful gifts, unlawful entertainment or other expenses relating to political activity, (ii) made any unlawful payment to foreign domestic governmental officials or employees or to foreign or domestic political parties or campaigns from funds of DMGI or any of its Subsidiaries, (iii) violated any provision that would result in the violation of the Foreign Corrupt Practices Act of 1977, as amended, or any similar law (iv) established or maintained any unlawful fund of monies or other assets of DMGI or any of its Subsidiaries, (v) made any fraudulent entry on the books or records of DMGI or any of its Subsidiaries, or (vi) made any unlawful bribe, unlawful rebate, unlawful payoff, unlawful influence payment, unlawful kickback or other unlawful payment to any person, private or public, regardless of form, whether in money, property or services, to obtain favorable treatment in securing business to obtain special concessions for DMGI or any of its Subsidiaries, to pay for favorable treatment for business secured or to pay for special concessions already obtained for DMGI or any of its Subsidiaries.

4.13 *Certain Contracts.* (a) Neither DMGI nor any of its Subsidiaries is a party to or bound by any contract, arrangement, commitment or understanding (whether written or oral) (i) with respect to the employment of any directors, officers or employees, other than in the ordinary course of business consistent with past practice, (ii) which, upon the execution or delivery of this Agreement, stockholder approval of this Agreement or the consummation of the transactions contemplated by this Agreement will (either alone or upon the occurrence of any additional acts or events) result in any payment (whether of severance pay or otherwise) becoming due from DMGI, the Orchard, the Surviving Corporation, or any of their respective Subsidiaries to any officer or employee thereof, (iii) which materially restricts the conduct of any line of business by DMGI or any of its Subsidiaries or upon consummation of the Merger will materially restrict the ability of the Surviving Corporation to engage in any line of business, (iv) with or to a labor union or guild (including any collective bargaining agreement) or (v) (including any stock option plan, stock appreciation rights plan, restricted stock plan or stock purchase plan) any of the benefits of which will be increased, or the vesting of the benefits of which will be accelerated, by the occurrence of the execution and delivery of this Agreement, stockholder approval of this Agreement or the consummation of any of the transactions contemplated by this Agreement, or the value of any of the benefits of which will be calculated on the basis of any of the transactions contemplated by this Agreement. DMGI has previously made available to the Orchard true and correct copies of all employment and deferred compensation agreements which are in writing and to which DMGI or any of its Subsidiaries is a party. Each contract,

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arrangement, commitment or understanding to which DMGI is a party or by which its properties or assets are bound, whether or not set forth in the DMGI Disclosure Schedule, is referred to herein as a DMGI Contract, and to the Knowledge of DMGI, there are not nor has DMGI received notice of, any violations of the above by any DMGI Contract of the other parties thereto which would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on DMGI.

(b) (i) Each DMGI Contract is valid and binding on DMGI and/or one of its Subsidiaries, as applicable, and, to the Knowledge of DMGI, is in full force and effect, (ii) DMGI and each of its Subsidiaries has in all material respects performed all obligations required to be performed by it through the Execution Date under each DMGI Contract, except where such noncompliance, either individually or in the aggregate, would not reasonably be expected to have a Material Adverse Effect on DMGI, (iii) to the Knowledge of DMGI, each third-party counterparty to each DMGI Contract has in all material respects performed all obligations required to be performed by it through the Execution Date under such DMGI Contract and (iv) no event or condition exists which constitutes or, after notice or lapse of time or both, will constitute, a material default on the part of DMGI or any of its Subsidiaries under any such DMGI Contract, except where such default, either individually or in the aggregate, would not reasonably be expected to have a Material Adverse Effect on DMGI.

(c) Section 4.13 of the DMGI Disclosure Schedule identifies all of the libraries or collections of Content of DMGI or its Subsidiaries.

(d) Subject to the rights of the Content owners pursuant to DMGI's Standard Form of Agency Agreement, DMGI or its Subsidiaries have valid rights to license, distribute and sell all of the Content through DMGI's Channel Outlets to consumers.

(e) Neither DMGI nor any of its Subsidiaries has transferred ownership of or granted any right to sell, license, use or distribute the Content other than to consumers through DMGI's Channel Outlets in the ordinary course of business.

(f) Excluding third-party, peer-to-peer file sharing, peer-to-peer providers, device distributors, illegal pay sites, unlicensed video content providers and other systematic infringers, neither DMGI nor its Subsidiaries has received written notice of any person violating, infringing or misappropriating any rights with respect to the Content.

(g) Since March 31, 2007, no Content owner, Channel Outlet, vendor or supplier of DMGI or its Subsidiaries has cancelled or otherwise modified its relationship with DMGI or any of its Subsidiaries, as applicable, in a manner adverse to DMGI and its Subsidiaries, taken as a whole, and no such person has, to the Knowledge of DMGI, communicated in writing to DMGI or its Subsidiaries any intention to do so.

4.14 *Environmental Liability*. There are no legal, administrative, arbitral or other proceedings, claims, actions, causes of action, private environmental investigations or remediation activities or governmental investigations of any nature seeking to impose, or that could reasonably result in the imposition, on DMGI of any liability or obligation arising under common law or under any local, state or federal environmental statute, regulation or ordinance including, without limitation, CERCLA, pending or threatened against DMGI, which liability or obligation would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on DMGI. To the Knowledge of DMGI, there is no reasonable basis for any such proceeding, claim, action or governmental investigation that would impose any liability or obligation that would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on DMGI. DMGI is not subject to any agreement, order, judgment, decree, letter or memorandum by or with any court, governmental authority, regulatory agency or third party imposing any liability or obligation with respect to the foregoing that would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on DMGI.

4.15 *Property*. DMGI or a DMGI Subsidiary (a) has good and marketable title to all the properties and assets reflected in the latest audited balance sheet included in the DMGI Reports as being owned by DMGI or a

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DMGI Subsidiary or acquired after the date thereof (except properties sold or otherwise disposed of since the date thereof in the ordinary course of business) (the DMGI Owned Properties ), free and clear of all material Liens, except for Permitted Encumbrances, and (b) is the lessee of all leasehold estates reflected in the latest audited financial statements included in such DMGI Reports or acquired after the date thereof (except for leases that have expired by their terms or leased property that has been disposed of in accordance with the terms of its lease and in the ordinary course of business since the date thereof) (the DMGI Leased Properties and, collectively with the DMGI Owned Properties, the DMGI Real Property ), free and clear of all material Liens, except for Permitted Encumbrances, and is in possession of the properties purported to be leased thereunder, and each such lease is a valid obligation of DMGI or a DMGI Subsidiary without default thereunder by the lessee or, to the Knowledge of DMGI, the lessor.

4.16 *Intellectual Property.* DMGI and each of its Subsidiaries owns, or is licensed to use (in each case, free and clear of any material Liens), all Intellectual Property used in or necessary for the conduct of its business as currently conducted. The use of any Intellectual Property by DMGI and its Subsidiaries does not, to the Knowledge of DMGI, infringe on or otherwise violate the rights of any person and is in accordance with any applicable license pursuant to which DMGI or any DMGI Subsidiary acquired the right to use any Intellectual Property. To the Knowledge of DMGI, no person is challenging, or to the Knowledge of DMGI, infringing on or otherwise violating any right of DMGI or any of its Subsidiaries with respect to any Intellectual Property owned by and/or licensed to DMGI or its Subsidiaries. Neither DMGI nor any DMGI Subsidiary has received any written notice of any pending claim with respect to any Intellectual Property used by DMGI or any DMGI Subsidiary which would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on DMGI.

4.17 *State Takeover Laws; DMGI Rights.* (a) The Board of Directors of DMGI has unanimously approved this Agreement and the transactions contemplated hereby as required to render inapplicable to such agreements and transactions Section 203 of the DGCL and, to the Knowledge of DMGI, any other Takeover Statutes.

(b) DMGI has taken all action, if any, necessary or appropriate so that the entering into of this Agreement and the consummation of the transactions contemplated hereby, do not and will not result in the ability of any person to exercise any DMGI Rights or enable or require the DMGI Rights to separate from the shares of DMGI Common Stock to which they are attached or to be triggered or become exercisable.

4.18 *Opinion.* Prior to the execution of this Agreement, DMGI has received an opinion from SMH Capital Inc. to the effect that as of the date thereof and based upon and subject to the matters set forth therein, the Exchange Ratio pursuant to this Agreement is fair from a financial point of view to DMGI and its shareholders (the Fairness Opinion ). The Fairness Opinion has not been amended or rescinded as of the Execution Date.

4.19 *DMGI Information.* The information relating to DMGI and its Subsidiaries to be contained in the Proxy Statement filed with the SEC in definitive form relating to the meeting of stockholders to be held in connection with this Agreement and the transactions contemplated hereby (including any amendments or supplements thereto (the Proxy Statement ), or the information relating to DMGI and its Subsidiaries that is provided by DMGI or its representatives for inclusion in any other document filed with any other Governmental Entity in connection herewith, will not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements therein, in light of the circumstances in which they are made, not misleading. The Proxy Statement (except for such portions thereof that relate only to the Orchard or any of its Subsidiaries) will comply with the provisions of the Exchange Act and the rules and regulations thereunder.

4.20 *Merger Subsidiaries Operations.* Merger Sub was formed solely for the purpose of engaging in the transactions contemplated by this Agreement and has not engaged in any business activities or conducted any operations other than in connection with such transactions.

4.21 *Receivables.* All accounts receivable reflected on the consolidated balance sheet included in DMGI's quarterly report on Form 10-Q for the quarter ended March 31, 2007, and created since March 31, 2007,

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represent valid obligations of customers of DMGI arising from bona fide transactions entered into in the ordinary course of business consistent with past practices.

4.22 *Registration Rights*. Section 4.22 of the DMGI Disclosure Schedule sets forth a complete and accurate list of all DMGI stockholders who have registration rights, and the number of registerable shares of DMGI Common Stock held by such stockholders, pursuant to DMGI's Second Amended and Restated Stockholders Agreement, dated September 8, 2005, or otherwise.

**ARTICLE V**

**COVENANTS RELATING TO CONDUCT OF BUSINESS**

5.1 *Conduct of Businesses Prior to the Effective Time*. During the period from the Execution Date to the Effective Time, except as expressly contemplated or permitted by this Agreement (including the Orchard Disclosure Schedule and the DMGI Disclosure Schedule), each of DMGI and the Orchard shall, and shall cause each of their respective Subsidiaries to, (a) conduct its business in the ordinary course, (b) use reasonable best efforts to maintain and preserve intact its business organization, employees and advantageous business relationships and retain the services of its key officers and key employees, and (c) take no action that would reasonably be expected to adversely affect or delay the ability of either DMGI or the Orchard to obtain any necessary approvals of any Governmental Entity required for the transactions contemplated hereby or to perform its covenants and agreements under this Agreement or to consummate the transactions contemplated hereby.

5.2 *Forbearances*. During the period from the Execution Date to the Effective Time, except as set forth in the DMGI Disclosure Schedule or the Orchard Disclosure Schedule, as the case may be, and, except as expressly contemplated or permitted by this Agreement, neither DMGI nor the Orchard shall, and neither DMGI nor the Orchard shall permit any of their respective Subsidiaries to, without the prior written consent of the other party to this Agreement:

(a) incur any indebtedness for borrowed money (other than indebtedness of the Orchard or any of its Subsidiaries to the Orchard or any of its Subsidiaries, on the one hand, or of DMGI or any of its Subsidiaries to DMGI or any of its Subsidiaries, on the other hand), assume, guarantee, endorse or otherwise as an accommodation become responsible for the obligations of any other individual, corporation or other entity, or make any loan or advance;

(b) (i) other than with respect to a single possible reverse stock split, in a ratio ranging from one-for-two to one-for-five, of all DMGI Common Stock then issued and outstanding (and any DMGI Common Stock underlying any then outstanding preferred stock, option, warrant convertible note or other security) (the Reverse Split), adjust, split, combine or reclassify any capital stock;

(ii) make, declare or pay any dividend, or make any other distribution on, or directly or indirectly redeem, purchase or otherwise acquire, any shares of its capital stock or any securities or obligations convertible (whether currently convertible or convertible only after the passage of time or the occurrence of certain events) into or exchangeable for any shares of its capital stock (except (A) dividends paid by any of the Subsidiaries of each of DMGI and the Orchard to DMGI or the Orchard or any of their wholly-owned Subsidiaries, respectively of each of DMGI and the Orchard, (B) the acceptance of shares of the Orchard Common Stock or DMGI Common Stock, as the case may be, as payment for the exercise price of stock options or for withholding taxes incurred in connection with the exercise of stock options or the vesting of restricted stock, in each case in accordance with past practice and the terms of the applicable award agreements and (C) pursuant to the DMGI Rights);

(iii) grant any stock appreciation rights, performance shares, restricted stock units or other equity-based interests, or grant any individual, corporation or other entity any right to acquire any shares of its capital stock; or

(iv) issue any additional shares of capital stock except pursuant to the exercise of stock options or warrants outstanding as of the Execution Date;

(c) sell, transfer, mortgage, encumber or otherwise dispose of any of its material properties or assets to any individual, corporation or other entity other than a Subsidiary, or cancel, release or assign any

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indebtedness owed to or from any such person or any claims by or against any such person, in each case other than in the ordinary course of business consistent with past practices or pursuant to contracts or agreements in force at the Execution Date;

(d) except for transactions in the ordinary course of business consistent with past practices or pursuant to contracts or agreements in force at the Execution Date or otherwise permitted by this Agreement, make any material investment either by purchase of stock or securities, contributions to capital, property transfers, or purchase of any property or assets of any other individual, corporation or other entity other than a Subsidiary thereof;

(e) except for transactions in the ordinary course of business consistent with past practices, terminate, or waive any material provision of, any Orchard Contract or DMGI Contract, as the case may be, or make any change in any instrument or agreement governing the terms of any of its securities, or material lease or contract, other than normal renewals of contracts and leases without material adverse changes of terms with respect to the Orchard or DMGI, as the case may be;

(f) increase in any manner the compensation or fringe benefits of any of its employees or pay any pension or retirement allowance not required by any existing plan or agreement to any such employees or become a party to, amend or commit itself to any pension, retirement, profit-sharing or welfare benefit plan or agreement or employment agreement with or for the benefit of any employee other than in the ordinary course of business, or accelerate the vesting of, or the lapsing of restrictions with respect to, any stock options or other stock-based compensation (except to the extent required under the terms of the applicable plan or related award agreement);

(g) settle any material claim, action or proceeding, except in the ordinary course of business consistent with past practices;

(h) knowingly take any action that would reasonably be expected to prevent the Merger from qualifying as a reorganization within the meaning of Section 368 of the Code;

(i) amend its articles of incorporation, its bylaws or comparable governing documents;

(j) take any action that is intended or expected to result in any of its representations and warranties set forth in this Agreement being or becoming untrue in any material respect at any time prior to the Effective Time, or in any of the conditions to the Merger set forth in Article VII not being satisfied or in a violation of any provision of this Agreement, except, in every case, as may be required by applicable law;

(k) implement or adopt any change in its accounting principles, practices or methods, other than as may be required by GAAP; or

(l) agree to take, make any commitment to take, or adopt any resolutions of its board of directors in support of, any of the actions prohibited by this Section 5.2.

**ARTICLE VI**

**ADDITIONAL AGREEMENTS**

6.1 *Regulatory Matters.* (a) DMGI shall promptly prepare and file with the SEC the Proxy Statement and as promptly as practicable after such filing, DMGI shall mail or deliver the Proxy Statement to its stockholders. DMGI shall also use its reasonable best efforts to obtain all necessary state securities law or Blue Sky permits and approvals required to carry out the transactions contemplated by this Agreement, and the Orchard shall furnish all information concerning the Orchard and the holders of the Orchard Capital Stock as may be reasonably requested in connection with any such action.

(b) The parties hereto shall cooperate with each other and use their reasonable best efforts to promptly prepare and file all necessary documentation, to effect all applications, notices, petitions and filings

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(including the filing under the HSR Act), to obtain as promptly as practicable all permits, consents, approvals and authorizations of all third parties and Governmental Entities which are necessary or advisable to consummate the transactions contemplated by this Agreement (including, without limitation, the Merger), and to comply with the terms and conditions of all such permits, consents, approvals and authorizations of all such Governmental Entities. With the exception of any filings made under the HSR Act, DMGI and the Orchard shall have the right to review in advance, and, to the extent practicable, each will consult the other on, in each case subject to applicable laws relating to the exchange of information, all the information relating to the Orchard or DMGI, as the case may be, and any of their respective Subsidiaries, which appear in any filing made with, or written materials submitted to, any third party or any Governmental Entity in connection with the transactions contemplated by this Agreement. In exercising the foregoing right, each of the parties hereto shall act reasonably and as promptly as practicable. The parties hereto agree that they will consult with each other with respect to the obtaining of all permits, consents, approvals and authorizations of all third parties and Governmental Entities necessary or advisable to consummate the transactions contemplated by this Agreement and each party will keep the other apprised of the status of matters relating to completion of the transactions contemplated herein.

(c) DMGI and the Orchard shall, upon request, furnish each other with all information concerning themselves, their Subsidiaries, directors, officers and stockholders and such other matters as may be reasonably necessary or advisable in connection with the Proxy Statement or any other statement, filing, notice or application made by or on behalf of DMGI, the Orchard or any of their respective Subsidiaries to any Governmental Entity in connection with the Merger and the other transactions contemplated by this Agreement.

(d) DMGI and the Orchard shall promptly advise each other upon receiving any communication from any Governmental Entity whose consent or approval is required for consummation of the transactions contemplated by this Agreement that causes such party to believe that there is a reasonable likelihood that any Requisite Regulatory Approval will not be obtained or that the receipt of any such approval will be materially delayed.

6.2 *Access to Information.* (a) Upon reasonable notice and subject to the matters set forth in the Orchard Disclosure Schedule and the DMGI Disclosure Schedule and to all antitrust laws, each of DMGI and the Orchard, for the purposes of verifying the representations and warranties of the other and preparing for the Merger and the other matters contemplated by this Agreement, shall, and shall cause each of their respective Subsidiaries to, afford to the officers, employees, accountants, counsel and other representatives of the other party, access, during normal business hours during the period prior to the Effective Time, to all its properties, books, contracts, commitments and records, and, during such period, each of DMGI and the Orchard shall, and shall cause their respective Subsidiaries to, make available to the other party (i) a copy of each report, schedule, registration statement and other document filed or received by it during such period pursuant to the requirements of federal securities laws (other than reports or documents which DMGI or the Orchard, as the case may be, is not permitted to disclose under applicable law) and (ii) all other information concerning its business, properties and personnel as such party may reasonably request. Neither DMGI nor the Orchard nor any of their respective Subsidiaries shall be required to provide access to or to disclose information where (x) such access or disclosure would violate or prejudice the rights of DMGI or the Orchard, as the case may be, customers, (y) jeopardize the attorney-client privilege of the institution in possession or control of such information or (z) contravene any law, rule, regulation, order, judgment, decree, fiduciary duty or binding agreement entered into prior to the Execution Date. The parties hereto will make appropriate substitute disclosure arrangements under circumstances in which the restrictions of the preceding sentence apply.

(b) Each of DMGI and the Orchard shall hold all information furnished by or on behalf of the other party or any of such party's Subsidiaries or representatives pursuant to Section 6.2(a) in confidence to the extent required by, and in accordance with, the provisions of the confidentiality agreement, dated December 8, 2006, between DMGI and the Orchard (the Confidentiality Agreement).

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(c) No investigation by either of the parties or their respective representatives shall affect the representations and warranties of the other set forth herein.

**6.3 Stockholders Approvals.** Each of DMGI and the Orchard shall call a meeting of its stockholders (the DMGI Meeting and Orchard Meeting, respectively) to be held as soon as reasonably practicable for the purpose of voting upon the requisite stockholder approvals required in connection with this Agreement and the Merger and, if so desired and mutually agreed, upon other matters of the type customarily brought before an annual meeting of shareholders, and each shall use its reasonable best efforts to cause such meetings to occur as soon as reasonably practicable and on the same date. The Board of Directors of each of DMGI and the Orchard shall use its reasonable best efforts to obtain from the stockholders of DMGI and the Orchard, as the case may be, the vote in favor of the approval of this Agreement (which shall include the amendment to the DMGI Articles) required by the DGCL to consummate the transactions contemplated hereby. Notwithstanding anything to the contrary contained in this Agreement, DMGI shall adjourn or postpone the DMGI Meeting to the extent necessary to ensure that any necessary supplement or amendment to the Proxy Statement is provided to DMGI's stockholders, in advance of a vote on the matters described above, or, if, as of the time for which such meeting is originally scheduled there are insufficient shares of DMGI Common Stock, represented (either in person or by proxy) to constitute a quorum necessary to conduct the business of such meeting, or if in the reasonable good faith determination of DMGI additional time is needed to solicit an affirmative stockholder vote by the DMGI stockholders in order to obtain the requisite vote for the foregoing matters; provided that DMGI shall, at least three business days prior to any such adjournment or postponement, notify the Orchard of the potential adjournment or postponement and shall consult with the Orchard regarding the necessity of such adjournment or postponement. Notwithstanding anything to the contrary herein, unless this Agreement has been terminated, this Agreement shall be submitted to the stockholders of DMGI and the Orchard at the DMGI Meeting and the Orchard Meeting, respectively, for the purpose of voting on the approval of this Agreement and the other matters contemplated hereby, and nothing contained herein shall be deemed to relieve either DMGI or the Orchard of such obligation, the shareholders of Orchard shall have approved the transactions contemplated herein by written consent in lieu of a meeting.

**6.4 Legal Conditions to Merger.** Each of DMGI and the Orchard shall, and shall cause its Subsidiaries to, use their reasonable best efforts (a) to take, or cause to be taken, all actions necessary, proper or advisable to comply promptly with all legal requirements that may be imposed on such party or its Subsidiaries with respect to the Merger and, subject to the conditions set forth in Article VII hereof, to consummate the transactions contemplated by this Agreement and (b) to obtain (and to cooperate with the other party to obtain) any material consent, authorization, order or approval of, or any exemption by, any Governmental Entity and any other third party that is required to be obtained by the Orchard or DMGI or any of their respective Subsidiaries in connection with the Merger and the other transactions contemplated by this Agreement.

**6.5 Stock Exchange Listing.** DMGI shall cause the shares of DMGI Common Stock to be issued in the Merger or to be issued upon conversion of the DMGI Series A Preferred Stock in accordance with the terms thereof, to be approved for listing on the NASDAQ Global Market System, subject to official notice of issuance, prior to the Effective Time.

**6.6 Employee Benefit Plans.** (a) From and after the Effective Time, unless otherwise mutually determined, the Orchard Benefit Plans and DMGI Benefit Plans in effect as of the Execution Date shall remain in effect with respect to employees of the Orchard and DMGI (and their respective Subsidiaries), respectively, covered by such plans at the Effective Time until such time as DMGI and the Surviving Corporation shall, subject to applicable law, the terms of this Agreement and the terms of such plans, modify any existing plans or adopt new benefit plans with respect to employees of DMGI and the Surviving Corporation and their respective Subsidiaries (the New Benefit Plans). Prior to the Closing Date, the Orchard and DMGI shall cooperate in reviewing, evaluating and analyzing the DMGI Benefit Plans and the Orchard Benefit Plans with a view towards developing appropriate New Benefit Plans for the employees covered thereby. It is the intention of the Orchard and DMGI, to the extent permitted by applicable laws, to develop New Benefit Plans (including amending existing plans), as



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soon as reasonably practicable after the Effective Time, which, among other things, (i) treat similarly situated employees on a substantially equivalent basis, taking into account all relevant factors, including duties, geographic location, tenure, qualifications and abilities, and (ii) do not discriminate between employees who were covered by the DMGI Benefit Plans, on the one hand, and those covered by the Orchard Benefit Plans on the other, at the Effective Time.

(b) With respect to any Benefit Plans in which any employees of DMGI or the Orchard (or their Subsidiaries) prior to the Effective Time first become eligible to participate on or after the Effective Time, and in which such employees did not participate prior to the Effective Time (the New Plans ), DMGI or the Surviving Corporation, as the case may be, shall: (A) waive all pre-existing conditions, exclusions and waiting periods with respect to participation and coverage requirements applicable to such employees and their eligible dependents under any New Plans in which such employees may be eligible to participate after the Effective Time, except to the extent such pre-existing conditions, exclusions or waiting periods would apply under the analogous DMGI Benefit Plan or Orchard Benefit Plan, as the case may be; (B) provide each such employee and their eligible dependents with credit for any co-payments and deductibles paid prior to the Effective Time under a DMGI Benefit Plan or the Orchard Benefit Plan (to the same extent that such credit was given under the analogous Benefit Plan prior to the Effective Time) in satisfying any applicable deductible or out-of-pocket requirements under any New Plans in which such employees may be eligible to participate after the Effective Time; and (C) recognize all service of such employees with the Orchard and DMGI, and their respective affiliates, for all purposes (including, purposes of eligibility to participate, vesting credit, entitlement to benefits, and, except with respect to defined benefit pension plans, benefit accrual) in any New Plan in which such employees may be eligible to participate after the Effective Time, to the extent such service is taken into account under the applicable New Plans; provided that the foregoing shall not apply to the extent it would result in duplication of benefits.

(c) Each of DMGI and the Surviving Corporation, as the case may be, agrees to honor in accordance with their terms all benefits vested as of the Execution Date under the DMGI Benefit Plans or Orchard Benefit Plans or under other contracts, arrangements, commitments, or understandings described in the DMGI Disclosure Schedule and the Orchard Disclosure Schedule.

(d) Nothing in this Section 6.6 shall be interpreted as preventing DMGI and the Surviving Corporation, as the case may be, from amending, modifying or terminating any DMGI Benefit Plans, Orchard Benefit Plans, or other contracts, arrangements, commitments or understandings, in accordance with their terms and applicable law. Without limiting the generality of the final sentence of Section 9.10, nothing in this Section 6.6, express or implied, is intended to or shall confer upon any other person including without limitation any employee of DMGI or the Orchard, any right, benefit or remedy of any nature whatsoever under or by reason of this Agreement and no provision of this Section 6.6 shall constitute an amendment of any benefit plan of DMGI or the Orchard.

*6.7 Indemnification; Directors and Officers Insurance.* (a) In the event of any threatened or actual claim, action, suit, proceeding or investigation, whether civil, criminal or administrative, including, without limitation, any such claim, action, suit, proceeding or investigation in which any individual who is now, or has been at any time prior to the Execution Date, or who becomes prior to the Effective Time, a director or officer or employee of the Orchard or any of its Subsidiaries (the Orchard Indemnified Parties ), is, or is threatened to be, made a party based in whole or in part on, or arising in whole or in part out of, or pertaining to (i) the fact that he is or was a director, officer or employee of the Orchard or any of its Subsidiaries or (ii) this Agreement or any of the transactions contemplated hereby, whether in any case asserted or arising before or after the Effective Time, the parties hereto agree to cooperate, and the parties shall use their reasonable best efforts to defend against and respond thereto, except that prior to the Effective Time, the foregoing obligation of DMGI with respect to the directors, officers or employees of the Orchard shall be only to cooperate. In the event of any threatened or actual claim, action, suit, proceeding or investigation, whether civil, criminal or administrative, including, without limitation, any such claim, action, suit, proceeding or investigation in which any individual who is now, or has been at any time prior to the Execution Date, or who becomes prior to the Effective Time, a director or officer or

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employee of DMGI or any of its Subsidiaries (the "DMGI Indemnified Parties"), is, or is threatened to be, made a party based in whole or in part on, or arising in whole or in part out of, or pertaining to (i) the fact that he is or was a director, officer or employee of DMGI or any of its Subsidiaries or (ii) this Agreement or any of the transactions contemplated hereby, whether in any case asserted or arising before or after the Effective Time, the parties hereto agree to cooperate, and the parties shall use their reasonable best efforts to defend against and respond thereto, except that prior to the Effective Time, the foregoing obligation of the Orchard with respect to the directors, officers or employees of DMGI shall be only to cooperate. It is understood and agreed that after the Effective Time, DMGI shall indemnify and hold harmless, as and to the fullest extent permitted by law, each such Orchard Indemnified Party and DMGI Indemnified Party against any losses, claims, damages, liabilities, costs, expenses (including reasonable attorney's fees and expenses in advance of the final disposition of any claim, suit, proceeding or investigation to each Indemnified Party to the fullest extent permitted by law upon receipt of any undertaking required by applicable law), judgments, fines and amounts paid in settlement (to the extent, in the case of settlements, that the settlement was approved in writing by DMGI, such approval not to be unreasonably withheld) in connection with any such threatened or actual claim, action, suit, proceeding or investigation. It is understood that after the Effective Time DMGI may assume and control the defense of any claim for which DMGI is obligated to provide indemnification under this Section 6.7(a), provided that the foregoing shall not apply with respect to any claim for which counsel has been retained with the approval of the applicable liability insurer (if such approval is required under the applicable insurance policy, if any, to obtain coverage) and commenced the defense prior to the Effective Time unless DMGI's Audit Committee otherwise determines following the Effective Time.

(b) DMGI shall cause the individuals serving as officers and directors of DMGI and the Orchard or any of their Subsidiaries immediately prior to the Effective Time to be (i) covered for a period of two years from the Effective Time by the directors' and officers' liability insurance policy maintained by DMGI (in the case of officers and directors of DMGI) and the Orchard (in the case of officers and directors of the Orchard) (provided that DMGI and the Orchard, as the case may be, may substitute therefor policies of at least the same coverage and amounts containing terms and conditions that are not less advantageous than such policy) with respect to acts or omissions occurring prior to the Effective Time that were committed by such officers and directors in their capacity as such or (ii) if such insurance cannot be obtained, covered for a period of five years by a tail policy on the Orchard's and DMGI's existing directors' and officers' liability insurance policies, as the case may be, of at least the same coverage and amounts containing terms and conditions that are no less advantageous than such existing policy; provided, however, that in no event shall DMGI be required to expend more than 200% per year of coverage of the amount currently expended by DMGI per year of coverage as of the Execution Date (the "Maximum Amount") to maintain or procure insurance coverage pursuant hereto. If DMGI is unable to maintain or obtain the insurance called for by this Section 6.7, DMGI shall obtain as much comparable insurance as available for the Maximum Amount. DMGI shall cause such DMGI and Orchard officers and directors, as may be required, to make reasonable application and provide reasonable and customary representations and warranties to DMGI's insurance carrier for the purpose of obtaining such insurance, comparable in nature and scope to the applications, representations and warranties required of persons who are officers and directors of DMGI (in the case of DMGI) and the Orchard (in the case of the Orchard) as of the Execution Date.

(c) The provisions of this Section 6.7 shall survive the Effective Time and are intended to be for the benefit of, and shall be enforceable by, each Indemnified Party and his or her heirs and representatives.

**6.8 Additional Agreements.** In case at any time after the Effective Time any further action is necessary or desirable to carry out the purposes of this Agreement (including, without limitation, any merger between a Subsidiary of DMGI, on the one hand, and a Subsidiary of the Orchard, on the other) or to vest the Surviving Corporation with full title to all properties, assets, rights, approvals, immunities and franchises of any of the parties to the Merger, the proper officers and directors of each party to this Agreement and their respective Subsidiaries shall take all such necessary action as may be reasonably requested by, and at the sole expense of, DMGI.

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6.9 *Advice of Changes.* DMGI and the Orchard shall each promptly advise the other party of any change or event (i) having a Material Adverse Effect on it or (ii) which it believes would or would be reasonably likely to cause or constitute a material breach of any of its representations, warranties or covenants contained herein; provided that any failure to give notice in accordance with the foregoing with respect to any breach shall not be deemed to constitute a violation of this Section 6.9 or the failure of any condition set forth in Section 7.2 or 7.3 to be satisfied, or otherwise constitute a breach of this Agreement by the party failing to give such notice, in each case unless the underlying breach would independently result in a failure of the conditions set forth in Section 7.2 or 7.3 to be satisfied or give rise to such termination right.

6.10 *Officers following Effective Time.* DMGI shall take all such action as may be necessary so that the officers of DMGI immediately after the Effective Time are only as set forth on Schedule 6.10(a) hereto, assuming that such persons are willing to serve in the capacities indicated on such Schedule 6.10(a). Orchard shall take all such action as may be necessary so that the officers of Orchard immediately after the Effective Time are as only set forth on Schedule 6.10(b) hereto, assuming that such persons are willing to serve in the capacities indicated on such Schedule 6.10(b).

6.11 *Board of Directors.* (a) DMGI shall take all such action as may be necessary so that, immediately following the Effective Time, the size of the DMGI Board of Directors shall be seven (7) members and that the directors of DMGI are as set forth on Schedule 6.11(a) hereto, assuming that such persons are willing to serve in such capacity. In the event that any such person listed as a DMGI Designee on such schedule shall be unable or unwilling to so serve, DMGI shall have the power to designate a replacement for such person. In the event that any such person listed as an Orchard Designee such schedule shall be unable or unwilling to so serve, Orchard shall have the power to designate a replacement for such person.

(b) Orchard shall take all such action as may be necessary so that, immediately following the Effective Time, the directors of Orchard are only as set forth on Schedule 6.11(b) hereto, assuming that such persons are willing to serve in such capacity.

6.12 *Acquisition Proposals.* (a) Until this Agreement has been terminated in accordance with Section 8.1, each of DMGI and the Orchard agrees that it will not, and will cause its controlled Affiliates and its and their officers, directors, agents and representatives not to, directly or indirectly, (i) (A) initiate, solicit, encourage or knowingly facilitate inquiries or proposals with respect to, (B) engage or participate in any negotiations concerning, (C) provide any confidential or nonpublic information or data to or (D) have, or engage or participate in, any discussions with any person relating to, any Acquisition Proposal (as defined in clause (d) below), (ii) release or permit the release of any person from, or waive or permit the waiver of any provisions of, or otherwise fail to exercise its rights under, any confidentiality, standstill or similar agreement to which such party is a party or under which such party has any rights with respect to the sale or transfer of the voting securities or any material portion of the assets of such party, (iii) withdraw, modify or qualify (or propose to withdraw, modify or qualify) in any manner adverse to the other party the recommendation by such party's Board of Directors of this Agreement to its stockholders or take any action or make any statement in connection with such party's meeting of stockholders inconsistent with such recommendation, including any action to approve, recommend or endorse, or to propose to approve, recommend or endorse, any Acquisition Proposal (collectively, a Change in Recommendation) or (iv) enter into any agreement, letter of intent, agreement-in-principle, acquisition agreement or other instrument contemplating or otherwise relating to any Acquisition Proposal or requiring such party to abandon, terminate or fail to consummate any of the transactions contemplated hereby, including the Merger.

(b) Notwithstanding Section 6.12(a), prior to approval of the transactions contemplated by this Agreement at its meeting of stockholders to be held pursuant to Section 6.3, each of DMGI and the Orchard (the Acting Party) may, and may permit its Affiliates and its and their appropriate officers, directors, agents and representatives to furnish or cause to be furnished nonpublic information or data and participate in such negotiations or discussions with, any person in response to an unsolicited, bona fide and written Acquisition Proposal that is submitted to the Acting Party after the Execution Date and prior to the approval

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of the transactions contemplated by this Agreement at its meeting of stockholders to be held pursuant to Section 6.3, and may withdraw, modify or qualify the recommendation by such party's Board of Directors of this Agreement to its stockholders in connection therewith, if and so long as (A) none of the Acting Party, any of its controlled Affiliates or any of its or their officers, directors, agents or representatives has violated any of the provisions of this Section 6.12, (B) the Board of Directors of the Acting Party concludes in good faith (after receiving the advice of its outside counsel and its financial advisors) that failure to take such actions would result in a violation of its fiduciary duties under applicable law, (C) at least twenty-four (24) hours prior to furnishing or causing to be furnished nonpublic information or data to, and participating in such negotiations or discussions with, such person, the Acting Party provides the other party with written notice of the identity of such person and of the Acting Party's intention to participate in discussions or negotiations with, or to furnish or disclose nonpublic information to, such person, (D) prior to providing any nonpublic information to such person, the Acting Party shall have entered into a confidentiality and standstill agreement with such person (a copy of which it shall have provided to the other party) on terms no less restrictive upon such person, in any respect, than the terms applicable to the other party under the Confidentiality Agreement, which confidentiality and standstill agreement shall not provide such person with any exclusive right to negotiate with the Acting Party or have the effect of preventing the Acting Party from satisfying its obligations under this Agreement, (E) at least twenty-four (24) hours prior to furnishing or causing to be furnished nonpublic information or data to such person, the Acting Party furnishes such information to the other party (to the extent such information has not been previously delivered or made available by the Acting Party to the other party) and (F) prior to so withdrawing, modifying or qualifying the recommendation by its Board of Directors of this Agreement, the Acting Party gives the other party five business days' prior written notice of its intention to do so (unless at the time such notice is otherwise required to be given there are less than five business days prior to the Acting Party's stockholders meeting, in which case the Acting Party shall provide as much notice as is reasonably practicable), and during such time, the Acting Party, if requested by the other party, shall have engaged in good faith negotiations to amend this Agreement (including by making its officers and its financial and legal advisors reasonably available to negotiate) such that the Board of Directors of the Acting Party may continue to recommend the approval of this Agreement.

(c) If DMGI effects a Change in Recommendation, the Orchard shall have the option (the "Stockholder Vote Option"), exercisable within ten business days after such Change in Recommendation, to cause DMGI's Board of Directors to submit this Agreement to its stockholders for the purpose of adopting this Agreement and approving the Merger.

(d) Each of DMGI and the Orchard shall, and shall cause its controlled Affiliates and its and their appropriate officers, directors, agents and representatives to, immediately cease and cause to be terminated any activities, discussions or negotiations conducted before the Execution Date with any persons other than the Orchard or DMGI, as applicable, with respect to any Acquisition Proposal. Each party will promptly (within one day) request each person who has heretofore executed a confidentiality agreement in connection with its consideration of acquiring such party or any portion thereof (including any of its Subsidiaries) to return all nonpublic information heretofore furnished to such person by or on behalf of such party and shall advise the other party of the particulars of such request. Each party will (i) promptly (within 24 hours) advise the other party following receipt of any request for information, of any Acquisition Proposal or any inquiry which could reasonably be expected to lead to an Acquisition Proposal, and the substance thereof (including the terms and conditions of, and the identity of the person making, such request, Acquisition Proposal or inquiry), (ii) promptly (within 24 hours) provide the other party with all written materials received by such party in connection with the foregoing and (iii) keep the other party apprised of any related developments, discussions and negotiations on a current basis. Each of DMGI and the Orchard shall use its reasonable best efforts to enforce any existing confidentiality or standstill agreements to which it or any of its Subsidiaries is a party in accordance with the terms thereof.

(e) As used in this Agreement, "Acquisition Proposal" shall mean any offer, proposal or inquiry relating to, or any indication of interest in, an Alternative Transaction received by a party from any person

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other than the other party, in each case, whether or not in writing and whether or not delivered to such party or to the stockholders of such party generally. As used in this Agreement, an *Alternative Transaction* means any of (i) a transaction (or series of related transactions) pursuant to which any person (or group of persons), directly or indirectly, acquires or would acquire direct or indirect beneficial ownership of more than 15% of the outstanding shares of a party's common stock or outstanding voting power or of any new series or new class of preferred stock that would be entitled to a class or series vote with respect to the Merger or that would be entitled to more than 15% of the fair market value of the outstanding equity interests of such party, whether from such party or pursuant to a tender offer or exchange offer or otherwise, (ii) a merger, share exchange, business combination, consolidation, sale of all or substantially all of the assets, liquidation, dissolution or similar transaction involving a party or any of its significant subsidiaries (as defined in Rule 1-02 of Regulation S-X promulgated by the SEC), (iii) any transaction (or series of related transactions) pursuant to which any person (or group of persons) acquires or would acquire control of assets (including for this purpose the outstanding equity securities of Subsidiaries of such party and securities of the entity surviving any merger or business combination including any of its Subsidiaries) of such party, or any of its Subsidiaries representing more than 15% of the fair market value of all the assets, net revenues or net income of such party and its Subsidiaries, taken as a whole, immediately prior to such transaction (or series of related transactions) or (iv) any other consolidation, business combination, recapitalization or similar transaction (or series of related transactions) involving a party or any of its Subsidiaries.

(f) Nothing contained in this Agreement shall prevent DMGI or its Board of Directors from complying with Rule 14d-9 and Rule 14e-2 under the Exchange Act with respect to an Acquisition Proposal; provided, that such Rules will in no way eliminate or modify the effect that any action pursuant to such Rules would otherwise have under this Agreement.

(g) Any violation of this Section 6.12 by a party's Affiliates or a party's or any of its controlled Affiliates' officers, directors, agents and representatives shall be deemed to be a breach of this Agreement by such party.

**6.13 *Agreement of Affiliates.*** The Orchard has disclosed in Section 6.13 of the Orchard Disclosure Schedule each person whom it reasonably believes may be deemed an affiliate of the Orchard for purposes of Rule 145 under the Securities Act. The Orchard shall use its reasonable efforts to cause each such person to deliver to DMGI, not later than the date of mailing of the Proxy Statement, a written agreement in substantially the form of Exhibit A.

**6.14 *Certificate of Designation; Doing Business As.***

(a) DMGI shall take all such actions as are necessary so that prior to the Effective Time a Certificate of Designative is filed with the Secretary of State of the State of Delaware establishing the terms and number of authorized shares of DMGI Series A Preferred Stock as set forth in Exhibit B attached hereto.

(b) DMGI shall take all such actions as are necessary so that immediately after the Effective Time, DMGI is authorized to do business as The Orchard, Inc. in all jurisdictions where it conducts business.

**6.15 *Certain Tax Matters.*** (a) Each of DMGI and the Orchard shall use its reasonable best efforts to cause the Merger to qualify as a reorganization within the meaning of Section 368(a) of the Code and to obtain the opinions from its respective counsel set forth in Section 7.2(d) or 7.3(f) hereof. This Agreement is intended to constitute a plan of reorganization within the meaning of Treasury Regulation Section 1.368-2(g).

(b) Officers of DMGI, Merger Sub and the Orchard shall execute and deliver to Jackson Walker, L.L.P., tax counsel to DMGI and Merger Sub, and Reed Smith LLP, tax counsel to the Orchard, certificates substantially in the form agreed to by the parties and such law firms at such time or times as may be reasonably requested by such law firms, including at the Effective Time, in connection with such tax counsel's respective delivery of opinions pursuant to Sections 7.2(d) and 7.3(f) hereof. Each of DMGI, Merger Sub and the Orchard shall use its reasonable best efforts not to take or cause to be taken any action

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which would cause to be untrue (or fail to take or cause not to be taken any action which would cause to be untrue) any of the certifications and representations included in the certificates described in this Section 6.15(b).

(c) DMGI and the Orchard shall cooperate in the preparation, execution and filing of all Tax Returns, questionnaires, applications or other documents regarding any real property transfer or gains, sales, use, transfer, value added, stock transfer and stamp taxes, any transfer, recording, registration and other fees and any similar Taxes which become payable in connection with the transactions contemplated by this Agreement that are required or permitted to be filed on or before the Effective Date. Each of DMGI and the Orchard shall pay, without deduction from any amount payable to holders of shares of the Orchard Capital Stock and without reimbursement from the other party, any such Taxes or fees imposed on it by any Governmental Entity (or for which its stockholders are primarily liable), which becomes payable in connection with the transactions contemplated by this Agreement.

6.16 *Headquarters.* The parties hereby acknowledge and agree that DMGI shall be headquartered in New York City.

6.17 *Financial Statements.* Within 15 business days following the Execution Date, the Orchard shall prepare and deliver (or cause to be delivered) to DMGI an audited consolidated balance sheet of the Orchard and its Subsidiaries as of December 31, 2006 and the related audited consolidated statement of operations, shareholders' equity and cash flows for the period then ended along with accompanying footnotes, together with a report thereon by Deloitte & Touche LLP (the "2006 Audited Financial Statements"). Within 20 business days following the Execution Date, the Orchard shall prepare and deliver (or cause to be delivered) to DMGI the Reviewed consolidated balance sheet of the Orchard and its Subsidiaries as of March 31, 2007 and the related Reviewed consolidated statements of operations, shareholders' equity and cash flows of the Orchard and its Subsidiaries for the period then ended, including the condensed, consolidated footnotes thereto (the "Reviewed Quarterly Statements"). As used herein, the term "Reviewed" means reviewed by Deloitte & Touche LLP under the guidance of Statement of Auditing Standards No. 100 Objective and General Principles Governing an Audit of Financial Statements.

6.18 *NY Office Lease.* Between the Execution Date and the Effective Time, the Orchard shall use commercially reasonable efforts to obtain the consent of both the over-landlord and the sub-landlord to the assignment of that certain Sublease between Seligman Data Corp., as sub-landlord and eMusic.com, Inc., as subtenant, dated December 20, 2005.

6.19 *Advances.* The parties hereby acknowledge and agree that any advance to be paid by the Orchard during the period between the Execution Date and the Effective Time to Content owners in connection with the Orchard's acquisition or licensing of Content shall be funded to the Orchard by Dimensional Associates, LLC ("Dimensional") and shall be treated as follows: (a) the first \$250,000 so advanced shall be treated as additional capital contributions made by Dimensional to the Orchard, and (b) any amounts advanced in excess of \$250,000 shall be treated as a loan to the Orchard (the "Advances Loan"), which shall (i) have a maximum aggregate principal amount of \$1,500,000, (ii) bear interest at the applicable federal rate (as defined in Section 1274(d) of the Code) in effect on the date of each such advance (iii) be due and payable upon the earlier of the demand of the holder or one year from the date of such advance. DMGI hereby acknowledges and agrees that it shall assume and be responsible for repaying the Advances Loan to Dimensional as soon as practicable after the Effective Time, but in any event, no later than 30 days after the Effective Time, so long as (x) the Orchard and Dimensional adequately document that the initial \$250,000 was contributed to the Orchard and (y) the Advances Loan is adequately documented.

6.20 *DMGI Options.* Following the Effective Time, subject to the approval of the Compensation Committee of the Board of Directors of DMGI, DMGI shall grant (a) options to purchase DMGI Common Stock and (b) restricted awards of DMGI Common Stock, collectively up to an aggregate of 650,000 shares pursuant to DMGI's Amended and Restated 2005 Stock Plan and form of stock option grant agreement (including the

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vesting provisions thereunder) or the form of restricted stock award grant (including the vesting provisions thereunder), as applicable, to those employees of the Orchard and DMGI in such amounts as shall be approved by the Compensation Committee of the Board of Directors based upon the recommendation of Greg Scholl; provided that such employees remain employees of DMGI or the Surviving Corporation following the Effective Time (or become employees of DMGI).

6.21 *Deferred Stock Awards*. The parties acknowledge and agree that prior to the date hereof the Orchard has entered into Amended and Restated Deferred Stock Award Agreements with each of Greg Scholl and David Pakman (the Recipients ), pursuant to which each of the Recipients is entitled to receive shares of Orchard Common Stock and Series B Preferred Stock in the number and on the terms and conditions set forth therein (the Deferred Stock Awards ). DMGI acknowledges that the Orchard has provided it with copies of the Deferred Stock Awards. DMGI further acknowledges and agrees that to the extent that the shares subject to the Deferred Stock Awards have not been issued (or deemed to have been issued) prior to the Effective Time (a) it shall assume and be responsible for (or shall cause to be assumed or responsible for) performing all of the Orchard's obligations under the Deferred Stock Awards from and after the Effective Time, (b) it shall reserve for issuance that number of shares of DMGI Series A Preferred Stock and DMGI Common Stock, as applicable, that the Deferred B Shares or Deferred Common Shares, as applicable, would have been exchangeable for pursuant to Section 1.4 had such shares already been transferred to the Recipients as of the Effective Time (the Reserved Shares ), which such Reserved Shares shall be deducted from the DMGI Common Limit and the DMGI Preferred Limit available for issuance at the Effective Time, (c) it shall issue and transfer to the Recipients the Reserved Shares at the times, in the amounts and in the manner specified in the Deferred Stock Awards and (d) as soon as practicable following the issuance of shares to the Recipients pursuant to the Deferred Stock Awards, it shall register for resale all such shares of DMGI Common Stock so issued and such shares of DMGI Common Stock issuable upon conversion of the shares of DMGI Series A Preferred Stock so issued, under and in accordance with the provisions of the Securities Act by filing with the SEC a registration statement covering the resale of all such shares on Form S-8 or other appropriate registration statement under the Securities Act.

6.22 *Reverse Split*. The parties acknowledge and agree that to the extent that the Reverse Split is effected and finalized prior to the Effective Time that (a) the number of votes per share of DMGI Series A Preferred Stock and the conversion ratio governing the conversion of DMGI Series A Preferred Stock into shares of DMGI Common Stock shall each be adjusted as appropriate to reflect the impact of the Reverse Split and (b) the DMGI Common Limit shall be adjusted as appropriate to reflect the impact of the Reverse Split.

**ARTICLE VII**

**CONDITIONS PRECEDENT**

7.1 *Conditions to Each Party's Obligation To Effect the Merger*. The respective obligations of the parties to effect the Merger shall be subject to the satisfaction at or prior to the Effective Time of the following conditions:

(a) *Stockholder Approval*. This Agreement (which shall include the requisite approval of the amendment to the DMGI Articles) shall have been approved by the requisite affirmative vote of the holders of DMGI Common Stock entitled to vote thereon and by the requisite affirmative votes of the holders of the Orchard Capital Stock entitled to vote thereon.

(b) *Other Approvals*. The applicable waiting period under the HSR Act shall have expired or been terminated, and all other approvals of Governmental Entities required to consummate the transactions contemplated hereby shall have been obtained and shall remain in full force and effect and all statutory waiting periods in respect thereof shall have expired, other than such approvals the failure of which to obtain would not, either individually or in the aggregate, reasonably be expected to have a Material Adverse Effect on DMGI or the Surviving Corporation (such approvals and the expiration of such waiting periods being referred to herein as the Requisite Regulatory Approvals ).

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(c) *No Injunctions or Restraints; Illegality.* No order, injunction or decree issued by any court or agency of competent jurisdiction or other legal restraint or prohibition preventing the consummation of the Merger or any of the other transactions contemplated by this Agreement shall be in effect. No statute, rule, regulation, order, injunction or decree shall have been enacted, entered, promulgated or enforced by any Governmental Entity which prohibits or makes illegal consummation of the Merger.

*7.2 Conditions to Obligations of DMGI.* The obligation of DMGI to effect the Merger is also subject to the satisfaction, or waiver by DMGI, at or prior to the Effective Time, of the following conditions:

(a) *Representations and Warranties.* The representations and warranties of the Orchard set forth in this Agreement that are qualified by materiality or Material Adverse Effect shall be true and correct in all respects, and the representations and warranties that are not qualified by materiality or Material Adverse Effect shall be true and correct in all material respects, other than representations and warranties that expressly speak as of a specific date or time (which need only be true and correct in all respects or true and correct in all material respects, as applicable, as of such date or time). DMGI shall have received a certificate signed on behalf of the Orchard by the Chief Executive Officer of the Orchard to the foregoing effect.

(b) *Performance of Obligations of the Orchard.* The Orchard shall have performed in all material respects the obligations required to be performed by it under this Agreement at or prior to the Closing Date, and DMGI shall have received a certificate signed on behalf of the Orchard by the Chief Executive Officer of the Orchard to such effect.

(c) *Officers and Directors.* Orchard shall have complied with its obligations under Section 6.10(b) and Section 6.11(b) hereof.

(d) *Tax Opinions.* DMGI shall have received the opinion of Jackson Walker, L.L.P., or such other counsel reasonably satisfactory to DMGI in form and substance reasonably satisfactory to DMGI dated as of the Closing Date, rendered on the basis of facts, representations and assumptions set forth in such opinions and the certificates obtained from officers of DMGI, Merger Sub and the Orchard, all of which are consistent with the state of facts existing as of the Effective Time, to the effect that the Merger will qualify as a reorganization within the meaning of Section 368(a) of the Code. In rendering the opinion described in this Section 7.2(d), Jackson Walker, L.L.P. shall have received and may rely upon the certificates and representations referred to in Section 6.15(b) hereof.

(e) *Affiliate Agreements.* DMGI shall have received from each person named in Section 6.13 of the Orchard Disclosure Schedule an executed agreement substantially in the form of Exhibit B hereto.

(f) *Release of Claims.* DMGI shall have received from each of the Orchard's shareholders a release, in substantially the form attached hereto as Exhibit C.

*7.3 Conditions to Obligations of the Orchard.* The obligation of the Orchard to effect the Merger is also subject to the satisfaction or waiver by the Orchard at or prior to the Effective Time of the following conditions:

(a) *Representations and Warranties.* The representations and warranties of DMGI set forth in this Agreement that are qualified by materiality or Material Adverse Effect shall be true and correct in all respects, and the representations and warranties that are not qualified by materiality or Material Adverse Effect shall be true and correct in all material respects, other than representations and warranties that expressly speak as of a specific date or time (which need only be true and correct in all respects or true and correct in all material respects, as applicable, as of such date or time). The Orchard shall have received a certificate signed on behalf of DMGI by the Chief Executive Officer of DMGI to the foregoing effect.

(b) *Performance of Obligations of DMGI.* DMGI shall have performed in all material respects the obligations required to be performed by it under this Agreement at or prior to the Closing Date, and the Orchard shall have received a certificate signed on behalf of DMGI by the Chief Executive Officer of DMGI to such effect.

(c) *Certificate of Designation.* DMGI shall have complied with its obligations under Section 6.14(a).



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(d) *Officers and Directors.* DMGI shall have complied with its obligations under Section 6.10(a) and Section 6.11(a) hereof.

(e) *Officer and Director Resignations.* Each of the officers and directors of DMGI as listed in the Orchard Disclosure Schedule shall have submitted to DMGI his or her resignation in such capacity to be effective as of the Effective Time.

(f) *Tax Opinions.* The Orchard shall have received the opinion of Reed Smith LLP, or such other counsel reasonably satisfactory to the Orchard, in form and substance reasonably satisfactory to the Orchard, dated as of the Closing Date, rendered on the basis of facts, representations and assumptions set forth in such opinions and the certificates obtained from officers of DMGI, Merger Sub and the Orchard, all of which are consistent with the state of facts existing as of the Effective Time, to the effect that (i) the Merger will qualify as a reorganization within the meaning of Section 368(a) of the Code, and (ii) no gain or loss will be recognized by the stockholders of the Orchard as a result of the exchange of their shares of Common Stock solely for shares of DMGI Common Stock pursuant to the Merger, except with respect to cash, if any, received in lieu of fractional shares of DMGI Common Stock, (iii) no gain or loss should be recognized by the stockholders of the Orchard as a result of the exchange of their shares of Series A Preferred Stock solely for shares of DMGI Series A Preferred Stock and, possibly, DMGI Common Stock, as the case may be, pursuant to the Merger, except with respect to cash, if any, received in lieu of fractional shares of DMGI Capital Stock, (iv) no gain or loss should be recognized by the stockholders of the Orchard as a result of the exchange of their shares of Series B Preferred Stock solely for shares of DMGI Series A Preferred Stock and/or DMGI Common Stock, as the case may be, pursuant to the Merger, except with respect to cash, if any, received in lieu of fractional shares of DMGI Capital Stock, and (v) no gain or loss should be recognized by the stockholders of the Orchard as a result of the exchange of their shares of Series C Preferred Stock solely for shares of DMGI Series A Preferred Stock and, possibly, DMGI Common Stock, as the case may be, pursuant to the Merger, except with respect to cash, if any, received in lieu of fractional shares of DMGI Capital Stock. In rendering the opinion described in this Section 7.3(f), Reed Smith LLP shall have received and may rely upon the certificates and representations referred to in Section 6.15(b) hereof.

(g) *Registration Rights Agreement.* DMGI shall have executed and delivered a Registration Rights Agreement in the form attached hereto as Exhibit D.

(h) *Lien Releases.* DMGI shall have secured the termination of all liens on its assets (and the assets of its Subsidiaries), including, those liens set forth on Section 4.15 of the DMGI Disclosure Schedule, and shall have provided the Orchard with evidence (reasonably satisfactory to the Orchard) of the termination of all such liens; provided, however that the lien filed against Digital Rights Agency LLC by Hewlett Packard, as provided for in Section 4.15 of the DMGI Disclosure Schedule, shall not be terminated.

**ARTICLE VIII**

**TERMINATION AND AMENDMENT**

8.1 *Termination.* This Agreement may be terminated at any time prior to the Effective Time, whether before or after approval of this Agreement by the stockholders of DMGI or the Orchard:

(a) by mutual consent of DMGI and the Orchard in a written instrument, if the Board of Directors of each so determines by a vote of a majority of the members of its entire Board of Directors;

(b) by either the Board of Directors of DMGI or the Board of Directors of the Orchard if any Governmental Entity that must grant a Requisite Regulatory Approval has denied approval of the Merger and such denial has become final and nonappealable or any Governmental Entity of competent jurisdiction shall have issued a final nonappealable order permanently enjoining or otherwise prohibiting the consummation of the transactions contemplated by this Agreement, unless the failure to obtain a Requisite Regulatory Approval shall be due to the failure of the party seeking to terminate this Agreement to perform or observe the covenants and agreements of such party set forth herein;

(c) by either the Board of Directors of DMGI or the Board of Directors of the Orchard if the Merger shall not have been consummated on or before December 31, 2007, unless the failure of the Closing to occur

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by such date shall be due to the failure of the party seeking to terminate this Agreement to perform or observe the covenants and agreements of such party set forth herein;

(d) by either the Board of Directors of DMGI or the Board of Directors of the Orchard (provided that the terminating party is not then in material breach of any representation, warranty, covenant or other agreement contained herein) if there shall have been a breach of any of the covenants or agreements or any of the representations or warranties set forth in this Agreement on the part of the Orchard, in the case of a termination by DMGI, or DMGI, in the case of a termination by the Orchard, which breach, either individually or in the aggregate, would constitute, if occurring or continuing on the Closing Date, the failure of the conditions set forth in Section 7.2 or 7.3, as the case may be, and which is not cured within 30 days following written notice to the party committing such breach or by its nature or timing cannot be cured prior to the Closing Date;

(e) by either the Board of Directors of DMGI or the Board of Directors of the Orchard if either party shall have failed to obtain the requisite affirmative vote of its stockholders required to consummate the transactions contemplated hereby at the DMGI Meeting or the Orchard Meeting, as applicable, or any adjournment or postponement thereof at which a vote on such approval was taken; provided that a party shall not have the right to terminate this Agreement pursuant to this Section 8.1(e) as a result of that party's stockholders failing to approve this Agreement at the DMGI Meeting or the Orchard Meeting, as applicable, if such party has failed to comply in all material respects with its obligations under Sections 6.1(a), 6.3 or 6.12;

(f) by the Orchard, if the Board of Directors of DMGI shall have (i) failed to recommend in the Proxy Statement the approval of this Agreement, (ii) effected a Change in Recommendation, or resolved to do so, or failed to recommend against acceptance of a tender offer or exchange offer for outstanding DMGI Common Stock that has been publicly disclosed (other than by the Orchard or an Affiliate of the Orchard) within 10 business days after the commencement of such tender or exchange offer, in any such case whether or not permitted by the terms hereof or (iii) knowingly breached its obligations under Section 6.1(a), 6.3 or 6.12 in any material respect;

(g) by DMGI, if the Board of Directors of the Orchard shall have (i) effected a Change in Recommendation, or resolved to do so, or (ii) knowingly breached its obligations under Section 6.1(a), 6.3 or 6.12 in any material respect;

(h) by DMGI, if within five business days of the Orchard's delivery of the 2006 Audited Financial Statements to DMGI, DMGI's Board of Directors delivers written notification to the Orchard of (i) its good faith determination that any of the financial position, results of operations or cash flows of the Orchard as set forth in the 2006 Audited Financial Statements has changed from that set forth in the Unaudited Financial Statements in such a manner that the amount of change could be deemed to have a Material Adverse Effect on the Orchard and (ii) its intention to terminate this Agreement; provided, however that notwithstanding anything to the contrary herein, for purposes of this Section 8.1(i), non-cash compensation charges shall not be considered in determining whether a Material Adverse Effect shall be deemed to have occurred;

(i) by DMGI, if within five business days of the Orchard's delivery of the Reviewed Quarterly Statements to DMGI, DMGI's Board of Directors delivers written notification to the Orchard of (i) its good faith determination that any of the financial position, results of operations or cash flows of the Orchard as set forth in the Reviewed Quarterly Statements has changed from that set forth in the Draft Quarterly Statements in such a manner that the amount of change could be deemed to have a Material Adverse Effect on the Orchard and (ii) its intention to terminate this Agreement; provided, however that notwithstanding anything to the contrary herein, for purposes of this Section 8.1(j), non-cash compensation charges shall not be considered in determining whether a Material Adverse Effect shall be deemed to have occurred;

(j) by DMGI if within two business days of the Orchard's delivery of the 2006 Audited Financial Statements to DMGI, SMH Capital Inc. rescinds or withdraws the Fairness Opinion;

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(k) by DMGI, if the Board of Directors of DMGI shall have effected a Change in Recommendation and the Orchard shall not have elected the Stockholder Vote Option within ten business days of being notified of the DMGI Board of Director s Change of Recommendation; or

(l) by the Orchard, if the Board of Directors of the Orchard shall have effected a Change in Recommendation.

8.2 *Effect of Termination.* (a) In the event of termination of this Agreement by either DMGI or the Orchard as provided in Section 8.1, this Agreement shall forthwith become void and have no effect, and none of DMGI, the Orchard, any of their respective Subsidiaries or any of the officers or directors of any of them shall have any liability of any nature whatsoever hereunder, or in connection with the transactions contemplated hereby, except that (i) Sections 6.2(b) and 8.2 and Article IX (other than Section 9.1) shall survive any termination of this Agreement and (ii) notwithstanding anything to the contrary contained in this Agreement, neither DMGI nor the Orchard shall be relieved or released from any liabilities or damages (which the parties acknowledge and agree shall not be limited to reimbursement of expenses or out-of-pocket costs, and may include to the extent proven the benefit of the bargain lost by a party s shareholders (taking into consideration relevant matters, including other combination opportunities and the time value of money), which shall be deemed in such event to be damages of such party) arising out of its willful breach of any provision of this Agreement.

(b)(i) In the event that (A) a Pre-Termination Takeover Proposal Event (as hereinafter defined) shall have occurred after the Execution Date with respect to the Orchard and thereafter this Agreement is terminated by either DMGI or the Orchard pursuant to Section 8.1(e), or thereafter this Agreement is terminated by DMGI pursuant to Section 8.1(d) as a result of a willful material breach of this Agreement by the Orchard or pursuant to Section 8.1(c) if the failure to consummate the Merger on or before the date contained in Section 8.1(c) results from any willful material breach of this Agreement by the Orchard and (B) either (1) prior to the date that is twelve (12) months after the date of such termination the Orchard consummates an Alternative Transaction, the Orchard shall, on the date an Alternative Transaction is consummated, pay DMGI a fee equal to \$1.11 million plus DMGI s reasonable costs and expenses incurred in connection with the transactions contemplated by this Agreement, not to exceed \$500,000 in the aggregate, by wire transfer of same day funds, or (2) prior to the date that is twelve (12) months after the date of such termination the Orchard enters into a definitive acquisition agreement related to any Alternative Transaction ( Acquisition Agreement ), the Orchard shall, on the date of entry into such Acquisition Agreement, pay DMGI a fee equal to \$1.11 million plus DMGI s reasonable costs and expenses incurred in connection with the transactions contemplated by this Agreement, not to exceed \$500,000 in the aggregate, by wire transfer of same day funds.

(ii) In the event that this Agreement is terminated by DMGI pursuant to Section 8.1(g) or by the Orchard pursuant to Section 8.1(l), then the Orchard shall pay DMGI a fee equal to \$1.11 million plus DMGI s reasonable costs and expenses incurred in connection with the transactions contemplated by this Agreement, not to exceed \$500,000 in the aggregate, by wire transfer of same day funds on the date of termination.

(c)(i) In the event that (A) a Pre-Termination Takeover Proposal Event (as hereinafter defined) shall have occurred after the Execution Date with respect to DMGI and thereafter this Agreement is terminated by either DMGI or the Orchard pursuant to Section 8.1(e), or thereafter this Agreement is terminated by the Orchard pursuant to Section 8.1(d) as a result of a willful material breach of this Agreement by DMGI or pursuant to Section 8.1(c) if the failure to consummate the Merger on or before the date contained in Section 8.1(c) results from any willful material breach of this Agreement by DMGI and (B) either (1) prior to the date that is twelve (12) months after the date of such termination DMGI consummates an Alternative Transaction, DMGI shall, on the date an Alternative Transaction is consummated, pay the Orchard a fee equal to \$1.11 million plus the Orchard s reasonable costs and expenses incurred in connection with the transactions contemplated by this Agreement, not to exceed \$500,000 in the aggregate, by wire transfer of same day funds or (2) prior to the date that is twelve (12) months after the date of such termination DMGI enters into an Acquisition Agreement, DMGI shall, on the date of entry into such Acquisition Agreement,

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pay the Orchard a fee equal to \$1.11 million plus the Orchard's reasonable costs and expenses incurred in connection with the transactions contemplated by this Agreement, not to exceed \$500,000 in the aggregate, by wire transfer of same day funds; provided, however, notwithstanding anything to the contrary contained in this Section 8.1(c)(i), that if this Agreement is terminated by either DMGI or the Orchard pursuant to Section 8.1(e) after the Orchard has elected to use the Stockholder Vote Option, any fee otherwise payable pursuant to this Section 8.2(c)(i) shall be reduced by one half.

(ii) In the event that this Agreement is terminated by the Orchard pursuant to Section 8.1(f) or by DMGI pursuant to Section 8.1(k), then DMGI shall pay the Orchard a fee equal to \$1.11 million plus the Orchard's reasonable costs and expenses incurred in connection with the transactions contemplated by this Agreement, not to exceed \$500,000 in the aggregate, by wire transfer of same day funds on the date of termination.

(d) For purposes of this Section 8.2, a Pre-Termination Takeover Proposal Event shall be deemed to occur if, prior to the event giving rise to the right to terminate this Agreement, a bona fide Acquisition Proposal shall have been made known to the Orchard (in the case of an Acquisition Proposal relating to the Orchard) or shall have been made known to DMGI (in the case of any Acquisition Proposal relating to DMGI) or has been made directly to its stockholders generally or any person shall have publicly announced an Acquisition Proposal or an intention (whether or not conditional) to make an Acquisition Proposal (the term Acquisition Proposal, as used in the definition of Acquisition Proposal for purposes of this Section 8.2, and as used in this Section 8.2, shall have the same meaning set forth in Section 6.12 except that the references to more than 15% contained in the definition of Alternative Transaction shall be deemed to be references to 40% or more and such definition shall not include any merger, share exchange, consolidation, business combination or similar transaction where (i) the holders of shares of such party immediately prior to such transaction (or series of related transactions) would continue, in the aggregate, to own at least a majority of the outstanding shares of common stock and the outstanding voting power of the surviving or resulting entity (or its ultimate parent) in the transaction (or series of related transactions) immediately after the consummation thereof in substantially the same proportion as such holders held the shares of such party's common stock immediately prior to the consummation thereof and (ii) such party would retain at least a majority of the surviving or resulting entity's (or its ultimate parent's) board of directors).

(e) Notwithstanding anything to the contrary herein, but without limiting the right of any party to recover liabilities or damages, the maximum aggregate amount of fees payable by a single party under this Section 8.2 shall be \$1.61 million.

(f) Each of DMGI and the Orchard acknowledges that the agreements contained in this Section 8.2 are an integral part of the transactions contemplated by this Agreement, and that, without these agreements, the other party would not enter into this Agreement; accordingly, if DMGI or the Orchard, as the case may be, fails promptly to pay the amount due pursuant to this Section 8.2, and, in order to obtain such payment, the other party commences a suit which results in a judgment against the non-paying party for the fee set forth in this Section 8.2, such non-paying party shall pay the costs and expenses of the other party (including attorneys' fees and expenses) in connection with such suit. In addition, if DMGI or the Orchard, as the case may be, fails to pay the amounts payable in this Section 8.2, then such party shall pay interest on such overdue amounts at a rate per annum equal to the prime rate (as announced by JPMorgan Chase & Co. or any successor thereto) in effect on the date on which such payment was required to be made.

8.3 *Amendment.* Subject to compliance with applicable law and Section 1.1(b), this Agreement may be amended by the parties hereto, by action taken or authorized by their respective Boards of Directors, at any time before or after approval of the matters presented in connection with Merger by the stockholders of DMGI and the Orchard; provided, however, that after any approval of the transactions contemplated by this Agreement by the respective stockholders of DMGI or the Orchard, there may not be, without further approval of such stockholders, any amendment of this Agreement that changes the amount or the form of the consideration to be delivered hereunder to the holders of Orchard Capital Stock, other than as contemplated by this Agreement. This Agreement may not be amended except by an instrument in writing signed on behalf of each of the parties hereto.



Edgar Filing: NETFLIX INC - Form 4

Jackson Walker L.L.P.

1401 McKinney

Suite 1900

Houston, TX 77010

Attention: Richard S. Roth

Facsimile: (713) 752-4221

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(b) if to the Orchard, to:                   The Orchard Enterprises, Inc.  
  
100 Park Avenue  
  
2<sup>nd</sup> Floor  
  
New York, NY 10017  
  
Attention: Chief Executive Officer  
  
Telecopier: (212) 201-9292

and

Attention: General Counsel  
  
Telecopier: (212) 201-9203

With a copy to:

Reed Smith LLP  
  
599 Lexington Avenue  
  
New York, NY 10022  
  
Attention: David M. Grimes

Antone P. Manha, Jr.

Facsimile: (212) 521-5450

*9.5 Interpretation.* When a reference is made in this Agreement to Articles, Sections, Exhibits or Schedules, such reference shall be to an Article or Section of or Exhibit or Schedule to this Agreement unless otherwise indicated. The table of contents and headings contained in this Agreement are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement. Whenever the words include, includes or including are used in this Agreement, they shall be deemed to be followed by the words without limitation. For all purposes hereof, documents shall have been deemed to have been made available to a party to the extent such documents are publicly available on the EDGAR system of the SEC. The Orchard Disclosure Schedule and the DMGI Disclosure Schedule, as well as all other schedules and all exhibits hereto, shall be deemed part of this Agreement and included in any reference to this Agreement. To the extent either of such Schedules contains language expressing agreements of the parties, such agreements shall be deemed to be enforceable to the same extent as if they were set forth in Article VI of this Agreement.

*9.6 Counterparts.* This Agreement may be executed in counterparts, all of which shall be considered one and the same agreement and shall become effective when counterparts have been signed by each of the parties and delivered to the other parties, it being understood that all parties

need not sign the same counterpart.

*9.7 Entire Agreement; Effect on Old Agreement.* This Agreement (including the documents and the instruments referred to herein) together with the Confidentiality Agreement constitutes the entire agreement and supersedes all prior agreements and understandings, both written and oral, among the parties with respect to the subject matter hereof. For the avoidance of doubt, this Agreement amends, restates and supersedes the Old Agreement in its entirety and the Old Agreement is null and void and shall have no further force or effect.

*9.8 Governing Law.* This Agreement shall be governed and construed in accordance with the laws of the State of New York applicable to contracts executed in and to be performed entirely within the State of New York, without regard to any applicable conflicts of law principles, except as specifically provided herein.

*9.9 Publicity.* Except as otherwise required by applicable law or the rules of the NASDAQ, neither DMGI nor the Orchard shall, or shall permit any of its Subsidiaries to, issue or cause the publication of any press release or other public announcement with respect to, or otherwise make any public statement concerning, the transactions contemplated by this Agreement without the consent of the Orchard, in the case of a proposed announcement or statement by DMGI, or DMGI, in the case of a proposed announcement or statement by the Orchard, which consent shall not be unreasonably withheld.



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9.10 *Assignment; Third Party Beneficiaries.* Neither this Agreement nor any of the rights, interests or obligations shall be assigned by any of the parties hereto (whether by operation of law or otherwise) without the prior written consent of the other parties. Subject to the preceding sentence, this Agreement will be binding upon, inure to the benefit of and be enforceable by the parties and their respective successors and assigns. Except (a) as otherwise specifically provided in Section 6.7, and (b) for the rights of DMGI and the Orchard, on behalf of their respective stockholders, to pursue damages pursuant Section 8.2(a)(ii) hereof, this Agreement (including the documents and instruments referred to herein) is not intended to confer upon any person other than the parties hereto any rights or remedies hereunder.

9.11 *Specific Performance.* The parties hereto agree that irreparable damage would occur if any provision of this Agreement were not performed in accordance with the terms hereof and, accordingly, that the parties shall be entitled to an injunction or injunctions to prevent breaches of this Agreement or to enforce specifically the performance of the terms and provisions hereof (including the parties' obligation to consummate the Merger) in any federal court located in the State of New York (or, to the extent that subject matter or personal jurisdiction does not exist in any such federal court, then in any New York state court located in New York County), in addition to any other remedy to which they are entitled at law or in equity. Each of the parties hereto submits to the jurisdiction of any such court in any suit, action or proceeding seeking to enforce any provision of, or based on any matter arising out of, or in connection with, this Agreement or the transactions contemplated hereby and hereby irrevocably waives the benefit of jurisdiction derived from present or future domicile or otherwise in such action or proceeding. Each party hereto irrevocably waives, to the fullest extent permitted by law, any objection that it may now or hereafter have to the laying of the venue of any such suit, action or proceeding in any such court or that any such suit, action or proceeding brought in any such court has been brought in an inconvenient forum.

[Signature Page Follows]

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IN WITNESS WHEREOF, The Orchard Enterprises, Inc., Digital Music Group, Inc. and DMGI New York, Inc. have caused this Agreement to be executed by their respective officers thereunto duly authorized as of the date first above written.

THE ORCHARD ENTERPRISES INC.

By: /s/ DANIEL STEIN  
Name: **Daniel Stein**  
Title: **Vice President and Director**

DIGITAL MUSIC GROUP, INC.

By: /s/ CLAYTON TRIER  
Name: **Clayton Trier**  
Title: **Chairman of the Board**

DMGI NEW YORK, INC.

By: /s/ CLAYTON TRIER  
Name: **Clayton Trier**  
Title: **President**

[Signature Page to Agreement and Plan of Merger]

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**Exhibit A**

**Form of Affiliate Letter**

Digital Music Group, Inc.

2151 River Plaza Drive

Suite 200

Sacramento, CA 95833

Ladies and Gentlemen:

I have been advised that as of the date hereof I may be deemed to be an affiliate of The Orchard Enterprises Inc., a New York corporation, as the term affiliate is defined for purposes of paragraphs (c) and (d) of Rule 145 of the rules and regulations of the Securities and Exchange Commission under the Securities Act of 1933, as amended. I have been further advised that pursuant to the terms of the Agreement and Plan of Merger dated as of July 10, 2007, by and between the Orchard and Digital Music Group, Inc. and DMGI New York, Inc., the Orchard shall be merged with and into Merger Sub.

All terms used in this letter but not defined herein shall have the meanings ascribed thereto in the Merger Agreement.

I represent, warrant and covenant to DMGI that in the event I receive any DMGI Capital Stock as a result of the Merger:

(a) The DMGI Capital Stock to be received by me as a result of the Merger will be taken for my own account, and not for others, directly or indirectly, in whole or part, and I shall not make any sale, transfer or other disposition of DMGI Capital Stock in violation of the Act or the Rules and Regulations.

(b) I have carefully read this letter and the Merger Agreement and discussed its requirements and other applicable limitations upon my ability to sell, transfer or otherwise dispose of DMGI Capital Stock to the extent I believed necessary with my counsel or counsel for the Orchard.

(c) I have been advised that the issuance of DMGI Capital Stock to me pursuant to the Merger will not be registered with the Commission under the Act on a Registration Statement but will be subject to certain registration rights. I have also been advised that, since at the time the Merger will be submitted for a vote of the stockholders of the Orchard I may be deemed to have been an affiliate of the Orchard and the distribution by me of DMGI Capital Stock has not been registered under the Act, I may not sell, transfer or otherwise dispose of DMGI Capital Stock issued to me in the Merger unless (i) such sale, transfer or other disposition has been registered under the Act, (ii) such sale, transfer or other disposition is made in conformity with the volume and other limitations of Rule 145 promulgated by the Commission under the Act, or (iii) in the opinion of counsel reasonably acceptable to DMGI, such sale, transfer or other disposition is otherwise exempt from registration under the Act.

(d) I understand that, except to the extent set forth in the Registration Rights Agreement, DMGI is under no obligation to register the sale, transfer or other disposition of DMGI Capital Stock by me or on my behalf under the Act or to take any other action necessary in order to make compliance with an exemption from such registration available.

(e) I also understand that stop transfer instructions will be given to DMGI's transfer agents with respect to DMGI Capital Stock and that there will be placed on the certificates for DMGI Capital Stock issued to me, or any substitutions therefor, a legend stating in substance:

The securities represented by this certificate have been issued in a transaction to which Rule 145 promulgated under the Securities Act of 1933 applies and may only be sold or otherwise transferred in

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compliance with the requirements of Rule 145 or pursuant to a registration statement under said act or an exemption from such registration.

(f) I also understand that unless the transfer by me of my DMGI Capital Stock has been registered under the Act or is a sale made in conformity with the provisions of Rule 145, DMGI reserves the right to put the following legend on the certificates issued to my transferee:

The shares represented by this certificate have not been registered under the Securities Act of 1933 and were acquired from a person who received such shares in a transaction to which Rule 145 promulgated under the Securities Act of 1933 applies. The shares have been acquired by the holder not with a view to, or for resale in connection with, any distribution thereof within the meaning of the Securities Act of 1933 and may not be offered, sold, pledged or otherwise transferred except in accordance with an exemption from the registration requirements of the Securities Act of 1933.

It is understood and agreed that the legends set forth above shall be removed by delivery of substitute certificates without such legend, and/or the issuance of a letter to DMGI's transfer agent removing such stop transfer instructions, and the above restrictions on sale will cease to apply, if (A) one year (or such other period as may be required by Rule 145(d)(2) under the Securities Act or any successor thereto) shall have elapsed from the Closing Date and the provisions of such Rule are then available to me; or (B) if two years (or such other period as may be required by Rule 145(d)(3) under the Securities Act or any successor thereto) shall have elapsed from the Effective Date and the provisions of such Rule are then available to me; or (C) I shall have delivered to DMGI (i) a copy of a letter from the staff of the Commission, or an opinion of counsel in form and substance reasonably satisfactory to DMGI, or other evidence reasonably satisfactory to DMGI, to the effect that such legend and/or stop transfer instructions are not required for purposes of the Securities Act or (ii) evidence or representations reasonably satisfactory to DMGI that the securities represented by such certificates are being or have been transferred in a transaction made in conformity with the provisions of Rule 145 under the Securities Act or pursuant to an effective registration under the Securities Act.

I recognize and agree that the foregoing provisions also apply to (i) my spouse, (ii) any relative of mine or my spouse occupying my home, (iii) any trust or estate in which I, my spouse or any such relative owns at least 10% beneficial interest or of which any of us serves as trustee, executor or in any similar capacity and (iv) any corporate or other organization in which I, my spouse or any such relative owns at least 10% of any class of equity securities or of the equity interest.

By its acceptance hereof, DMGI agrees, for a period of two years after the Effective Time that it will use commercially reasonable efforts to file on a timely basis all reports required to be filed by it pursuant to Section 13 of the Exchange Act, so that the public information provisions of Rule 144(c) under the Securities Act are satisfied and the resale provisions of Rules 145(d)(1) and (2) under the Securities Act are therefore available to the undersigned in the event the undersigned desires to transfer any DMGI Capital Stock issued to the undersigned in communication with the Merger.

It is understood and agreed that this Letter Agreement shall terminate and be of no further force and effect if the Merger Agreement is terminated in accordance with its terms.

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Execution of this letter should not be construed as an admission on my part that I am an affiliate of the Orchard as described in the first paragraph of this letter or as a waiver of any rights I may have to object to any claim that I am such an affiliate on or after the date of this letter.

Very truly yours,

By:  
Name:

Accepted this [ ] day of [ ], 2007

Digital Music Group, Inc.

By:  
Name:  
Title:

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**EXHIBIT B**

**Terms of DMGI**

**Preferred Series A Stock**

*CONVERTIBLE PREFERRED STOCK.*

Four hundred forty-eight thousand eight hundred thirty-three (448,833) shares of the authorized Preferred Stock of the Corporation are hereby designated Series A Convertible Preferred Stock (the *Series A Preferred Stock*), each with the following rights, preferences, powers, privileges and restrictions, qualifications and limitations.

1. *Dividends.* Except as provided herein, the holders of Series A Preferred Stock shall not be entitled to receive any dividends. The Corporation shall not declare, pay or set aside any dividends on shares of Common Stock unless the holders of the Series A Preferred Stock then outstanding shall first receive, or simultaneously receive, a dividend in an amount equal to the dividend they would have received if all outstanding shares of Series A Preferred Stock (subject in each case to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization affecting such shares) had been converted into shares of Common Stock on the record date fixed for the payment of such dividend.

2. *Priority in Certain Payments and Distributions.*

(a) *Payments to Holders of Series A Preferred Stock Upon Liquidation, Dissolution or Winding Up of the Corporation.* In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Corporation, the holders of shares of Series A Preferred Stock then outstanding shall be entitled to be paid out of the assets of the Corporation available for distribution to its stockholders (whether in cash, securities or other property), before any payment shall be made to the holders of Common Stock or any other class or series of stock ranking on liquidation junior to the Series A Preferred Stock by reason of their ownership thereof, an amount equal to the greater of (i) \$55.70 per share (subject in each case to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization affecting such shares), plus any dividends declared pursuant to Subsection 1 above but unpaid thereon, and (ii) such amount per share as would have been payable had each share of the Series A Preferred Stock been converted into Common Stock pursuant to Subsection 4 below immediately prior to such liquidation, dissolution or winding up, plus any dividends declared pursuant to Subsection 1 above but unpaid thereon (the greater of (i) and (ii) is hereinafter referred to as the *Series A Liquidation Amount*). If, upon any such liquidation, dissolution or winding up of the Corporation, the remaining assets of the Corporation available for distribution to its stockholders shall be insufficient to pay the holders of shares of Series A Preferred Stock, and any class or series of stock ranking on liquidation on a parity with the Series A Preferred Stock, the full amount to which such holders shall be entitled, the holders of shares of Series A Preferred Stock, and any class or series of stock ranking on liquidation on a parity with the Series A Preferred Stock, shall share ratably in any distribution of the remaining assets and funds of the Corporation in proportion to the respective amounts which would otherwise be payable in respect of the shares held by them upon such distribution if all amounts payable on or with respect to such shares were paid in full.

(b) *Payments to Holders of Junior Stock Upon Liquidation, Dissolution or Winding Up of the Corporation.* After the payment of all preferential amounts required to be paid to the holders of the Series A Preferred Stock and any other class or series of stock of the Corporation ranking on liquidation senior to or on parity with the Series A Preferred Stock, upon the dissolution, liquidation or winding up of the Corporation, the holders of shares of Common Stock or any other class or series of stock ranking on liquidation junior to the Series A Preferred Stock then outstanding shall be entitled to receive the remaining assets and funds of the Corporation available for distribution to its stockholders.

(c) *Payments and Distributions Upon Change of Control Event.* For so long as any shares of Series A Preferred Stock remain outstanding, the Corporation shall not enter into or otherwise effect any transaction (or

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series of transactions) constituting a Change of Control Event (as defined below) unless (i) with respect to a Change of Control Event involving the sale or exclusive license of all or substantially all of the Corporation's assets or intellectual property (pursuant to a single transaction or a series of transactions) the Corporation shall as promptly as practicable thereafter liquidate, dissolve and wind up the Corporation and distribute the assets of the Corporation (whether in cash, securities or other property) to the Corporation's stockholders in accordance with Subsections 2(a) and 2(b) and (ii) with respect to a Change of Control Event involving a transaction in which the stockholders of the Corporation will receive consideration from an unrelated third party, the agreement governing such transaction (or series of transactions) provides that the consideration payable to the stockholders of the Corporation (whether in cash, securities or other property) shall be allocated among them in accordance with Subsections 2(a) and 2(b).

For purposes of this Section 2(c), a *Change of Control Event* shall mean any of the following:

(A) a merger or consolidation in which: (1) the Corporation is a constituent party; or (2) a subsidiary of the Corporation is a constituent party, except in either case, any such merger or consolidation involving the Corporation or a subsidiary in which the holders of capital stock of the Corporation immediately prior to such merger or consolidation continue to hold immediately following such merger or consolidation, in approximately the same proportion as such shares were held immediately prior to such merger or consolidation, at least 51%, by voting power and economic interest, of the capital stock of (x) the surviving or resulting corporation or (y) if the surviving or resulting corporation is a wholly owned subsidiary of another corporation immediately following such merger or consolidation, the parent corporation of such surviving or resulting corporation;

(B) the sale or exclusive license, in a single transaction or series of related transactions, by the Corporation of all or substantially all of the assets or intellectual property of the Corporation (except where such sale or exclusive license is to a wholly owned subsidiary of the Corporation); or

(C) the sale, in a single transaction or series of related transactions, by the Corporation or its stockholders of more than 50% of the outstanding stock by voting power or economic interest (or securities convertible into stock) of the Corporation, except any such sale or series of sales in which the holders of capital stock of the Corporation immediately prior to such sale or sales continue to hold immediately following such sale or sales, in approximately the same proportion as such shares were held immediately prior to such sale or sales, at least 51%, by voting power and economic interest, of the capital stock of the Corporation.

3. *Voting.*

(a) *General Rights.* On any matter presented to the stockholders of the Corporation for their action or consideration at any meeting of stockholders of the Corporation (or by written action of stockholders in lieu of meeting), each holder of outstanding shares of Series A Preferred Stock shall be entitled to the number of votes equal to the number of whole shares of Common Stock into which the shares of Series A Preferred Stock held by such holder are convertible as of the record date for determining stockholders entitled to vote on such matter. Except as provided by law or by the provisions of Subsection 2(c) above and Subsection 3(b) below, holders of Series A Preferred Stock shall vote together with the holders of Common Stock, and with the holders of any other series of Preferred Stock the terms of which so provide, as a single class.

(b) *Separate Vote of Series A Preferred.* For so long as any shares of Series A Preferred Stock remain outstanding, in addition to any other vote or consent required herein or by law, the vote or written consent of the holders of at least a majority of the then outstanding Series A Preferred Stock, consenting or voting (as the case may be) separately as a class, shall be necessary for effecting or validating the following actions:

(i) Any amendment, alteration or repeal (including any amendment, alteration or repeal effected by a merger, consolidation or similar business combination) of any provision of the Certificate of Incorporation

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or the Bylaws of the Corporation (including any filing of a Certificate of Designation) that affects adversely the voting powers, preferences, dividends or other special rights or privileges, qualifications, limitations or restrictions of the Series A Preferred Stock;

(ii) Any increase or decrease (other than by redemption or conversion) in the authorized number of shares of Preferred Stock;

(iii) Any authorization or any designation, whether by reclassification or otherwise, of any new class or series of stock (or any other securities convertible into equity securities of the Corporation) ranking superior to or on a parity with the Series A Preferred Stock with respect to voting powers, preferences, dividends or the other special rights or privileges, qualifications or restrictions of the Series A Preferred Stock; or, if any such new class or series is consented to by the holders of Series A Preferred Stock, any subsequent increase in the authorized or designated number of any such new class or series;

(iv) Any reorganization, recapitalization or reclassification of the Corporation and its capital stock; or

(v) Any redemption or repurchase of any securities of the Corporation or rights to acquire securities of the Corporation (other than repurchases of Common Stock made in accordance with the terms of any applicable stock plan of the Corporation then in effect).

4. *Conversion.*

The holders of the Series A Preferred Stock shall have conversion rights as follows (the *Conversion Rights*):

(a) *Right to Convert.*

(i) Each share of Series A Preferred Stock shall be convertible, at the option of the holder thereof, at any time and from time to time, and without the payment of additional consideration by the holder thereof, into such number of fully paid and nonassessable shares of Common Stock as is determined by dividing \$55.70 by the Series A Conversion Price in effect at the time of conversion (the *Series A Conversion Rate*). The *Series A Conversion Price* shall initially be \$55.70. Such initial Series A Conversion Price, and the rate at which shares of Series A Preferred Stock may be converted into shares of Common Stock, shall be subject to adjustment as provided below.

(ii) In the event of a notice of redemption of any shares of Series A Preferred Stock pursuant to Section 5 hereof, the Conversion Rights of the shares designated for redemption shall terminate at the close of business on the last full day preceding the Redemption Date (as defined below), unless either (A) a Redemption Right Termination occurs in which case the Corporation's attempt to exercise the Redemption Right shall immediately terminate and become null and void and the Conversion Rights for such shares shall not terminate or (B) the Redemption Price (as defined below) is not paid on such Redemption Date, in which case the Conversion Rights for such shares shall continue until such price is paid in full. In the event of a liquidation, dissolution or winding up of the Corporation, the Conversion Rights shall terminate at the close of business on the last full day preceding the date fixed for the payment of any such amounts distributable on such event to the holders of Series A Preferred Stock. In the event of such a redemption or liquidation, dissolution or winding up, the Corporation shall provide to each holder of shares of Series A Preferred Stock notice of such redemption or liquidation, dissolution or winding up, which notice shall (x) be sent at least 30 days prior to the termination of the Conversion Rights and (y) state the amount per share of Series A Preferred Stock that will be paid or distributed on such redemption or liquidation, dissolution or winding up, as the case may be.

(b) *Fractional Shares.* No fractional shares of Common Stock shall be issued upon conversion of the Series A Preferred Stock. In lieu of any fractional shares to which the holder would otherwise be entitled, the Corporation shall pay cash equal to such fraction multiplied by the then effective Series A Conversion Price.



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(c) *Mechanics of Conversion.*

(i) In order for a holder of Series A Preferred Stock to convert shares of Series A Preferred Stock into shares of Common Stock, such holder shall surrender the certificate or certificates for such shares of Series A Preferred Stock, at the office of the transfer agent for the Series A Preferred Stock (or at the principal office of the Corporation if the Corporation serves as its own transfer agent), together with written notice that such holder elects to convert all or any number of the shares of the Series A Preferred Stock represented by such certificate or certificates. Such notice shall state such holder's name or the names of the nominees in which such holder wishes the certificate or certificates for shares of Common Stock to be issued. If required by the Corporation, certificates surrendered for conversion shall be endorsed or accompanied by a written instrument or instruments of transfer, in form satisfactory to the Corporation, duly executed by the registered holder or his or its attorney duly authorized in writing. The date of receipt of such certificates and notice by the transfer agent (or by the Corporation if the Corporation serves as its own transfer agent) shall be the conversion date ( *Conversion Date* ), and the shares of Common Stock issuable upon conversion of the shares represented by such certificate shall be deemed to be outstanding of record as of such date. The Corporation shall, as soon as practicable after the Conversion Date, issue and deliver at such office to such holder of Series A Preferred Stock, or to his or its nominees, a certificate or certificates for the number of shares of Common Stock to which such holder shall be entitled, together with cash in lieu of any fraction of a share.

(ii) The Corporation shall at all times when any Series A Preferred Stock shall be outstanding, reserve and keep available out of its authorized but unissued stock, for the purpose of effecting the conversion of the Series A Preferred Stock, such number of its duly authorized shares of Common Stock as shall from time to time be sufficient to effect the conversion of all outstanding Preferred Stock.

(iii) All shares of Series A Preferred Stock which shall have been surrendered for conversion as herein provided shall no longer be deemed to be outstanding and all rights with respect to such shares, including the rights, if any, to receive notices and to vote, shall immediately cease and terminate on the Conversion Date, except only the right of the holders thereof to receive shares of Common Stock in exchange therefor and payment of any dividends declared or accrued pursuant to Subsection 1 above but unpaid thereon. Any shares of Series A Preferred Stock so converted shall be retired and cancelled and shall not be reissued, and the Corporation (without the need for stockholder action) may from time to time take such appropriate action as may be necessary to reduce the authorized number of shares of such series of Series A Preferred Stock accordingly.

(iv) The Corporation shall pay any and all issue and other similar taxes that may be payable in respect of any issuance or delivery of shares of Common Stock upon conversion of shares of Series A Preferred Stock pursuant to this Subsection 4. The Corporation shall not, however, be required to pay any tax which may be payable in respect of any transfer involved in the issuance and delivery of shares of Common Stock in a name other than that in which the shares of Series A Preferred Stock so converted were registered, and no such issuance or delivery shall be made unless and until the person or entity requesting such issuance has paid to the Corporation the amount of any such tax or has established, to the satisfaction of the Corporation, that such tax has been paid.

(d) *Adjustment for Stock Splits and Combinations.* If the Corporation shall at any time or from time to time on or after the Original Issue Date for the Series A Preferred Stock effect a subdivision of the outstanding Common Stock or combine the outstanding shares of Series A Preferred Stock, the applicable Series A Conversion Price then in effect immediately before that subdivision or combination shall be proportionately decreased. If the Corporation shall at any time or from time to time after the Original Issue Date for the Series A Preferred Stock combine the outstanding shares of Common Stock or effect a subdivision of the outstanding shares of Series A Preferred Stock, the Series A Conversion Price then in effect immediately before the combination or subdivision shall be proportionately increased. Any

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adjustment under this paragraph shall become effective at the close of business on the date the subdivision or combination becomes effective.

For purposes of this Subsection 4, the term *Original Issue Date* shall mean the date on which a share of Series A Preferred Stock, was first issued.

(e) *Adjustment for Certain Dividends and Distributions.* In the event the Corporation at any time, or from time to time on or after the Original Issue Date for the Series A Preferred Stock shall make or issue, or fix a record date for the determination of holders of Common Stock entitled to receive, a dividend or other distribution payable in additional shares of Common Stock, then and in each such event the Series A Conversion Price then in effect immediately before such event shall be decreased as of the time of such issuance or, in the event such a record date shall have been fixed, as of the close of business on such record date, by multiplying the Series A Conversion Price then in effect by a fraction:

(1) the numerator of which shall be the total number of shares of Common Stock issued and outstanding immediately prior to the time of such issuance or the close of business on such record date, and

(2) the denominator of which shall be the total number of shares of Common Stock issued and outstanding immediately prior to the time of such issuance or the close of business on such record date plus the number of shares of Common Stock issuable in payment of such dividend or distribution; *provided, however,* that if such record date shall have been fixed and such dividend is not fully paid or if such distribution is not fully made on the date fixed therefor, the Series A Conversion Price shall be recomputed accordingly as of the close of business on such record date and thereafter the Series A Conversion Price shall be adjusted pursuant to this paragraph as of the time of actual payment of such dividends or distributions; and *provided further, however,* that no such adjustment shall be made if the holders of Series A Preferred Stock simultaneously receive (i) a dividend or other distribution of shares of Common Stock in a number equal to the number of shares of Common Stock as they would have received if all outstanding shares of Series A Preferred Stock had been converted into Common Stock on the date of such event or (ii) a dividend or other distribution of shares of Series A Preferred Stock which are convertible, as of the date of such event, into such number of shares of Common Stock as is equal to the number of additional shares of Common Stock being issued with respect to each share of Common Stock in such dividend or distribution.

(f) *Adjustments for Other Dividends and Distributions.* In the event the Corporation at any time or from time to time on or after the Original Issue Date for the Series A Preferred Stock shall make or issue, or fix a record date for the determination of holders of Common Stock entitled to receive, a dividend or other distribution payable in securities of the Corporation (other than shares of Common Stock) or in cash or other property, then and in each such event the holders of Series A Preferred Stock shall receive, simultaneously with the distribution to the holders of Common Stock, a dividend or other distribution of such securities, cash or other property in an amount equal to the amount of such securities, cash or other property as they would have received if all outstanding shares of Series A Preferred Stock had been converted into Common Stock on the date of such event or record date, as the case may be.

(g) *Certificate as to Adjustments.* Upon the occurrence of each adjustment or readjustment of the Series A Conversion Price pursuant to this Subsection 4, the Corporation at its expense shall, as promptly as reasonably practicable but in any event not later than 10 days thereafter, compute such adjustment or readjustment in accordance with the terms hereof and furnish to each holder of Series A Preferred Stock a certificate setting forth such adjustment or readjustment and showing in detail the facts upon which such adjustment or readjustment is based. The Corporation shall, as promptly as reasonably practicable after the written request at any time of any holder of Series A Preferred Stock (but in any event not later than 10 days thereafter), furnish or cause to be furnished to such holder a certificate setting forth the Series A Conversion Price then in effect.

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(h) *Notice of Record Date*. In the event:

(i) the Corporation shall take a record of the holders of its Common Stock (or other stock or securities at the time issuable upon conversion of the Series A Preferred Stock) for the purpose of entitling or enabling them to receive any dividend or other distribution, or to receive any right to subscribe for or purchase any shares of stock of any class or any other securities, or to receive any other right; or

(ii) of any capital reorganization of the Corporation, any reclassification of the Common Stock of the Corporation, any consolidation or merger of the Corporation with or into another corporation (other than a consolidation or merger in which the Corporation is the surviving entity and its Common Stock is not converted into or exchanged for any other securities or property), or any transfer of all or substantially all of the assets of the Corporation; or

(iii) of the voluntary or involuntary dissolution, liquidation or winding-up of the Corporation,

then, and in each such case, the Corporation will send or cause to be sent to the holders of the Series A Preferred Stock a notice specifying, as the case may be, (i) the record date for such dividend, distribution or right, and the amount and character of such dividend, distribution or right, or (ii) the effective date on which such reorganization, reclassification, consolidation, merger, transfer, dissolution, liquidation or winding-up is to take place, and the time, if any is to be fixed, as of which the holders of record of Common Stock (or such other stock or securities at the time issuable upon the conversion of the Series A Preferred Stock) shall be entitled to exchange their shares of Common Stock (or such other stock or securities) for securities or other property deliverable upon such reorganization, reclassification, consolidation, merger, transfer, dissolution, liquidation or winding-up. Such notice shall be sent at least 10 days prior to the record date or effective date for the event specified in such notice.

**5. *Redemption*.**

(a) *Optional Redemption*. On any date commencing after the fifth anniversary of the Original Issue Date (the *Exercise Date* ), so long as the Stock Price Requirement (as defined below) has been satisfied the Corporation, at the option of its Board of Directors or any duly authorized committee thereof, may exercise its right to redeem in whole, but not in part, all shares of Series A Preferred Stock then outstanding, upon delivery of a Redemption Notice (as defined below) in accordance with the requirements and subject to the conditions of Subsection 5(c) (the *Redemption Right* ); *provided, however*, that if for any day during the period between the Exercise Date and the business day immediately preceding the Redemption Date, the closing price of the Corporation's Common Stock on the applicable Trading Market (as defined below) is less than \$8.50 (subject to adjustment for stock splits, combinations or stock dividends), then the Corporation's attempt to exercise the Redemption Right in such instance shall immediately terminate and become null and void (a *Redemption Right Termination* ) and the Corporation shall not be entitled to exercise the Redemption Right again unless and until the Stock Price Requirement and the other requirements and conditions of this Subsection 5 are subsequently satisfied. Notwithstanding anything to the contrary contained in this Subsection 5 or elsewhere, holders of Series A Preferred Stock shall be entitled to convert their shares pursuant to Subsection 4 above up through the close of business on the business day immediately preceding the Redemption Date (as defined below) regardless of whether such holder exercises such right after the Corporation has exercised the Redemption Right or delivered a Redemption Notice.

For purposes of this Subsection 5, the *Stock Price Requirement* shall be satisfied if the average closing price of the Corporation's Common Stock on the applicable Trading Market for the 30 day period immediately prior to the Exercise Date shall be greater than or equal to \$10.00 (subject to adjustment for stock splits, combinations or stock dividends). For purposes of this Subsection 5, *Trading Market* shall mean any of the following markets, exchanges or systems on which the Corporation's Common Stock is listed or quoted for trading for the 30 day period in question: the OTC Bulletin Board, the American Stock Exchange, the New York Stock Exchange, the Nasdaq National Market, the Nasdaq Global Market or the Nasdaq SmallCap Market.

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(b) *Redemption Price.* The redemption price for shares of Series A Preferred Stock shall be \$5.57 per share (subject in each case to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization affecting such shares), plus any dividends declared pursuant to Subsection 1 above but unpaid thereon (the *Redemption Price* ).

(c) *Notice of Redemption.* No later than five business days after the Exercise Date, notice of redemption of shares of Series A Preferred Stock shall be mailed by first class mail, postage prepaid, addressed to the holders of record of such shares at their respective last addresses appearing on the stock register of the Corporation (the *Redemption Notice* ). The Redemption notice shall be delivered at least 30 days and not more than 60 days before the date fixed for redemption. Each Redemption Notice shall state (i) the redemption date (the *Redemption Date* ); (ii) the Redemption Price per share and the aggregate Redemption Price payable to such holder; (iii) the place or places where the certificates for such shares are to be surrendered for payment of the Redemption Price; and (iv) that dividends on the shares to be redeemed will cease to accrue on the Redemption Date. If a Redemption Right Termination occurs, the Corporation shall promptly give notice of such event to holders of record of shares of Series A Preferred Stock in the manner contemplated by this Subsection 5(c) for delivery of Redemption Notices.

(d) *Surrender of Certificates; Payment.* Unless a Redemption Right Termination has subsequently occurred or a holder of Series A Preferred Stock has exercised his, her or its right to convert such shares as provided in Subsection 4 hereof, on or before the respective Redemption Date, each holder of shares of Series A Preferred Stock shall surrender the certificate or certificates representing such shares to the Corporation, in the manner and at the place designated in the Redemption Notice, and thereupon the respective Redemption Price for such shares shall be payable to the order of the person whose name appears on such certificate or certificates as the owner thereof, and each surrendered certificate shall be canceled and retired.

(e) *Rights Subsequent to Redemption.* Unless a Redemption Right Termination has subsequently occurred or a holder of Series A Preferred Stock has exercised his, her or its right to convert such shares as provided in Subsection 4 hereof, if the Redemption Notice shall have been duly given, and if on the applicable Redemption Date the applicable Redemption Price payable upon redemption of the Series A Preferred Stock is paid or tendered for payment, then notwithstanding that the certificates evidencing any of the shares of Series A Preferred Stock called for redemption shall not have been surrendered, dividends with respect to such shares of Series A Preferred Stock shall cease to accrue after such respective Redemption Date and all rights with respect to such shares shall forthwith after the respective Redemption Date terminate, except only the right of the holders to receive the applicable Redemption Price without interest upon surrender of their certificate or certificates therefor.

(f) *Redeemed or Otherwise Acquired Shares.* Any shares of Series A Preferred Stock which are redeemed or otherwise acquired by the Corporation or any of its subsidiaries shall be automatically and immediately canceled and shall not be reissued, sold or transferred. Neither the Corporation nor any of its subsidiaries may exercise any voting or other rights granted to the holders of Series A Preferred Stock following redemption or repurchase.

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**EXHIBIT C**

**Form of Release**

This Release is being executed and delivered in accordance with Section 7.2(f) of the Agreement and Plan of Merger dated July 10, 2007, as amended and restated on September 13, 2007, among Digital Music Group, Inc., DMGI New York, Inc. and The Orchard Enterprises, Inc. ( *TO*, and such agreement, the *Merger Agreement* ). Capitalized terms used in this Release that are not defined herein have the respective meanings given to them in the Merger Agreement.

( *Stockholder* ), on behalf of himself and each of [his, her or its] Related Persons (such persons individually, a *Releasing Party* ) hereby unconditionally and irrevocably releases and forever discharges, effective as of and forever after the Effective Time, to the fullest extent applicable law permits, all parties to the Merger Agreement, and each of their respective individual, joint or mutual, past, present and future Affiliates, directors, officers, stockholders, employees, subsidiaries, successors and assigns (such persons individually, a *Released Party* and collectively, *Released Parties* ) from any and all debts, liabilities, obligations, claims, demands, actions or causes of action, suits, judgments or controversies of any kind whatsoever (collectively, *Pre-Acquisition Claims* ) against TO that arises out of or is based on any agreement or understanding or act or failure to act (including any act or failure to act that constitutes ordinary or gross negligence or reckless or willful, wanton misconduct), misrepresentation, omission, transaction, fact, event or other matter occurring prior to the Effective Time (whether based on any requirement of a Governmental Entity or right of action, at law or in equity or otherwise, foreseen or unforeseen, matured or unmatured, known or unknown, accrued or not accrued) (collectively, *Pre-Acquisition Matters* ), including without limitation: (i) claims with respect to repayment of loans or indebtedness; (ii) any rights, titles and interests in, to or under any agreements, arrangements or understandings; and (iii) claims with respect to dividends, violation of preemptive rights, or payment of salaries or other compensation or in any way arising out of or in connection with the Stockholder's employment with TO or any of its subsidiaries or affiliates (the *TO Group* ), the cessation of that employment, such Stockholder's status as an officer, director or stockholder of any party in the TO Group or otherwise (but excluding any and all claims in respect of: (A) accrued and unpaid amounts owing to the Stockholder as an employee of the TO Group, (B) accrued and unpaid cash compensation owing to the Stockholder at the rates or in the amounts, as the case may be, consistent with the terms of such employment and (C) benefits accrued under each Orchard Benefit Plan).

Each Releasing Party hereby irrevocably covenants to refrain from, directly or indirectly, asserting any claim or demand, or commencing, instituting or causing to be commenced, any proceeding of any kind against any Released Party, based upon any matter purported to be released pursuant to this Release.

Without in any way limiting any of the rights and remedies otherwise available to any Released Party, the Stockholder shall indemnify and hold harmless each Released Party from and against all loss, liability, claim, damage (including incidental and consequential damages) or expense (including costs of investigation and defense and reasonable attorney's fees), arising from or in connection with the assertion by or on behalf of the Stockholder or any of [his, her or its] Related Persons of any claim or other matter purported to be released pursuant to this Release.

Each Stockholder (i) acknowledges that [he, she or it] fully comprehends and understands all the terms of this Release and their legal effects and (ii) expressly represents and warrants that: (A) [he, she or it] is competent to effect the release made in this Release knowingly and voluntarily and without reliance on any statement or representation of any Released Party or its representatives and (B) [he, she or it] had the opportunity to consult with an attorney of [his, her or its] choice regarding this Release.

If any provision of this Release is held invalid or unenforceable by any court of competent jurisdiction, the other provisions of this Release will remain in full force and effect. Any provision of this Release held invalid or unenforceable only in part or degree will remain in full force and effect to the extent not held invalid or unenforceable.

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For purposes of this Release, the following shall be a *Related Person* of the Stockholder:

[If the Stockholder is an individual:

- (i) each other member of the Stockholder's Family;
- (ii) any individual or entity that is directly or indirectly controlled by the Stockholder or one or more members of the Stockholder's Family;
- (iii) any individual or entity in which the Stockholder or members of such Stockholder's Family hold (individually or in the aggregate) a Material Interest; and
- (iv) any individual or entity with respect to which the Stockholder or one or more members of [his or her] Family serves as a director, officer, partner, executor, or trustee (or in a similar capacity).]

[If the Stockholder is an entity:

- (i) any individual or entity that directly or indirectly controls, is directly or indirectly controlled by, or is directly or indirectly under common control with the Stockholder;
- (ii) any individual or entity that holds a Material Interest in the Stockholder;
- (iii) each individual that serves as a director, officer, partner, executor, or trustee of the Stockholder (or in a similar capacity);
- (iv) any individual or entity in which the Stockholder holds a Material Interest;
- (v) any entity with respect to which the Stockholder serves as a general partner or a trustee (or in a similar capacity); and
- (vi) any Related Person of any individual or entity described in clause (ii) or (iii) above].

For purposes of this definition, [(a) the *Family* of an individual includes (i) the Stockholder, (ii) the Stockholder's spouse, (iii) any other natural person who is related to the Stockholder or the Stockholder's spouse within the second degree, and (iv) any other natural person who resides with the Stockholder, and (b)] *Material Interest* means direct or indirect beneficial ownership (as defined in Rule 13d-3 under the Securities Exchange Act of 1934) of voting securities or other voting interests representing at least 5% of the outstanding voting power of an entity or equity securities or other equity interests representing at least 5% of the outstanding equity securities or equity interests in an entity.

IN WITNESS WHEREOF, the undersigned has executed and delivered this Release as of this            day of            , 2007.

[Name of Stockholder]

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**EXHIBIT D**

**Registration Rights Agreement**

This Registration Rights Agreement (this *Agreement*) is made and entered into as of [ ] [ ], 2007, by and among Digital Music Group, Inc., a Delaware corporation (the *Company*) and certain stockholders of The Orchard Enterprises, Inc., a New York corporation (*Orchard*) listed on Schedule A (the *Holder*s), who are to be issued shares of Common Stock of the Company or Series A Preferred Stock pursuant to an Agreement and Plan of Merger, dated July 10, 2007, as amended and restated on September 13, 2007 (the *Merger Agreement*), by and between the Company, Orchard Enterprises Inc. (*Orchard*) and DMGI New York, Inc., a New York corporation. The entry into this Agreement is contemplated in the Merger Agreement and is a condition to the obligations of Orchard contained therein.

The Registrable Securities shall have the registration rights as set forth herein.

The Company and the Holders hereby agree as follows:

1. *Definitions*. As used in this Agreement, the following terms shall have the following meanings:

*Commission* means the United States Securities and Exchange Commission.

*Common Stock* means the Company's common stock par value \$0.01 per share.

*Demand Notice* shall have the meaning set forth in *Section 2(a)*.

*Demand Registration Statement* shall have the meaning set forth in *Section 2(a)*.

*Effective Date* shall mean, as to the Registration Statement, the date on which such registration Statement is first declared effective by the Commission.

*Effectiveness Period* shall mean from the Effective Date until the earlier to occur of the date when all Registrable Securities covered by a Registration Statement either (a) have been sold pursuant to a Registration Statement or an exemption from the registration requirements of the Securities Act, and (b) pursuant to a written opinion of Company counsel acceptable to the Company's transfer agent and the legal counsel for the Holders, may be sold pursuant to Rule 144(k).

*Exchange Act* means the Securities Exchange Act of 1934, as amended.

*Holder* or *Holder*s means the holder or holders, as the case may be, from time to time of Registrable Securities (including any permitted assignee).

*Indemnifying Party* shall have the meaning set forth in *Section 5(c)*.

*Losses* shall have the meaning set forth in *Section 5(a)*.

*Person* shall mean an individual or corporation, partnership, trust, incorporated or unincorporated association, joint venture, limited liability company, joint stock company, government (or an agency or subdivision thereof) or other entity of any kind.

*Proceeding* means an action, claim, suit, investigation or proceeding (including, without limitation, an investigation or partial proceeding, such as a deposition), whether commenced or threatened.

*Prospectus* means the prospectus included in the Registration Statement (including, without limitation, a prospectus that includes any information previously omitted from a prospectus filed as part of an effective registration statement in reliance upon Rule 430A promulgated under the Securities Act), as amended or supplemented by any prospectus supplement, with respect to the terms of the offering of any portion of the Registrable Securities covered by the Registration Statement, and all other amendments and supplements to the Prospectus, including

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post-effective amendments, and all material incorporated by reference or deemed to be incorporated by reference in such Prospectus.

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*Registrable Securities* means (i) the shares of Common Stock issued to the Holders pursuant to the Merger Agreement, (ii) the shares of Common Stock issuable upon conversion of the Series A Preferred Stock of the Company issued to the Holders pursuant to the Merger Agreement, and (iii) any shares of Common Stock issued or issuable upon any stock split, dividend or other distribution, recapitalization, anti-dilution adjustment or similar event with respect to the foregoing.

*Registration Statement* means any registration statement required to be filed hereunder (which, at the Company's option, may be an existing registration statement of the Company previously filed with the Commission, but not declared effective), including (in each case) the Prospectus, amendments and supplements to the registration statement or Prospectus, including pre- and post-effective amendments, all exhibits thereto, and all material incorporated by reference or deemed to be incorporated by reference in the registration statement.

*Rule 415* means Rule 415 promulgated by the Commission pursuant to the Securities Act, as such Rule may be amended from time to time, or any similar Rule or regulation hereafter adopted by the Commission having substantially the same effect as such Rule.

*Rule 424* means Rule 424 promulgated by the Commission pursuant to the Securities Act, as such Rule may be amended from time to time, or any similar Rule or regulation hereafter adopted by the Commission having substantially the same effect as such Rule.

*Securities Act* means the Securities Act of 1933, as amended.

*Trading Day* means (a) a day on which the Common Stock is traded on a Trading Market, or (b) if the Common Stock is not quoted on a Trading Market, a day on which the Common Stock is quoted in the over-the-counter market as reported by the National Quotation Bureau Incorporated (or any similar organization or agency succeeding to its functions of reporting price); provided, that in the event that the Common Stock is not listed or quoted as set forth in (a), and (b) hereof, then Trading Day shall mean a Business Day;

*Trading Market* means the following markets or exchanges on which the Common Stock is listed or quoted for trading on the date in question: the OTC Bulletin Board, the American Stock Exchange, the New York Stock Exchange, the Nasdaq National Market or the Nasdaq SmallCap Market.

**2. Registration.**

(a) *Demand Registration Rights.* At any time commencing on the date six (6) months following the closing of the merger contemplated in the Merger Agreement, the Holders shall have a two (2) time right, by written notice, signed by the Holders of a majority in interest of the then outstanding Registrable Securities, provided to the Company (the *Demand Notice*), to demand the Company to register for resale all Registrable Securities under and in accordance with the provisions of the Securities Act by filing with the Commission a Registration Statement covering the resale of all of the Registrable Securities (the *Demand Registration Statement*). The Demand Registration Statement required hereunder shall be on Form S-3 (except if the Company is not then eligible to register for resale the Registrable Securities on Form S-3, in which case the Demand Registration Statement shall be on a Form S-1 or another appropriate form). To the extent then permitted by law, the Demand Registration Statement required hereunder shall contain the Plan of Distribution, attached hereto as *Annex A* (which may be modified to respond to comments, if any, received by the Commission). The Company shall keep the Demand Registration Statement continuously effective under the Securities Act until the earlier of (i) the date when all Registrable Securities have been sold pursuant to the Demand Registration Statement, and (ii) the date the Holders can sell all of their shares, without limitation, pursuant to Rule 144(k) of the Securities Act.

(b) *Piggyback Registrations Rights.* If, at any time commencing on the date twelve (12) months following the closing of the merger contemplated in the Merger Agreement, the Company shall

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determine to prepare and file with the Commission a registration statement relating to an offering for its own account (a *Company Registration*) or the account of others under the Securities Act of any of its equity securities, other than on Form S-4 or Form S-8 (each as promulgated under the Securities Act) or their then equivalents relating to equity securities to be issued solely in connection with any acquisition of any entity or business or equity securities issuable in connection with stock option or other employee benefit plans, then the Company shall send to each Holder a written notice of such determination at least twenty (20) days prior to the filing of any such registration statement and shall automatically include in such registration statement all Registrable Securities; provided, however, that (i) if, at any time after giving written notice of its intention to register any securities and prior to the Effective Date of the registration statement filed in connection with such registration, the Company determines for any reason not to proceed with such registration, the Company will be relieved of its obligation to register any Registrable Securities in connection with such registration, (ii) in case of a determination by the Company to delay registration of its securities, the Company will be permitted to delay the registration of Registrable Securities for the same period as the delay in registering such other securities, or (iii) if in the written opinion of the Company's managing underwriter or underwriters, if any, for such Company Registration (the *Underwriter*), the inclusion of such Registrable Securities, when added to the securities being registered by the Company or the selling stockholder(s), will exceed the maximum amount of the Company's securities which can be marketed at a price reasonably related to their then current market value, or without materially and adversely affecting the entire offering, the number of securities to be sold by all stockholders in such public offering (if any) shall be apportioned pro rata among all such selling stockholders, including all holders of the Registrable Securities, according to the total amount of securities of the Company proposed to be sold by said selling stockholders, including all holders of the Registrable Securities.

(c) Notwithstanding the registration rights specified in (a) and (b), if the Commission staff takes the position that the registration statement is a primary offering, then the Company shall only be required to register an amount of Registrable Securities at any one time that enables the offering to be conducted without being contrary to Rule 415 and otherwise facilitates the Commission declaring the Registration Statement effective. In the event that less than all Registrable Shares may be registered at any one time then, in a manner consistent with this paragraph, (i) unless the Holders agree otherwise, the number of shares shall be reduced pro rata, and (ii) the Company shall be obligated to file additional registration statements or post-effective amendments to a prior related registration statement for the duration of the Effectiveness Period to reflect any remaining Registrable Securities.

3. *Registration Procedures.* In connection with the Company's registration obligations hereunder, and during the Effectiveness Period, the Company shall:

(a) Not less than five (5) business days prior to the filing of the Registration Statement or any related Prospectus or any amendment or supplement thereto, the Company shall furnish to Holders, a draft of the Registration Statement, or any related Prospectus or any amendment or supplement thereto.

(b)(i) Prepare and file with the Commission such amendments, including post-effective amendments, to the Registration Statement and the Prospectus used in connection therewith as may be necessary to keep the Registration Statement continuously effective as to the applicable Registrable Securities for the Effectiveness Period; (ii) cause the related Prospectus to be amended or supplemented by any required Prospectus supplement, and as so supplemented or amended to be filed pursuant to Rule 424; and (iii) respond to any comments received from the Commission with respect to the Registration Statement or any amendment thereto.

(c) Notify as promptly as reasonably possible, but no later than three (3) business days, each Holder of Registrable Securities included in the Registration Statement: (i) (A) when a Prospectus or any Prospectus supplement or post-effective amendment to the Registration Statement has been filed, provided such Holder has previously requested in writing to receive notice of such filing; (B) when the Commission notifies the Company whether there will be a review of the Registration Statement and

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whenever the Commission comments in writing on the Registration Statement, provided such Holder has previously requested in writing to receive notice of such notification; and (C) when the Registration Statement or any post-effective amendment has become effective; (ii) of any request by the Commission or any other Federal or state governmental authority during the period of effectiveness of the Registration Statement for amendments or supplements to the Registration Statement or Prospectus or for additional information; (iii) of the issuance by the Commission or any other federal or state governmental authority of any stop order suspending the effectiveness of the Registration Statement covering any or all of the Registrable Securities or the initiation of any Proceedings for that purpose; (iv) of the receipt by the Company of any notification with respect to the suspension of the qualification or exemption from qualification of any of the Registrable Securities for sale in any jurisdiction, or the initiation of any Proceeding for such purpose; and (v) of the occurrence of any event or passage of time that makes the financial statements included in the Registration Statement ineligible for inclusion therein or any statement made in the Registration Statement or Prospectus or any document incorporated or deemed to be incorporated therein by reference untrue in any material respect or that requires any revisions to the Registration Statement, Prospectus or other documents so that, in the case of the Registration Statement or the Prospectus, as the case may be, it will not contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading.

(d) Use its best efforts to avoid the issuance of, or, if issued, obtain the withdrawal of (i) any order suspending the effectiveness of the Registration Statement, or (ii) any suspension of the qualification (or exemption from qualification) of any of the Registrable Securities for sale in any jurisdiction, at the earliest practicable moment.

(e) Promptly deliver to each Holder no later than three (3) business days after the Effective Date, without charge, two (2) copies of the Prospectus or Prospectuses (including each form of prospectus) and each amendment or supplement thereto (and, upon the request of the Holder such additional copies as such Persons may reasonably request in connection with resales by the Holder of Registrable Securities). The Company hereby consents to the use of such Prospectus and each amendment or supplement thereto by the Holder in connection with the offering and sale of the Registrable Securities covered by such Prospectus and any amendment or supplement thereto, except after the giving of any notice pursuant to Section 3(c).

(f) Prior to any resale of Registrable Securities by a Holder, use its best efforts to register or qualify or cooperate with the selling Holders in connection with the registration or qualification (or exemption from the registration or qualification) of such Registrable Securities for the resale by the Holder under the securities or Blue Sky laws of such jurisdictions within the United States as any Holder reasonably requests in writing, to keep such registration or qualification (or exemption therefrom) effective during the Effectiveness Period and to do any and all other acts or things reasonably necessary to enable the disposition in such jurisdictions of the Registrable Securities covered by the Registration Statement; provided, however, that the Company shall not be required (i) to qualify generally to do business in any jurisdiction where it is not then so qualified, (ii) subject the Company to any material tax in any such jurisdiction where it is not then so subject or file a general consent to service of process in any such jurisdiction, or (iii) comply with state securities or blue sky laws of any state for which registration by coordination is unavailable to the Company.

(g) Upon the occurrence of any event contemplated by Section 3(c)(v), as promptly as reasonably possible, prepare a supplement or amendment, including a post-effective amendment, to the Registration Statement or a supplement to the related Prospectus or any document incorporated or deemed to be incorporated therein by reference, and file any other required document so that, as thereafter delivered, neither the Registration Statement nor such Prospectus will contain an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading.

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(h) Use its best efforts to comply with all applicable rules and regulations of the Commission relating to the registration of the Registrable Securities pursuant to the Registration Statement or otherwise.

(i) Each Holder agrees to furnish to the Company a completed Questionnaire in the form attached to this Agreement as *Exhibit A*. Each Holder agrees further to supplement the Questionnaire as necessary to enable the Company to respond to comments, if any, received by the Commission. The Company shall not be required to include any Holder that does not complete, date and execute a Selling Shareholder Questionnaire or supplement promptly.

4. *Registration Expenses*. All fees and expenses incident to the performance of or compliance with this Agreement by the Company shall be borne by the Company whether or not any Registrable Securities are sold pursuant to the Registration Statement, other than fees and expenses of counsel or any other advisor retained by the Holders and discounts and commissions with respect to the sale of any Registrable Securities by the Holders. The fees and expenses referred to in the foregoing sentence shall include, without limitation, (i) all registration and filing fees (including, without limitation, fees and expenses (A) with respect to filings required to be made with the Trading Market on which the Common Stock is then listed for trading, and (B) in compliance with applicable state securities or Blue Sky laws), (ii) printing expenses (including, without limitation, expenses of printing certificates for Registrable Securities and of printing prospectuses if the printing of prospectuses is reasonably requested by the holders of a majority of the Registrable Securities included in the Registration Statement), (iii) messenger, telephone and delivery expenses, (iv) fees and disbursements of counsel for the Company, (v) Securities Act liability insurance, if the Company so desires such insurance,; and (vi) fees and expenses of all other Persons retained by the Company in connection with the consummation of the transactions contemplated by this Agreement.

5. *Indemnification*

(a) *Indemnification by the Company*. The Company shall, notwithstanding any termination of this Agreement, indemnify and hold harmless the Holders, the officers, directors, agents and employees of it, each Person who controls the Holders (within the meaning of Section 15 of the Securities Act or Section 20 of the Exchange Act) and the officers, directors, agents and employees of each such controlling Person, to the fullest extent permitted by applicable law, from and against any and all losses, claims, damages, liabilities, costs (including, without limitation, reasonable attorneys' fees) and expenses (including the cost (including without limitation, reasonable attorneys' fees) and expenses relating to an Indemnified Party's actions to enforce the provisions of this Section 5) (collectively, *Losses* ), as incurred, to the extent arising out of or relating to any untrue or alleged untrue statement of a material fact contained in the Registration Statement, any Prospectus or any form of prospectus or in any amendment or supplement thereto or in any preliminary prospectus, or arising out of or relating to any omission or alleged omission of a material fact required to be stated therein or necessary to make the statements therein (in the case of any Prospectus or form of prospectus or supplement thereto, in light of the circumstances under which they were made) not misleading, except to the extent, but only to the extent, that (1) such untrue statements or omissions are based solely upon information regarding such Holder furnished (or in the case of an omission, not furnished) in writing to the Company by or on behalf of such Holder expressly for use therein, or to the extent that such information relates to such Holder or such Holder's proposed method of distribution of Registrable Securities and was reviewed and expressly approved in writing by such Holder expressly for use in the Registration Statement, such Prospectus or such form of Prospectus or in any amendment or supplement thereto (it being understood that the Holder has approved Annex A hereto for this purpose), (2) in the case of an occurrence of an event of the type specified in Section 3(c)(ii)-(v), the use by such Holder of an outdated or defective Prospectus after the Company has notified such Holder in writing that the Prospectus is outdated or defective and prior to the receipt by such Holder of the Advice contemplated in Section 6(b), or (3) the failure of the Holder to deliver a prospectus prior to the confirmation of a sale. The Company shall notify the Holders promptly of the institution, threat or

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assertion of any Proceeding of which the Company is aware in connection with the transactions contemplated by this Agreement.

(b) *Indemnification by Holder.* The Holder shall indemnify and hold harmless the Company, its directors, officers, agents and employees, each Person who controls the Company (within the meaning of Section 15 of the Securities Act and Section 20 of the Exchange Act), and the directors, officers, agents or employees of such controlling Persons, to the fullest extent permitted by applicable law, from and against all Losses, as incurred, to the extent arising out of or based upon: (x) the Holder's failure to comply with the prospectus delivery requirements of the Securities Act or (y) any untrue or alleged untrue statement of a material fact contained in any Registration Statement, any Prospectus, or any form of prospectus, or in any amendment or supplement thereto or in any preliminary prospectus, or arising out of or relating to any omission or alleged omission of a material fact required to be stated therein or necessary to make the statements therein not misleading (i) to the extent, but only to the extent, that such untrue statement or omission is contained in any information so furnished (or in the case of an omission, not furnished) in writing by or on behalf of such Holder to the Company specifically for inclusion in the Registration Statement or such Prospectus or (ii) to the extent that (1) such untrue statements or omissions are based solely upon information regarding such Holder furnished (or in the case of an omission, not furnished) in writing to the Company by or on behalf of such Holder expressly for use therein, or to the extent that such information relates to such Holder or such Holder's proposed method of distribution of Registrable Securities, such Prospectus or such form of Prospectus or in any amendment or supplement thereto, or (2) in the case of an occurrence of an event of the type specified in Section 3(c)(ii)-(v), the use by such Holder of an outdated or defective Prospectus after the Company has notified such Holder in writing that the Prospectus is outdated or defective and prior to the receipt by such Holder of the Advice contemplated in Section 6(b), or (3) the failure of the Holder to deliver a Prospectus prior to the confirmation of a sale. In no event shall the liability of any selling Holder hereunder be greater in amount than the dollar amount of the Subscription Amount paid by the Holder in the Purchase Agreement.

(c) *Conduct of Indemnification Proceedings.* If any Proceeding shall be brought or asserted against any Person entitled to indemnity hereunder (an *Indemnified Party*), such Indemnified Party shall promptly notify the Person from whom indemnity is sought (the *Indemnifying Party*) in writing, and the Indemnifying Party shall have the right to assume the defense thereof, including the employment of counsel reasonably satisfactory to the Indemnified Party and the payment of all fees and expenses incurred in connection with defense thereof; provided, that the failure of any Indemnified Party to give such notice shall not relieve the Indemnifying Party of its obligations or liabilities pursuant to this Agreement, except (and only) to the extent that such failure shall have materially prejudiced the Indemnifying Party.

An Indemnified Party shall have the right to employ separate counsel in any such Proceeding and to participate in the defense thereof, but the fees and expenses of such counsel shall be at the expense of such Indemnified Party or Parties unless: (1) the Indemnifying Party has agreed in writing to pay such fees and expenses; (2) the Indemnifying Party shall have failed promptly to assume the defense of such Proceeding and to employ counsel reasonably satisfactory to such Indemnified Party in any such Proceeding; or (3) the named parties to any such Proceeding (including any impleaded parties) include both such Indemnified Party and the Indemnifying Party, and such Indemnified Party shall have been advised by counsel that a conflict of interest is likely to exist if the same counsel were to represent such Indemnified Party and the Indemnifying Party (in which case, if such Indemnified Party notifies the Indemnifying Party in writing that it elects to employ separate counsel at the expense of the Indemnifying Party, the Indemnifying Party shall not have the right to assume the defense thereof and the reasonable fees and expenses of one separate counsel for all Indemnified Parties in any matters related on a factual basis shall be at the expense of the Indemnifying Party). The Indemnifying Party shall not be liable for any settlement of any such Proceeding affected without its written consent, which consent shall not be unreasonably withheld. No Indemnifying Party shall, without the prior written

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consent of the Indemnified Party, effect any settlement of any pending Proceeding in respect of which any Indemnified Party is a party, unless such settlement includes an unconditional release of such Indemnified Party from all liability on claims that are the subject matter of such Proceeding.

All reasonable fees and expenses of the Indemnified Party (including reasonable fees and expenses to the extent incurred in connection with investigating or preparing to defend such Proceeding in a manner not inconsistent with this Section) shall be paid to the Indemnified Party, as incurred, within ten (10) Trading Days of written notice thereof to the Indemnifying Party; *provided*, that the Indemnified Party shall promptly reimburse the Indemnifying Party for that portion of such fees and expenses applicable to such actions for which such Indemnified Party is not entitled to indemnification hereunder, determined based upon the relative faults of the parties.

(d) *Contribution*. If a claim for indemnification under Section 5(a) or Section 5(b) is unavailable to an Indemnified Party (by reason of public policy or otherwise), then each Indemnifying Party, in lieu of indemnifying such Indemnified Party, shall contribute to the amount paid or payable by such Indemnified Party as a result of such Losses, in such proportion as is appropriate to reflect the relative fault of the Indemnifying Party and Indemnified Party in connection with the actions, statements or omissions that resulted in such Losses as well as any other relevant equitable considerations. The relative fault of such Indemnifying Party and Indemnified Party shall be determined by reference to, among other things, whether any action in question, including any untrue or alleged untrue statement of a material fact or omission or alleged omission of a material fact, has been taken or made by, or relates to information supplied by, such Indemnifying Party or Indemnified Party, and the parties relative intent, knowledge, access to information and opportunity to correct or prevent such action, statement or omission. The amount paid or payable by a party as a result of any Losses shall be deemed to include, subject to the limitations set forth in Section 5(c), any reasonable attorneys' or other reasonable fees or expenses incurred by such party in connection with any Proceeding to the extent such party would have been indemnified for such fees or expenses if the indemnification provided for in this Section was available to such party in accordance with its terms.

6. *Lock-up*. Each Holder agrees that, until the date six (6) months following the closing of the merger contemplated in the Merger Agreement, such Holder will not, directly or indirectly, offer for sale, sell, assign, pledge, issue, distribute, grant any option or enter into any contract for the sale of or otherwise transfer or dispose of any shares of Common Stock or any other securities of the Company or any security or other instrument which by its terms is convertible into or exercisable or exchangeable for shares of Common Stock or other securities of the Company, whether now owned or hereafter acquired by such Holder or with respect to which such Holder has or hereafter acquires the power of disposition.

7. *Miscellaneous*.

(a) *Compliance*. The Holder covenants and agrees that it will comply with the prospectus delivery requirements of the Securities Act as applicable to it in connection with sales of Registrable Securities pursuant to the Registration Statement.

(b) *Discontinued Disposition*. Each Holder agrees by its acquisition of such Registrable Securities that, upon receipt of a notice from the Company of the occurrence of any event of the kind described in Section 3(c), such Holder will forthwith discontinue disposition of such Registrable Securities under the Registration Statement until such Holder's receipt of the copies of the supplemented Prospectus and/or amended Registration Statement or until it is advised in writing (the **Advice**) by the Company that the use of the applicable Prospectus may be resumed, and, in either case, has received copies of any additional or supplemental filings that are incorporated or deemed to be incorporated by reference in such Prospectus or Registration Statement. The Company may provide appropriate stop orders to enforce the provisions of this paragraph.

(c) *Amendments and Waivers*. The provisions of this Agreement, including the provisions of this sentence, may not be amended, modified or supplemented, and waivers or consents to departures from

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the provisions hereof may not be given, unless the same shall be in writing and signed by the Company and the Holders of a majority in interest of the then outstanding Registrable Securities.

(d) *Notices.* Any and all notices or other communications or deliveries required or permitted to be provided hereunder shall be in writing and shall be deemed given and effective on the earliest of (i) the Trading Day following the date of delivery to the courier service, if sent by nationally recognized overnight courier service, (ii) the third Trading Day following the date of mailing, if sent by first-class, registered or certified mail, postage prepaid, (iii) the Trading Day following transmission by electronic mail with receipt confirmed or acknowledged, or (iv) upon actual receipt by the party to whom such notice is required to be given. The address for such notices and communications shall be delivered and addressed as set forth in the Merger Agreement or to such other address as shall be designated in writing from time to time by a party hereto.

(e) *Successors and Assigns.* This Agreement shall inure to the benefit of and be binding upon the successors and assigns of each of the parties and shall inure to the benefit of the Holder.

(f) *Execution and Counterparts.* This Agreement may be executed in any number of counterparts, each of which when so executed shall be deemed to be an original and, all of which taken together shall constitute one and the same Agreement. In the event that any signature is delivered by facsimile transmission, such signature shall create a valid binding obligation of the party executing (or on whose behalf such signature is executed) the same with the same force and effect as if such facsimile signature were the original thereof.

(g) *Governing Law.* This Agreement shall be governed by and construed exclusively in accordance with the internal laws of the State of New York without regard to the conflicts of laws principles thereof. The parties hereto hereby irrevocably agree that any suit or proceeding arising directly and/or indirectly pursuant to or under this Agreement shall be brought solely in a federal or state court located in the City, County and State of New York. By its execution hereof, the parties hereby covenant and irrevocably submit to the *in personam* jurisdiction of the federal and state courts located in the City, County and State of New York and agree that any process in any such action may be served upon any of them personally, or by certified mail or registered mail upon them or their agent, return receipt requested, with the same full force and effect as if personally served upon them in New York City. The parties hereto waive any claim that any such jurisdiction is not a convenient forum for any such suit or proceeding and any defense or lack of *in personam* jurisdiction with respect thereto. In the event of any such action or proceeding, the party prevailing therein shall be entitled to payment from the other party hereto of its reasonable counsel fees and disbursements.

(h) *Severability.* If any term, provision, covenant or restriction of this Agreement is held by a court of competent jurisdiction to be invalid, illegal, void or unenforceable, the remainder of the terms, provisions, covenants and restrictions set forth herein shall remain in full force and effect and shall in no way be affected, impaired or invalidated, and the parties hereto shall use their commercially reasonable efforts to find and employ an alternative means to achieve the same or substantially the same result as that contemplated by such term, provision, covenant or restriction. It is hereby stipulated and declared to be the intention of the parties that they would have executed the remaining terms, provisions, covenants and restrictions without including any of such that may be hereafter declared invalid, illegal, void or unenforceable.

(i) *Headings.* The headings in this Agreement are for convenience of reference only and shall not limit or otherwise affect the meaning hereof.

*[Remainder of page intentionally left blank]*

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IN WITNESS WHEREOF, the parties have executed this Registration Rights Agreement as of the date first written above.

**DIGITAL MUSIC GROUP, INC.**

By:

Name:

Title:

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**HOLDER S SIGNATURE PAGE**

By:  
Name:  
Title:

**Address**

**Facsimile Number**

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**SCHEDULE A**  
**LIST OF HOLDERS**

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**ANNEX A**

**Plan of Distribution**

The Selling Stockholders and any of their pledgees, assignees and successors-in-interest may, from time to time, sell any or all of their shares of Common Stock on any stock exchange, market or trading facility on which the shares are traded or in private transactions. These sales may be at fixed or negotiated prices. The Selling Stockholders may use any one or more of the following methods when selling shares:

ordinary brokerage transactions and transactions in which the broker/dealer solicits purchasers;

block trades in which the broker/dealer will attempt to sell the shares as agent but may position and resell a portion of the block as principal to facilitate the transaction;

purchases by a broker/dealer as principal and resale by the broker/dealer for its account;

an exchange distribution in accordance with the Rules of the applicable exchange;

privately negotiated transactions;

to cover short sales made after the date that this Registration Statement is declared effective by the Commission;

broker/dealers may agree with the Selling Stockholders to sell a specified number of such shares at a stipulated price per share;

a combination of any such methods of sale; and

any other method permitted pursuant to applicable law.

The Selling Stockholders may also sell shares under Rule 144 under the Securities Act, if available, rather than under this prospectus.

Broker/dealers engaged by the Selling Stockholders may arrange for other brokers/dealers to participate in sales. Broker/dealers may receive commissions from the Selling Stockholders (or, if any broker/dealer acts as agent for the purchaser of shares, from the purchaser) in amounts to be negotiated. The Selling Stockholders do not expect these commissions to exceed what is customary in the types of transactions involved.

The Selling Stockholders may from time to time pledge or grant a security interest in some or all of the shares of common stock owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of common stock from time to time under this prospectus, or under an amendment to this prospectus under Rule 424(b)(3) or other applicable provision of the Securities Act of 1933 amending the list of Selling Stockholders to include the pledgee, transferee or other successors in interest as Selling Stockholders under this prospectus.

The Selling Stockholders and any broker/dealers or agents that are involved in selling the shares may be deemed to be underwriters within the meaning of the Securities Act in connection with such sales. In such event, any commissions received by such broker/dealers or agents and any profit on the resale of the shares purchased by them may be deemed to be underwriting commissions under the Securities Act. The Selling

## Edgar Filing: NETFLIX INC - Form 4

Stockholders have informed the Company that it does not have any agreement or understanding, directly or indirectly, with any person to distribute the Common Stock.

The Company has advised each Selling Stockholder that it may not use shares registered on this Registration Statement to cover short sales of Common Stock made prior to the date on which this Registration Statement shall have been declared effective by the Commission. If a Selling Stockholder uses this prospectus for any sale of the Common Stock, it will be subject to the prospectus delivery requirements of the Securities Act. The Selling Stockholders will be responsible to comply with the applicable provisions of the Securities Act and

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Exchange Act, and the rules and regulations thereunder promulgated, including, without limitation, Regulation M, as applicable to such Selling Stockholders in connection with resales of their respective shares under this Registration Statement.

The Company is required to pay all fees and expenses incident to the registration of the shares. The Company has agreed to indemnify the Selling Stockholders against certain losses, claims, damages and liabilities, including liabilities under the Securities Act.

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**EXHIBIT A**

**SELLING STOCKHOLDER QUESTIONNAIRE**

Ladies and Gentlemen:

I acknowledge that I am a holder of securities of Digital Music Group, Inc. (the *Company* ). I understand that I will be named as a selling stockholder in the prospectus that forms a part of the registration statement on Form S-3 (or other applicable form) (the *Registration Statement* ) that the Company will file with the Securities and Exchange Commission to register under the Securities Act of 1933, as amended, the securities I expect to sell. The Company will use the information that I provide in this Questionnaire to ensure the accuracy of the registration statement and the prospectus.

**Please answer every question.**

**If the answer to any question is none or not applicable, please so state.**

1. **Name.** Type or print your name exactly as it should appear in the Registration Statement.

2. **Manner of Ownership of Shares:**

Individual \_\_\_\_\_ Community Property \_\_\_\_\_ Tenants in Common \_\_\_\_\_  
Joint Tenants with Rights of Survivorship \_\_\_\_\_ Corporate \_\_\_\_\_  
Partnership \_\_\_\_\_ Trust \_\_\_\_\_ Other \_\_\_\_\_

3. **Contact Information.** Provide the address, telephone number and fax number where you can be reached during business hours.

*Address:*

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*Phone:*

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*Fax:*

4. **Relationship with the Company.** Describe the nature of any position, office or other material relationship you or your affiliates have had with the Company or its affiliates during the past three years, or arrangement with the Company or its affiliates to be performed in the future.

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5. **Organizational Structure.** Please indicate or (if applicable) describe how you are organized.

(a) Are you a natural person?

Yes " No "

(if so, please mark the box and skip to Question 6)

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- (b) Are you a reporting company under the 1934 Act? Yes " No "  
**(if so, please mark the box and skip to Question 6)**
- (c) Are you a majority-owned subsidiary of a reporting company under the 1934 Act? Yes " No "  
**(if so, please mark the box and skip to Question 6)**
- (d) Are you a registered investment fund under the 1940 Act? Yes " No "  
**(if so, please mark the box and skip to Question 6)**

If you have answered "no" to all of the foregoing questions, please describe: (i) the exact legal description of your entity (e.g., corporation, partnership, limited liability company, etc.); (ii) whether the legal entity so described is managed by another entity and the exact legal description of such entity (repeat this step until the last entity described is managed by a person or persons, each of whom is described in any one of (a) through (d) above), (iii) the names of each person or persons having voting and investment control over the Company's securities that the entity owns (e.g., director(s), general partner(s), managing member(s), etc.).

*Legal Description of Entity:*

*Name of Entity(ies) Managing Such Entity (if any):*

*Name of Entity(ies) Managing Such Entity(ies) (if any):*

*Name(s) of Natural Persons Having Voting or Investment Control Over the Shares Held by such Entity(ies):*

**6. Ownership of the Company's Securities.** This question covers your beneficial ownership of the Company's securities. Please consult the Appendix A to this Questionnaire for information as to the meaning of "beneficial ownership." State the number of shares of the Company's common stock that you beneficially owned as of the date this Questionnaire is signed:  
*No. of Shares of Stock:* \_\_\_\_\_

**7. Acquisition of Shares.** Please describe below the manner in which you acquired your shares of Common Stock of the Company including, but not limited to, the date, the name and address of the seller(s), the purchase price and pursuant to which documents (the *Acquisition Documents* ). Please forward such documents used to acquire your shares as provided below.

**8. Plan of Distribution.** I have reviewed the proposed "Plan of Distribution" attached to this Registration Rights Agreement as **Annex A**, and agree that the statements contained therein reflect my intended method(s) of distribution or, to the extent these statements are inaccurate or incomplete, I have communicated in writing to one of the parties listed above my signature to any changes to the proposed "Plan of Distribution" that are required to make these statements accurate and complete. **(Please check the box if you have made any changes to Annex A)**





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**9. Broker-Dealer Status.**

(a) Are you a broker-dealer? Yes " No "  
**(if yes, the Commission's staff has indicated that you should be identified as an underwriter in the Registration Statement)**

(b) Did you acquire the securities to be registered for investment purposes Yes " No "  
**(if so, please mark the box and skip to Question 6)**

(c) Are you an affiliate of a broker-dealer? Yes " No "  
**(if no, mark the box and skip the remainder of this Question 9)**

(d) If you are an affiliate of a broker-dealer, do you certify that you bought the securities to be registered in the ordinary course of business, and at the time of the purchase of the securities to be resold, you had no agreements or understandings, directly or indirectly, with any person to distribute the securities? Yes " No "

**(if no, the Commission's staff has indicated that you should be identified as an underwriter in the Registration Statement)**

**10. Short Positions.** Do you currently have open, or since the time you became aware of the Company's offering, have you participated in any short position in the Company's shares? Yes " No " If yes, please describe all material terms such as dates, amounts, etc.

**11. Reliance on Responses.** I acknowledge and agree that the Company and its legal counsel shall be entitled to rely on my responses in this Questionnaire in all matters pertaining to the registration statement and the sale of any shares of common stock of the Company pursuant to the registration statement.

**12. NASD.** The National Association of Securities Dealers, Inc. ( *NASD* ) may request, in connection with their review of the Registration Statement and Prospectus under the Securities Act of 1933, as amended, that the Company inform them of the names of all persons who purchased securities from the Company, together with any affiliations with the NASD of such purchasers. In order to aid the Company in responding to such request, the undersigned furnishes the following information:

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**PART A: DETERMINATION OF RESTRICTED PERSON STATUS:**

**Please check all appropriate categories.**

The undersigned is:

- .. (i) a broker-dealer;
  
- .. (ii) an officer, director, general partner, associated person<sup>1</sup> or employee of a broker-dealer (other than a limited business broker-dealer)<sup>2</sup>;
  
- .. (iii) an agent of a broker-dealer (other than a limited business broker-dealer) that is engaged in the investment banking or securities business;
  
- .. (iv) an immediate family member<sup>3</sup> of a person described in (ii) or (iii) above. Under certain circumstances, if the undersigned checks this category, he/she/it may be able to participate in New Issue investments. The Company may request additional information in order to determine the eligibility of the undersigned under this Restricted Person category;
  
- .. (v) a finder or any person acting in a fiduciary capacity to a managing underwriter, including, but not limited to, attorneys, accountants and financial consultants;
  
- .. (vi) a person who has authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment advisor or collective investment account<sup>4</sup> (including a private investment vehicle such as a hedge fund or an offshore fund);
  
- .. (vii) an immediate family member of a person described in (v) or (vi) above who materially supports<sup>5</sup>, or receives material support from, the undersigned;
  
- .. (viii) a person listed or required to be listed in Schedule A, B or C of a Form BD (other than with respect to a limited business broker-dealer), except persons whose listing on Schedule A, B or C is related to a person identified by an ownership code of less than 10% on Schedule A;
  
- .. (ix) a person that (A) directly or indirectly owns 10% or more of a public reporting company listed, or required to be listed, in Schedule A of a Form BD or (B) directly or

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<sup>1</sup> A person associated with a broker-dealer includes any natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a broker-dealer, any partner, director, officer or sole proprietor of a broker-dealer.

<sup>2</sup> A limited business broker-dealer is any broker-dealer whose authorization to engage in the securities business is limited solely to the purchase and sale of investment company/variable contracts securities and direct participation program securities.

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- <sup>3</sup> The term **Immediate family** includes the investor s: (i) parents, (ii) mother-in-law or father-in-law, (iii) husband or wife, (iv) brother or sister, (v) brother-in-law or sister-in-law, (vi) son-in-law or daughter-in-law, (vii) children, and (viii) any other person who is supported, directly or indirectly, to a material extent by an officer, director, general partner, employee, agent of a broker-dealer or person associated with a broker-dealer.
- <sup>4</sup> A **collective investment account** is any hedge fund, investment corporation, or any other collective investment vehicle that is engaged primarily in the purchase and/or sale of securities, investment clubs (groups of individuals who pool their money to invest in stock or other securities and who are collectively responsible for making investment decisions) and family investment vehicles (legal entities that are beneficially owned solely by immediate family members (as defined above)) are not considered collective investment accounts.
- <sup>5</sup> The term **material support** means directly or indirectly providing more than 25% of a person s income in the prior calendar year or living in the same household with a member of one s Immediate family, indirectly owns 25% or more of a public reporting company listed, or required to be listed in Schedule B of a Form BD, in each case (A) or (B), other than a reporting company that is listed on a national securities exchange or is traded on the Nasdaq National Market, or other than with respect to a limited business broker/dealer;

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- .. (x) an immediate family member of a person described in (viii) or (ix) above. Under certain circumstances, if the undersigned places a check next to this category, he/she/it may be able to participate in New Issue investments. The Company may request additional information in order to determine the eligibility of the undersigned under this Restricted Person category;
- .. (xi) any entity (including a corporation, partnership, limited liability company, trust or other entity) in which any person or persons listed in (i)-(x) above has a beneficial interest<sup>6</sup>; or
- .. None of the above categories apply and the undersigned is eligible to participate in New Issue securities.

**PART B: DETERMINATION OF EXEMPTED ENTITY STATUS:**

The undersigned is:

- .. (i) a publicly-traded entity (other than a broker-dealer or an affiliate of a broker-dealer, where such broker-dealer is authorized to engage in the public offering of New Issues either as a selling group member or underwriter) that is listed on a national securities exchange or traded on the Nasdaq National Market or is a foreign issuer whose securities meet the quantitative designation criteria for listing on a national securities exchange or trading on the Nasdaq National Market;
- .. (ii) an investment company registered under the Investment Company Act of 1940, as amended;
- .. (iii) a corporation, partnership, limited liability company, trust or any other entity (including a private investment vehicle such as a hedge fund or an offshore fund, or a broker-dealer organized as an investment partnership) and
  - (A) the beneficial interests of Restricted Persons do not exceed in the aggregate 10% of such entity; or
  - (B) such entity limits participation by Restricted Persons to not more than 10% of the profits and losses of New Issues;
- .. (iv) an investment company organized under the laws of a foreign jurisdiction and
  - (A) the investment company is listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority; and

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<sup>6</sup> The term "beneficial interest" means any economic interest such as the right to share in gains or losses. The receipt of a management or performance based fee for operating a collective investment account, or other fee for acting in a fiduciary capacity, is not considered a beneficial interest in the account; however, if such fee is subsequently invested into the account (as a deferred fee arrangement or otherwise), it is considered a beneficial interest in that account.

- (B) no person owning more than 5% of the shares of the investment company is a Restricted Person;

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- .. (v) (A) an employee benefits plan under the U.S. Employee Retirement Income Security Act of 1974, as amended, that is qualified under Section 401(a) of the Internal Revenue Code of 1986, as amended (the Code ) and such plan is not sponsored solely by a broker-dealer, (B) a state or municipal government benefits plan that is subject to state and/or municipal regulation or (C) a church plan under Section 414(e) of the Code;
  
- .. (vi) a tax exempt charitable organization under Section 501(c)(3) of the Code;
  
- .. (vii) a common trust fund or similar fund as described in Section 3(a)(12)(A)(iii) of the Securities Exchange Act of 1934, as amended, and the Company
  - (A) has investments from 1,000 or more accounts, and
  
  - (B) does not limit beneficial interests in the Company principally to trust accounts of Restricted Persons; or

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- .. (viii) an insurance company general, separate or investment account, and
  - (A) the account is funded by premiums from 1,000 or more policyholders, or, if a general account, the insurance company has 1,000 or more policyholders, and
  - (B) the insurance company does not limit the policyholders whose premiums are used to fund the account principally to Restricted Persons, or, if a general account, the insurance company does not limit its policyholders principally to Restricted Persons.

Please acknowledge that your answers to the foregoing questions are true and correct to the best of your information and belief by signing and dating this Questionnaire where indicated below. Please return the completed executed questionnaire *via fax* to \_\_\_\_\_ at (XXX)-XXX-XXXX as soon as possible.

By signing this Questionnaire you agree to promptly notify the Company of any inaccuracies or changes in the information provided in this Questionnaire that may occur subsequent to the date of this Questionnaire and prior to the effective date of the Registration. Accordingly, if at any time you discover that your answer to any question was inaccurate, or if any event occurring after your completion hereof would require a change in your answer to any questions, please immediately contact \_\_\_\_\_ at XXX-XXX-XXXX.

Date: \_\_\_\_\_, 2007

**(Print name of selling stockholder)**

By: \_\_\_\_\_  
**(Signature)**

Name: \_\_\_\_\_  
**(Print name)**

Title:

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**APPENDIX A**

**1. Definition of Beneficial Ownership**

(a) *Beneficial Owner* of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares:

(1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or

(2) Investment power which includes the power to dispose, or direct the disposition of, such security.

Please note that either voting power or investment power, or both, is sufficient for you to be considered the beneficial owner of shares.

(b) Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement or device with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of the federal securities acts shall be deemed to be the beneficial owner of such security.

(c) Notwithstanding the provisions of paragraph (a), a person is deemed to be the beneficial owner of a security, if that person has the right to acquire beneficial ownership of such security within 60 days, including but not limited to any right to acquire: (A) through the exercise of any option, warrant or right; (B) through the conversion of a security; (C) pursuant to the power to revoke a trust, discretionary account or similar arrangement; or (D) pursuant to the automatic termination of a trust, discretionary account or similar arrangement; provided, however, any person who acquires a security or power specified in paragraphs (A), (B) or (C) above, with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect, immediately upon such acquisition shall be deemed to be the beneficial owner of the securities which may be acquired through the exercise or conversion of such security or power.

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**Schedule 6.10(a)**

Greg Scholl Chief Executive Officer, President, Treasurer and Secretary.

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**Schedule 6.10(b)**

Greg Scholl President, Treasurer and Secretary.

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**Schedule 6.11(a)**

*Orchard Nominees*

Daniel C. Stein

Michael J. Donahue

Viet D. Dinh

*DMGI Nominees*

Clayton Trier (Chairman)

Terry Hatchett

David Altschol

*Chief Executive Officer*

Greg Scholl

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**Schedule 6.11(b)**

Greg Scholl

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**ANNEX B**

August 7, 2007

Board of Directors

Digital Music Group, Inc.

2151 River Plaza Drive

Suite 200

Sacramento CA 95833

Members of the Board:

We understand that Digital Music Group, Inc. ( DMGI ), The Orchard Enterprises Inc. ( Orchard ) and DMGI New York, Inc., a wholly owned subsidiary of DMGI ( Merger Sub ), entered into an Agreement and Plan of Merger, dated as of July 10, 2007 (the Agreement ). The Agreement provides for the merger of Merger Sub with and into Orchard (the Merger ), which shall survive the Merger and, further, provides for DMGI to change its name to The Orchard Inc. and for Orchard to change its name to The Orchard NY We understand that, upon the Merger, all classes of Orchard stock on a combined basis will own (i) 9,064,941 shares of DMGI common stock; and (ii) 4,488,330 shares of DMGI preferred stock with a \$25 million liquidation preference and convertible into 4,488,330 shares of DMGI common stock ((i) and (ii), together, the Consideration ). The terms and conditions of the Merger are more fully set forth in the Agreement.

We have been requested by the Board of Directors of DMGI (the Board ) to render our opinion with respect to the fairness of the Merger, from a financial point of view, to DMGI shareholders (the Opinion ). We have not been requested to opine as to, and our Opinion does not in any manner address, DMGI s underlying business decision to proceed with or effect the Merger.

In arriving at the Opinion, we have reviewed and analyzed, among other things:

1. Agreement, dated as of July 10, 2007;
2. Publicly available information concerning DMGI that we believe to be relevant to our analysis, including, without limitation, DMGI S 2006 Annual Report on Form 10-K and its Quarterly Report on Form 10-Q for the quarter ended March 31, 2007;
3. Certain financial and operating information with respect to the respective businesses, operations, and prospects of DMGI and Orchard, including financial and operating projections furnished by the managements of DMGI and Orchard and in particular (a) projected revenue, cost of revenue, and operating costs for each of DMGI and Orchard; and (b) amounts and timing of cost savings and operating synergies expected by the management of DMGI and Orchard resulting from the Merger;
4. A comparison of the historical financial results and present financial condition of DMGI and Orchard with each other and with those of other publicly-traded companies that we deemed relevant;
5. A comparison of the financial terms of the Merger with the financial terms of certain other transactions that we deemed relevant;

6. Published estimates of independent research analysts with respect to the future financial performance of companies comparable to DMGI and Orchard;

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7. Derived valuations of net present values of the businesses, based on projected cash flows for DMGI and Orchard on a stand-alone basis and as a combined company;
8. The potential pro forma impact of the Merger on the future financial performance of DMGI;
9. The potential pro forma impact of the Merger on the current financial condition of DMGI;
10. The relative contributions of DMGI and Orchard to the current and future financial performance of the combined company on a pro forma basis;
11. The views of the respective managements of the strategic impacts of the Merger on the business, operations, assets, financial condition and strategic opportunities of DMGI;
12. DMGI's management's opinions regarding the merger structure relating to the preservation of the NOLs; and
13. Such other information, financial studies, analyses and investigations as we deemed relevant.

In arriving at our Opinion, we have assumed and relied upon the accuracy and completeness of the financial and other information used by us without assuming any responsibility for independent verification of such information and have further relied upon the assurances of the managements of DMGI and Orchard that they are not aware of any facts or circumstances that would make such information materially inaccurate or misleading. With respect to the financial projections of DMGI and Orchard, upon advice of DMGI and Orchard, respectively, we have assumed that such projections have been reasonably prepared on a basis reflecting the best currently available estimates and judgments of the managements of DMGI and Orchard as to the future financial performance of DMGI and Orchard, respectively, and that each of DMGI and Orchard will perform substantially in accordance with such projections. In arriving at our Opinion, we have visited the properties and facilities of DMGI and Orchard. We have not made or obtained from third parties any evaluations or appraisals of the assets and liabilities of DMGI or Orchard.

With respect to all legal, accounting, and tax matters arising in connection with the Merger, we have relied without independent verification on the accuracy and completeness of the advice provided to DMGI and Orchard by their legal counsel, accountants, and other advisers.

In arriving at this Opinion, we did not attribute any particular weight to any analysis or factor considered by us. Accordingly, we believe that our analyses must be considered as a whole and that selecting portions of our analyses, without considering all analyses, would create an incomplete view of the process underlying this Opinion.

We acted as a financial advisor to DMGI in connection with the Merger and will receive a fee upon the delivery of this Opinion. In addition, DMGI has agreed to indemnify us for certain liabilities that may arise out of our engagement. In the ordinary course of business, we or our affiliates may actively trade in DMGI's securities for our own accounts and for the accounts of our customers and, accordingly, may at any time hold a long or short position in such securities.

This Opinion is for the use and benefit of the Board and is provided to the Board in connection with its consideration of the Merger. This Opinion does not address DMGI's underlying business decision to pursue the Merger, the relative merits of the Merger as compared to any alternative business strategies that might exist for DMGI or the effects of any other transaction in which DMGI might engage. We were not requested to, and we did not, participate in the negotiation or structuring of the Merger. In addition, we have not been asked to, nor do we offer, any opinion as to the terms of the Agreement or the form of the Merger. Our opinion does not constitute a recommendation to any stockholder as to how such stockholder should vote or act with respect to any matters relating to the Merger. We also have assumed that each of the parties to the Merger will comply with all material terms of the Agreement and that the Merger will be consummated in accordance with its terms without waiver,





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modification or amendment of any material term, condition or agreement. We further have assumed, with your consent, that all governmental, regulatory or other consents and approvals necessary for the consummation of the Merger will be obtained without any adverse effect on DMGI, Orchard or the contemplated benefits of the Merger. In addition, we express no opinion as to the price at which shares of common stock of DMGI actually will trade following announcement of the Merger.

Our Opinion is subject to the assumptions and conditions contained herein and is based upon market, economic, financial and other conditions as they exist and can be evaluated on, and on the information available to us as of, the date of this letter. We assume no responsibility for updating or revising our Opinion based on circumstances or events occurring after the date hereof. The letter is not to be used for any other purpose, or to be reproduced, disseminated, quoted from or referred to at any time, in whole or in part, without our prior written consent, provided, however, that we consent to the inclusion of the text of this Opinion in any notice or appropriate disclosure to the public shareholders of DMGI and in any filing DMGI is required by law to make, if such inclusion is required by applicable law.

Based upon and subject to the foregoing, it is our opinion that, as of the date hereof, the Consideration to be paid by DMGI in the Merger is fair, from a financial point of view, to DMGI shareholders.

SMH Capital Inc.

By: Douglas Hurst

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ANNEX C

**INFORMATION WITH RESPECT TO DIRECTOR DESIGNEES OF ORCHARD**

**DIGITAL MUSIC GROUP, INC.**

**INFORMATION STATEMENT PURSUANT TO**

**SECTION 14(F) OF THE SECURITIES EXCHANGE ACT OF 1934**

**AND RULE 14F-1 THEREUNDER**

**NOTICE OF CHANGE IN THE COMPOSITION OF THE BOARD OF DIRECTORS**

*This Information Statement is attached to the proxy statement being mailed on or about October 10, 2007 to the holders of Digital Music Group, Inc. ( **DMGI** ) common stock, par value \$0.01 per share, and is being filed with the Securities and Exchange Commission and transmitted to such holders in accordance with Rule 14f-1 of the Exchange Act. The proxy statement to which this Information Statement is attached is incorporated herein by reference. Capitalized terms used in this Information Statement, but not otherwise defined, shall have the meanings ascribed to such terms in the proxy statement. Under the terms of the merger agreement, the obligation of The Orchard Enterprises Inc. ( **Orchard** ) to complete the merger is subject to, among other things, the appointment of certain persons designated by it to the board of directors of DMGI. Orchard has designated the following persons to be appointed to the board of directors of DMGI assuming the merger is completed: Viet D. Dinh, Michael Donahue, Greg Scholl and Daniel Stein (the **Proposed Directors** ).*

**NO VOTE OR OTHER ACTION BY OUR STOCKHOLDERS IS REQUIRED IN RESPONSE TO THIS INFORMATION STATEMENT. PROXIES ARE NOT BEING SOLICITED. YOU ARE URGED TO READ THIS INFORMATION STATEMENT CAREFULLY. YOU ARE NOT, HOWEVER, REQUIRED TO TAKE ANY ACTION.**

Please read this Information Statement carefully. It contains certain biographical and other information concerning the Proposed Directors after completion of the merger.

**VOTING SECURITIES AND PRINCIPAL STOCKHOLDERS**

*Voting Securities of the Company*

See THE SPECIAL MEETING OF DMGI STOCKHOLDERS Record Date on page 24 of the proxy statement to which this Information Statement is attached.

If the merger is completed, Orchard stockholders will be entitled to receive an aggregate maximum of 9,064,941 shares of DMGI common stock and 448,833 shares of Series A Preferred Stock (as adjusted to reflect the reverse stock split, if any) of DMGI in exchange for all of the outstanding shares of (and derivative rights to acquire) capital stock of Orchard owned by them, or approximately 60% of the outstanding shares of voting capital stock of DMGI immediately following the closing of the merger, and have the right (after acquiring a majority of the voting capital stock of DMGI) to designate persons to the board of directors of DMGI other than at a meeting of the stockholders of DMGI.

*Security Ownership of Certain Beneficial Owners*

The following table sets forth certain information known to us with respect to the beneficial ownership of DMGI common stock as of closing of the merger by each Proposed Director and all Proposed Directors as a group. We have relied exclusively upon information provided to us by the Proposed Directors for purposes of determining the number of shares each person will beneficially own upon closing of the merger. Beneficial ownership is determined in accordance with the rules and regulations of the SEC and generally includes those persons who have voting or investment power with respect to the securities. Except as otherwise indicated, and subject to applicable community property laws, the persons named in the table have sole voting and investment power with respect to all shares of our common stock beneficially owned by them. For each individual and group included in the table below, percentage ownership is calculated by dividing the number of shares beneficially

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owned by such person or group by the sum of the 9,121,939 shares of common stock outstanding on October 5, 2007 plus the number of shares of common stock we are obligated to issue in the merger and the number of shares of common stock issuable upon conversion of our Series A Preferred Stock. The address for each stockholder listed in the table below is as follows: Michael J. Donahue, 405 Mulberry Lane, Haverford, Pennsylvania 19041; Viet D. Dinh, Georgetown University Law Center, 600 New Jersey Avenue, NW, Washington, DC 20001; Daniel Stein, JDS Capital Management Inc., 1091 Boston Post Road, Rye, New York 10580; and Greg Scholl, The Orchard Enterprises Inc., 100 Park Avenue, 2nd floor, New York, New York 10017.

| Name                        | Amount and           | Percent of                              |
|-----------------------------|----------------------|---|
|                             | Nature of            |   |
|                             | Beneficial Ownership | Common Stock Outstanding <sup>(1)</sup> |
| Daniel Stein <sup>(2)</sup> | 12,833,469           | 56.6%                                   |
| Viet D. Dinh                | 0                    |   |
| Michael Donahue             | 0                    |   |
| Greg Scholl <sup>(3)</sup>  | 369,579              | 1.6%                                    |
| <b>Total</b>                | <b>13,203,048</b>    | <b>58.2%</b>                            |

- (1) Reflects the conversion of all Series A preferred stock to be issued in the merger.  
(2) Includes shares (both common and preferred) Dimensional Associates and/or its affiliates will be issued in the merger. Mr. Stein is the chief executive officer of Dimensional and, therefore, may be deemed to beneficially own such shares.  
(3) Reflects shares (both common and preferred) that Mr. Scholl has the right to receive pursuant to deferred stock awards.

***Changes in Control***

There will be a change in control of DMGI that will occur as a result of the merger. See also RISK FACTORS - Risk Factors Relating to the Merger - Upon completion of the Merger, Dimensional Associates, LLC will have significant influence on all of DMGI's stockholder votes and will have effective control over the outcome of actions requiring the approval of DMGI stockholders on page 12 and THE MERGER - Board of Directors and executive officers of DMGI after completion of the Merger on Page 38 of the proxy statement to which this Information Statement is attached.

**DIRECTORS**

Clayton Trier (chairman), David Altschul and Terry Hatchett, who are each currently independent directors of DMGI, will continue to serve in such capacities following the merger. For biographical information concerning these directors, see DMGI's proxy statement dated April 27, 2007 for its 2007 annual meeting of stockholders, which was filed with the SEC on that day.

The following table sets forth information regarding the Proposed Directors:

| Name            | Age | Position with DMGI                   | Served as a Director Since |
|-----------------|-----|--------------------------------------|----------------------------|
| Viet D. Dinh    | 39  | Director                             |                            |
| Michael Donahue | 48  | Director                             |                            |
| Greg Scholl     | 38  | Chief Executive Officer and Director |                            |
| Daniel Stein    | 38  | Director                             |                            |

*Viet D. Dinh*

Viet D. Dinh has been a Professor of Law at Georgetown University Law School since 1996, and currently is the Co-Director of its Asian Law & Policy Studies Program. He served as Assistant Attorney General of the



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United States from May 2001 to May 2003. Since June, 2003, he has been the principal at Bancroft Associates PLLC, a law and public policy consulting firm specializing in national security, regulatory compliance, and law enforcement. Mr. Dinh currently serves on the board of directors of News Corporation (NYSE: NWS) and M&F Worldwide (NYSE: MFW). Mr. Dinh has an A.B. degree in government and economics from Harvard University and a J.D. degree from Harvard Law School.

*Michael Donahue*

Michael Donahue currently serves as an independent advisor to firms in the information and technology industries. He served as executive chairman of Expensewatch.com from 2006 to March 2007. In 2005, Mr. Donahue completed a twenty-year career with KPMG LLP, KPMG Consulting and BearingPoint. During his tenure with KPMG and its successors, he most recently served as Managing Partner, Technology Solutions (1997 to 2001) and Group Executive Vice President and Chief Operating Officer (2001 to 2005). He also served on the board of directors of KPMG LLP from 1998 to 2001. Mr. Donahue currently serves on the boards of directors of Air Products and Chemicals, Inc. (NYSE: APD), Arbinet, Inc. (NASDAQ: ARBX) and GSI Commerce, Inc. (NASDAQ: GSIC). Mr. Donahue has degrees in economics and history from the University of Pennsylvania.

*Greg Scholl*

Greg Scholl has served as a managing director of Dimensional, the controlling shareholder of Orchard, and as president and chief executive officer of Orchard, since 2003. Mr. Scholl was an associate principal at the management consulting firm of McKinsey & Company from 2002 to 2003 in the media and entertainment practice. From 1999 to 2002, Mr. Scholl served as managing member of Carlin Ventures LLC, the private equity fund of Edwin Cohen. From 1993 to 1999, Mr. Scholl served in the technology and the media and entertainment practices of the management consulting firm of Booz Allen & Hamilton, and was a principal at the firm. Mr. Scholl has a bachelor of arts degree in history and science from Harvard College.

*Daniel Stein*

Daniel Stein serves as President of JDS Capital Management, Inc., an investment firm based in New York that invests in private and public debt and equity, and he has held this position since 2003. Mr. Stein also serves as chief executive officer of Dimensional, the operating company that manages the private equity investments made by JDS Capital Management, Inc., including eMusic and Orchard, and he has been a director of Orchard since April 2003. From May 2001 through October 2002, Mr. Stein was the chief executive officer of TTR Technologies, a company that specialized in copy-protection technologies whose assets were sold to Macrovision (MVSN). From 2000 to 2001, Mr. Stein was President of Javu Technologies, which licenses software and services to corporations that store, manage, deliver or repurpose video assets. From 1999 to May 2000, Mr. Stein was president, chief operating officer and a director of the Wedding List Company, an Internet company with retail outlets specializing in the wedding gift and registry business. Mr. Stein has a bachelor of science degree from Cornell University.

***Family Relationships***

There are no family relationships between any of the directors, executive officers of DMGI and the Proposed Directors.

**LEGAL PROCEEDINGS**

We are not aware of any legal proceedings in which any Proposed Director, or any affiliate of any such Proposed Director, is a party adverse to DMGI or has a material interest adverse to DMGI.

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**CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Except as described below, there have been no transactions or proposed transactions in which the amount involved exceeded \$120,000 since the beginning of DMGI's last fiscal year, in which any of the Proposed Directors, or any of their respective relatives, spouses, associates or affiliates, has had or will have any direct or material indirect interest.

On July 10, 2007, Greg Scholl entered into a three-year employment agreement with DMGI, effective upon closing of the merger (the Employment Agreement). Under the terms of the agreement, Mr. Scholl's employment will be at-will and the employment may be terminated at any time, with or without cause, by either him or DMGI. Mr. Scholl will receive (i) an initial annual base salary of \$250,000; (ii) a restricted stock grant under DMGI's Amended and Restated 2005 Stock Plan to purchase 100,000 shares of DMGI's common stock at a purchase price of \$0.01, subject to a DMGI repurchase option at the original purchase price that lapses with respect to 16,666 shares three months following closing of the merger, 16,666 shares six months following closing of the merger, 16,666 shares nine months following closing of the merger, 16,666 shares on the first anniversary of the closing of the merger, 16,666 shares 15 months following closing of the merger and the remaining 16,670 shares 18 months following closing of the merger, so long as Mr. Scholl remains employed by DMGI; (iii) an option to purchase 100,000 shares of DMGI common stock at a price per share equal to the fair market value of DMGI's common stock on the date of grant, vesting in the same amounts and at the same times as specified in clause (ii); and (iv) participation in a management incentive bonus plan for 2007 and subsequent years under which he will be eligible to earn cash bonuses up to 100% of his base salary with specific bonus criteria to be determined by the compensation committee of the DMGI board of directors. Under the terms of the Employment Agreement, if Mr. Scholl is terminated by DMGI without cause or if he terminates his employment for good reason, he will be entitled to (i) continued payment of his then base salary and provision of benefits for the greater of the remaining term of the Employment Agreement or one year and (ii) a pro rata share of any annual incentive bonus that he would have otherwise been eligible to receive in the year of termination. The Employment Agreement includes provisions that prohibit Mr. Scholl from disclosing DMGI confidential information and trade secrets, assigns all intellectual property developed by him in the course of employment to DMGI and prohibits him from competing with DMEI or soliciting DMGI's employees during the term of the Employment Agreement and for a period of one year following termination of employment.

In connection with the election of Mr. Scholl as Chief Executive Officer and director, and the election of Messrs. Dinh, Donahue and Stein as directors, DMGI and each of Messrs. Scholl, Dinh, Donahue and Stein will enter into DMGI's standard form of indemnification agreement for directors and officers of DMGI, which generally requires DMGI to indemnify and to advance expenses to him to the maximum extent that Delaware law permits a Delaware corporation to indemnify and to advance expenses to an officer of the corporation. A copy of the form of indemnification agreement for directors and officers has been previously filed by DMGI with the SEC.

Daniel Stein is a director and chairman of eMusic.com, Inc. During the year ended December 31, 2006, eMusic.com, Inc. paid \$171,000 in revenue to DMGI and \$1,783,000 in revenue to Orchard.

**Compensation of Directors**

Directors who are also employees of DMGI or any of our subsidiaries do not receive additional compensation for serving as directors. Each director who is not also an employee receives a fee of \$36,000 per year, except that the chairperson of the audit committee receives \$40,000 and the chairman of the board receives \$50,000 per year. Each non-employee director also receives \$500 per committee meeting attended. From time-to-time, special committees of the board may be formed and additional compensation may be paid to directors who serve on such special committees. Our directors are reimbursed for out-of-pocket expenses incurred in attending meetings of the board or the committees thereof, and for other expenses reasonably incurred in their capacity as directors. The compensation committee of the board of directors is responsible for

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periodically reviewing and assessing the adequacy and appropriateness of the compensation of our directors, and this committee may adjust the compensation as set forth above if necessary or warranted under the circumstances.

The timing and terms of stock option grants to non-employee directors are set forth in DMGI's Amended and Restated 2005 Stock Plan; they are automatic and non-discretionary with respect to the number and terms. Any new non-employee director, including the three non-employee nominees named above, will be entitled to receive an automatic stock option grant to purchase 12,000 shares of DMGI common stock with an exercise price per share equal to the fair market value of our common stock on the date of grant, vesting in equal monthly installments over the following 12 months. On each date of our annual meeting of stockholders, we will grant to each elected non-employee director who has served on the board for at least the preceding six months an additional option to purchase 6,000 shares of DMGI common stock with an exercise price per share equal to the fair market value of our common stock on the date of grant, vesting in equal monthly installments over the following 12 months.

Dated: October 5, 2007



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ANNEX D

DIGITAL MUSIC GROUP, INC.

STOCKHOLDER VOTING AGREEMENT

STOCKHOLDER VOTING AGREEMENT, dated as of July 5, 2007 (this *Agreement* ), among the stockholders identified on Schedule I (each, a *Stockholder* ; collectively, the *Stockholders* ) and The Orchard Enterprises, Inc., a New York corporation ( *Orchard* ).

WHEREAS, Digital Music Group, Inc., a Delaware corporation ( *DMGI* ), DMGI New York, Inc., a New York corporation and a wholly owned subsidiary of DMGI ( *Merger Sub* ), and Orchard have entered into an Agreement and Plan of Merger (the *Merger Agreement* ), dated as of the date of this Agreement, pursuant to which, on the Closing Date, Merger Sub will merge with and into Orchard (the *Merger* );

WHEREAS, as a condition to its willingness to enter into the Merger Agreement, Orchard has requested that the Stockholders make certain agreements with respect to the outstanding shares of Common Stock, par value \$.01 per share ( *Shares* ), of DMGI owned by the Stockholders as set forth in Schedule I and Shares and shares of other voting securities of DMGI hereafter acquired (including, without limitation, Shares acquired pursuant to the exercise of any options or warrants held by the Stockholders) (collectively, the *Subject Shares* ), upon the terms and subject to the conditions of this Agreement; and

WHEREAS, in order to induce Orchard to enter into the Merger Agreement, the Stockholders are willing to make certain agreements with respect to the Subject Shares;

NOW, THEREFORE, in consideration of the promises and the mutual covenants and agreements set forth in this Agreement, the parties agree as follows:

1. *Voting Agreements; Proxy.*

(a) For so long as this Agreement is in effect, in any meeting (or any adjournment or postponement thereof) of stockholders of DMGI, and in any action by consent of the stockholders of DMGI, each Stockholder shall vote (or cause to be voted), or, if applicable, give (or cause to be given) consents with respect to, all of the Subject Shares that are owned by that Stockholder and are entitled to vote at the meeting or deliver (or cause to be delivered) a consent, in any such case (i) in favor of the adoption of the Merger Agreement and the Merger or any other transaction contemplated by the Merger Agreement, as the Merger Agreement may be modified or amended from time to time in a manner not adverse to the Stockholders or with the written consent of the Stockholders, (ii) against any action, proposal, transaction or agreement which would reasonably be expected to result in a breach of any covenant, representation, or warranty or any other obligation or agreement of DMGI under the Merger Agreement or of such Stockholder under this Agreement, and (iii) against any action, proposal, transaction or agreement that would compete with or would delay, discourage, materially adversely affect or inhibit the timely consummation of the Merger (a *Competing Proposal* ). Each Stockholder shall use its commercially reasonable efforts to cast (or cause to be cast) that Stockholder's vote or give that Stockholder's consent in accordance with the procedures communicated to that Stockholder by DMGI relating thereto so that the vote or consent shall be duly counted for purposes of determining that a quorum is present and for purposes of recording the results of that vote or consent. No Stockholder (in his or her capacity as such) shall be required to independently initiate, organize or participate in any vote or consent that is not brought before the stockholders of DMGI generally in order to comply with its obligations under this Agreement.

(b) Upon the reasonable written request of Orchard, in furtherance of the transactions contemplated in this Agreement and by the Merger Agreement and in order to secure the performance of each Stockholder's obligations under Section 1(a), each Stockholder shall promptly execute, in accordance with the provisions of Section 212 of the Delaware General Corporation Law, and deliver to Orchard an irrevocable proxy, substantially in the form attached as Exhibit A, and irrevocably appoint Orchard or its designees, with full power of

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substitution, its attorney and proxy to vote, or, if applicable, to give consent with respect to, all Subject Shares as of the relevant record date with regard to any of the matters referred to in Section 1(a) at any meeting of the stockholders of DMGI, or in connection with any action by written consent by the stockholders of DMGI. Each Stockholder acknowledges and agrees that this proxy, if and when given, shall be coupled with an interest sufficient in law to support an irrevocable proxy, shall revoke any prior proxy granted by such stockholder, shall constitute, among other things, an inducement for Orchard to enter into the Merger Agreement, shall be irrevocable and shall not be terminated by operation of law or otherwise upon the occurrence of any event and that no subsequent proxies with respect to such Subject Shares shall be given (and if given shall not be effective); *provided, however*, that any such proxy shall terminate automatically and without further action on behalf of the Stockholders upon the termination of this Agreement.

**2. Covenants.**

(a) For so long as this Agreement is in effect, each Stockholder agrees not to directly or indirectly (i) sell, transfer, pledge, assign, hypothecate, encumber, tender or otherwise dispose of, or enter into any contract with respect to the sale, transfer, pledge, assignment, hypothecation, encumbrance, tender or other disposition of (each such disposition or contract, a *Transfer*) any of such Stockholder's Subject Shares (or options or warrants to purchase Shares) except to Orchard or, with prior written notice to Orchard, to another Stockholder (and any such Transfer, except to Orchard or to another Stockholder, shall be null and void); (ii) grant any proxies with respect to the Subject Shares, deposit any of the Subject Shares into a voting trust or enter into a voting or option agreement with respect to any of the Subject Shares or enter into any other agreement inconsistent with or violative of this Agreement; (iii) subject to Section 5, solicit, knowingly encourage or facilitate the submission of any Competing Proposal or enter into, initiate or participate in any discussions or negotiations with, otherwise cooperate in any way with, or assist or knowingly encourage any effort by any third party that is seeking to make, or has made, a Competing Proposal, or furnish any nonpublic information or data to, or have any discussions with any Person relating to, a Competing Proposal; or (iv) take any action which would make any representation or warranty of any Stockholder in this Agreement untrue or incorrect or prevent, or materially burden or delay the consummation of the transactions contemplated by this Agreement or the Merger Agreement.

(b) Each Stockholder agrees that in the event any Shares or other voting securities of DMGI are issued pursuant to any stock dividend, stock split, recapitalization, reclassification, combination or exchange of shares of capital stock of DMGI on, of, or affecting the Subject Shares of such Stockholder; (such Shares and other voting securities of DMGI, collectively, the *New Shares*), Stockholder agrees to vote such New Shares in the same manner as the Subject Shares and to notify Orchard and then deliver promptly to Orchard upon its request a proxy with respect to such New Shares, substantially in the form of Exhibit A attached hereto. Stockholder also agrees that any New Shares shall constitute Subject Shares.

(c) No Stockholder shall issue any press release or make any other public statement with respect to the Merger Agreement, the Merger or any other transaction contemplated hereby or by the Merger Agreement without the prior written consent of Orchard, except as may be required by applicable law or court process after consultation with, and having provided an opportunity for review and comment on such press release or other public statement by, Orchard to the extent practicable.

(d) Each Stockholder hereby waives, and agrees not to exercise or assert, any appraisal rights under Section 262 of the Delaware General Corporation Law in connection with the Merger.

**3. Representations and Warranties of Stockholders.** Each Stockholder severally but not jointly represents and warrants to Orchard as to itself that:

(a) *Authority; Enforceability; No Conflicts.* The Stockholder has the legal capacity to enter into this Agreement and to consummate the transactions contemplated by this Agreement. This Agreement has been duly executed and delivered by the Stockholder and constitutes a valid and binding agreement of the Stockholder enforceable against the Stockholder in accordance with its terms, except as such enforceability

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may be limited by applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally and general principles of equity (whether considered in a proceeding in equity or at law). The execution, delivery and performance by the Stockholder of this Agreement will not (i) conflict with, require a consent, waiver or approval under, or result in a breach or default under, any of the terms of any contract, commitment or other obligation to which the Stockholder is a party or by which the Stockholder is bound; (ii) violate any order, writ, injunction, decree or statute, or any law, rule or regulation applicable to the Stockholder or the Subject Shares; or (iii) result in the creation of, or impose any obligation on the Stockholder to create, any Lien upon the Subject Shares that would prevent the Stockholder from voting the Subject Shares (other than as set forth herein), except for any of the foregoing that would not, or would not reasonably be expected to, either individually or in the aggregate, materially impair the ability of such Stockholder to perform its obligations hereunder or to consummate the transactions contemplated hereby. In this Agreement, *Lien* shall mean any lien, pledge, security interest, claim, third party right or other encumbrance.

(b) *Ownership of Shares.* As of the date of this Agreement, the Stockholder is the beneficial owner of and has the power to vote or direct the voting of the Shares set forth on Schedule I free and clear of any Liens that would prevent the Stockholder from voting such Shares. As of the date of this Agreement, the Shares set forth on Schedule I are the only shares of any class of capital stock of DMGI which the Stockholder has the right, power or authority (sole or shared) to sell or vote, and, other than the warrants and/or options to purchase Shares held by the Stockholder as of this date, the Stockholder does not have any right to acquire, nor is it the beneficial owner of, any other shares of any class of capital stock of DMGI or any securities convertible into or exchangeable or exercisable for any shares of any class of capital stock of DMGI. The Stockholder is not a party to any contracts (including proxies, voting trusts or voting agreements) that would prevent, hinder or delay the Stockholder from voting or giving consent with respect to the Shares set forth on Schedule I.

4. *Expenses.* Each party to this Agreement shall pay its own expenses incurred in connection with this Agreement.

5. *Stockholder Capacity.* No natural person bound by this Agreement who is or becomes during the term hereof a director or officer of DMGI makes any agreement or understanding herein in such person's capacity as such director or officer. Each Stockholder signs solely in his or her capacity as the beneficial owner of, the managing member of a limited liability company or the general partner of a partnership which is the beneficial owner of, that Stockholder's Subject Shares, and nothing herein shall limit or affect any actions taken by a Stockholder in such Stockholder's capacity as an officer or director of DMGI in facilitation of the exercise of DMGI's or DMGI's board of directors' fiduciary duties to the extent specifically permitted by the Merger Agreement or required by applicable law. Nothing in this Agreement shall be deemed to constitute a transfer of the beneficial ownership of the Subject Shares by any Stockholder, other than to the extent that the execution by a Stockholder of Exhibit A would be deemed to be such.

6. *Termination.* This Agreement shall terminate automatically and without further action on behalf of any party at the earlier of (a) the effective time of the Merger and (b) the date the Merger Agreement is validly terminated in accordance with its terms.

7. *Assignment; Binding Effect.* This Agreement and the rights hereunder are not assignable (whether by operation of law or otherwise) unless such assignment is consented to in writing by each of Orchard and the Stockholders and any attempt to make any such assignment without such consent shall be null and void; *provided, however*, that Orchard may without such consent, assign in writing, directly or indirectly, its respective rights (but not its respective obligations) hereunder to any of its respective wholly owned subsidiaries (*provided* that no such assignment shall relieve Orchard of its obligations hereunder). Subject to the preceding clause, this Agreement and all the provisions hereof shall be binding upon and shall inure to the benefit of the parties and their respective successors and permitted assigns.

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8. *Choice of Law; Jurisdiction.* This Agreement, and all disputes between the parties under or related to this Agreement or the facts and circumstances leading to its execution, whether in contract, tort or otherwise, shall be governed by and construed in accordance with the laws of the State of New York, without reference to conflict of laws principles. Each of the parties hereto (i) irrevocably consents to submit itself to the exclusive personal jurisdiction of any New York State court located in New York County or any federal court located in the State of New York in the event any dispute arises out of or relates to this Agreement or any transaction contemplated hereby; (ii) agrees that all claims in respect of such action may be heard and determined in any such court; (iii) agrees that it will not attempt to deny or defeat such personal jurisdiction by motion or other request for leave from any such court; (iv) agrees that it will not bring any Action relating to this Agreement or any transaction contemplated hereby in any court other than the New York State court located in New York County or any federal court sitting in the State of New York; and (v) waives any right to trial by jury with respect to any action or proceeding related to or arising out of this Agreement or any transaction contemplated hereby. Each of the parties hereto waives any defense of inconvenient forum to the maintenance of any action or proceeding so brought.

Each of the parties further agrees to waive any bond, surety or other security that might be required of any other party with respect to any action or proceeding, including an appeal thereof. Any party hereto may make service on another party by sending or delivering a copy of the process to the party to be served at the address and in the manner provided for the giving of notices by registered mail in Section 9. Nothing in this Section 8, however, shall affect the right of any party to serve legal process in any other manner permitted by law.

9. *Notices.* All notices, requests, demands and other communications under this Agreement shall be in writing and shall be deemed to have been duly given (a) if delivered personally, when received, (b) if sent by cable, telecopy, telegram, email or facsimile (which is confirmed by the intended recipient), when sent, (c) if sent by overnight courier service, on the next business day after being sent, or (d) if mailed by certified or registered mail, return receipt requested, with postage prepaid five business days after being deposited in the mail; to the parties at the following addresses (or at such other address for a party as shall be specified by like notice):

If to the Stockholders, to the address set forth opposite such Stockholder's name below.

If to Orchard, to:

The Orchard Enterprises, Inc.  
100 Park Avenue  
2nd Floor  
New York, NY 10017  
Attn: Chief Executive Officer  
Fax: (212) 201-9292

with a copy to:

Reed Smith LLP  
599 Lexington Avenue  
New York, NY 10022  
Attn: David M. Grimes and Antone P. Manha, Jr.  
Fax: (212) 521-5450

10. *Headings.* The headings contained in this Agreement are inserted for convenience only and shall not be considered in interpreting or construing any of the provisions contained in this Agreement.

11. *Entire Agreement.* This Agreement (including the Schedule and Exhibit hereto), constitutes the entire agreement among the parties hereto with respect to the subject matter hereof and supersedes all prior agreements, arrangements, undertakings, understandings and representations by or among the parties hereto, or any of them, written or oral, with respect to the subject matter hereof.

12. *Waiver and Amendment.* This Agreement may be amended, modified or supplemented only by a written mutual agreement executed and delivered by the parties hereto. Except as otherwise provided in this Agreement,

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any failure of any party to comply with any obligation, covenant, agreement or condition herein may be waived by the party entitled to the benefits thereof only by a written instrument signed by the party granting such waiver, but such waiver shall not operate as a waiver of, or estoppel with respect to, any subsequent or other failure. The failure of any party to this Agreement to assert any of its rights under this Agreement or otherwise shall not constitute a waiver of such rights.

13. *Counterparts; Facsimile Signatures.* This Agreement may be executed in any number of counterparts, each of which, when executed, shall be deemed to be an original and all of which together shall be deemed to be one and the same instrument binding upon all of the parties notwithstanding the fact that all of the parties are not signatory to the original or the same counterpart. For purposes of this Agreement, facsimile signatures shall be deemed originals.

14. *Third-Party Beneficiaries.* This Agreement is for the sole benefit of the parties and their successors and permitted assigns and nothing herein express or implied shall give or be construed to give to any Person, other than the parties and such successors and permitted assigns, any legal or equitable rights hereunder.

15. *Specific Performance.* The Stockholder agrees that if any of its obligations under this Agreement were not performed in accordance with their specific terms or were otherwise breached, irreparable damage would occur to Orchard, no adequate remedy at law would exist and damages would be difficult to determine, and that Orchard shall be entitled to an injunction or injunctions and specific performance of the terms hereof, this being in addition to any other remedy at law or in equity, without the necessity of posting bonds or other undertaking in connection therewith. Accordingly, if Orchard should institute an action or proceeding seeking an injunction or specific enforcement of the provisions of this Agreement, the Stockholder hereby waives the claim or defense that Orchard has an adequate remedy at law and hereby agrees not to assert in that action or proceeding the claim or defense that a remedy at law exists. The Stockholder acknowledges that in the absence of a waiver, a bond or undertaking may be required by a court and the Stockholder hereby waives any such requirement of such bond or undertaking.

16. *Severability.* If any term, covenant, restriction or provision of this Agreement or the application of any such term, covenant, restriction or provision to any Person or circumstance shall be held invalid, illegal or unenforceable in any respect by a court of competent jurisdiction, such invalidity, illegality or unenforceability shall not affect any other term, covenant, restriction or provision hereof so long as the economic or legal substance of the transactions contemplated hereby is not affected in any manner materially adverse to any party. The parties shall engage in good faith negotiations to replace any term, covenant, restriction or provision which is declared invalid, illegal or unenforceable with a valid, legal and enforceable term, covenant, restriction or provision, the economic effect of which comes as close as possible to that of the invalid, illegal or unenforceable term, covenant, restriction or provision which it replaces.

17. *No Joint and Several Liability.* Notwithstanding anything to the contrary in this Agreement, all representations, warranties, covenants, liabilities and obligations under this Agreement are several, and not joint, to each Stockholder, and no Stockholder will be liable for any breach, default, liability or other obligation of the other Stockholders party to this Agreement.

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IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed the day and year first above written.

**THE ORCHARD ENTERPRISES, INC.**

By: /s/ GREG SCHOLL  
**Name: Greg Scholl**  
**Title: Chief Executive Officer**

/s/ MITCHELL KOULOURIS

**Mitchell Koulouris**

/s/ MITCHELL KOULOURIS

**Mitchell Koulouris**, Custodian f/b/o Katherine Elene Koulouris

/s/ MITCHELL KOULOURIS

**Mitchell Koulouris**, Custodian f/b/o Sara Maria Koulouris

/s/ RICHARD REES

**Richard Rees**

**RIO BRAVO ENTERTAINMENT LLC**

By: /s/ RICHARD REES  
**Name: Richard Rees**

**Title: President**

/s/ STEVE COLMAR

**Steve Colmar**

/s/ TUHIN ROY

**Tuhin Roy**

/s/ CLAYTON TRIER

**Clayton Trier**

/s/ TERRY HATCHETT

**Terry Hatchett**

**AUSTIN TRUST**

By: /s/ STEVE COLMAR  
**Name:**

**Title:**

/s/ CRAIG COLMAR

**Craig Colmar**

/s/ CLIFF HAIGLER

**Cliff Haigler**

/s/ KAREN DAVIS

**Karen Davis**

/s/ JOHN KILCULLEN

**John Kilcullen**

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| <b>STOCKHOLDER NAME AND ADDRESS</b>                           | <b>OUTSTANDING<br/>SHARES<br/>OWNED</b> |
|---|---|
| Mitchell Koulouris  | 532,138                                 |
| Mitchell Koulouris, custodian f/b/o Sara Maria Koulouris      | 17,807                                  |
| Mitchell Koulouris, custodian f/b/o Katherine Elene Koulouris | 17,807                                  |
| Richard Rees  | 375,017                                 |
| Rio Bravo Entertainment LLC                                   | 25,000                                  |
| Tuhin Roy   | 349,402                                 |
| Craig Colmar  | 321,000                                 |
| Steve Colmar  | 233,000                                 |
| Austin Trust  | 150,000                                 |
| Cliff Haigler   | 280,000                                 |
| Clayton Trier   | 109,000                                 |
| Karen Davis   | 45,000                                  |
| John Kilcullen  | 5,101                                   |
| Terry Hatchett  | 4,900                                   |

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**EXHIBIT A**

**IRREVOCABLE PROXY**

In order to secure the performance of the duties of the undersigned pursuant to the Voting Agreement, dated as of July 5, 2007 (the *Voting Agreement* ), between the undersigned and The Orchard Enterprises, Inc., a New York corporation ( *Orchard* ), a copy of such agreement being attached hereto and incorporated by reference herein, the undersigned hereby irrevocably appoints \_\_\_\_\_, and each of them, the attorneys, agents and proxies, with full power of substitution in each of them, for the undersigned and in the name, place and stead of the undersigned, to vote or, if applicable, to give written consent, in such manner as each such attorney, agent and proxy or his substitute shall in his sole discretion deem proper to record such vote (or consent) in the manner set forth in Section 1 of the Voting Agreement with respect to all shares of Common Stock, par value \$.01 per share (the *Shares* ), of Digital Music Group, Inc., a Delaware corporation ( *DMGI* ), which the undersigned is or may be entitled to vote at any meeting of DMGI held after the date hereof, whether annual or special and whether or not an adjourned meeting, or, if applicable, to give written consent with respect thereto. This Proxy is coupled with an interest sufficient in law to support an irrevocable proxy, shall be irrevocable and binding on any successor in interest of the undersigned and shall not be terminated by operation of law or otherwise upon the occurrence of any event (other than as provided in Section 6 of the Voting Agreement), including, without limitation, the death or incapacity of the undersigned. This Proxy shall operate to revoke any prior proxy as to the Shares heretofore granted by the undersigned. This Proxy shall terminate upon the termination of the Voting Agreement. This Proxy has been executed in accordance with Section 212 of the Delaware General Corporation Law.

Dated: \_\_\_\_\_, 2007

**[NAME OF STOCKHOLDER]**

By:

**Name:**

**Title:**



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**DIGITAL MUSIC GROUP, INC.**

000004  
 MR A SAMPLE  
 DESIGNATION (IF ANY)  
 ADD 1  
 ADD 2  
 ADD 3  
 ADD 4  
  
 ADD 5  
  
 ADD 6

**C123456789**

000000000.000000 ext      000000000.000000 ext  
 000000000.000000 ext      000000000.000000 ext  
 000000000.000000 ext      000000000.000000 ext

**Electronic Voting Instructions**  
**You can vote by Internet or telephone!**  
**Available 24 hours a day, 7 days a week!**

Instead of mailing your proxy, you may choose one of the two voting methods outlined below to vote your proxy.

VALIDATION DETAILS ARE LOCATED BELOW IN THE TITLE BAR.

**Proxies submitted by the Internet or telephone must be received by 1:00 a.m., Central Time, on November 13, 2007.**

**Vote by Internet**

Logon to the Internet and go to

**[www.investorvote.com](http://www.investorvote.com)**

Follow the steps outlined on the secured website.

**Vote by telephone**

Call toll free 1-800-652-VOTE (8683) within the United States, Canada & Puerto Rico any time on a touch tone telephone. There is **NO CHARGE** to you for the call.

Follow the instructions provided by the recorded message.

Using a **black ink** pen, mark your votes with an **X** as shown in this example. Please do not write outside the designated areas.

**X**

**Special Meeting Proxy Card**

C0123456789 12345

Ú IF YOU HAVE NOT VOTED VIA THE INTERNET OR TELEPHONE, FOLD ALONG THE PERFORATION, DETACH AND RETURN THE BOTTOM PORTION IN THE ENCLOSED ENVELOPE. Ú

**A Proposals** The Board of Directors recommends a vote FOR Proposals 1 4.

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|   | For | Against | Abstain |   | For | Against | Abstain |
|---|-----|---------|---------|---|-----|---------|---------|
| 1. Approval of the Second Amended and Restated Agreement and Plan of Merger by and among Digital Music Group, Inc., The Orchard Enterprises Inc. and DMGI New York, Inc., pursuant to which we will issue up to 9,064,941 shares of common stock and 448,833 shares of Series A Preferred Stock, as described in the Notice Of Special Meeting and Proxy Statement. | ..  | ..      | ..      | 2. Approval of an amendment to our Amended and Restated Certificate Of Incorporation to effect a reverse stock split in a ratio ranging from one-for-two to one-for-five of all issued and outstanding shares of our Common Stock, as described in the Notice of Special Meeting and Proxy Statement. | ..  | ..      | ..      |
| 3. Approval of adjournments of the Special Meeting, if necessary, to permit further solicitation of proxies if there are not sufficient votes at the time of the special meeting to approve and adopt Proposals No. 1 and 2.  | ..  | ..      | ..      | 4. In their discretion, the proxies will vote upon any other matter or matters, which may properly come before the Special Meeting or any adjournment or adjournments of the Special Meeting.   | ..  | ..      | ..      |

**B Non-Voting Items**

**Change of Address** Please print new address below.

**C Authorized Signatures** This section must be completed for your vote to be counted. Date and Sign Below

(This proxy should be marked, dated and signed by the stockholder(s) exactly as his or her name appears on this proxy, and returned promptly in the enclosed envelope. Persons signing in a fiduciary capacity should so indicate. If shares are held by joint tenants or as community property, both should sign.)

Date (mm/dd/yyyy) Please print date below.  
/ /

Signature 1 Please keep signature within the box. Signature 2 Please keep signature within the box.

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Ú IF YOU HAVE NOT VOTED VIA THE INTERNET OR TELEPHONE, FOLD ALONG THE PERFORATION, DETACH AND RETURN THE BOTTOM PORTION IN THE ENCLOSED ENVELOPE. Ú

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**Proxy DIGITAL MUSIC GROUP, INC.**

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**SPECIAL MEETING OF STOCKHOLDERS**

**TO BE HELD NOVEMBER 13, 2007**

**THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS**

The undersigned stockholder of DIGITAL MUSIC GROUP, INC., a Delaware corporation, acknowledges receipt of the notice of special meeting of stockholders and proxy statement, each dated October 5, 2007 and hereby appoints Barth Ballard and Cliff Haigler and each of them, proxies and attorneys-in-fact, with full power to each of substitution, on behalf and in the name of the undersigned, to represent the undersigned at the special meeting to be held on November 13, 2007 at 10:00 a.m. local time, at the office of Digital Music Group, Inc., 2151 River Plaza Drive, Suite 200, Sacramento, California 95833 and at any adjournment or adjournments of the special meeting, and to vote all shares of common stock which the undersigned would be entitled to vote if then and there personally present, on the matters set forth on the reverse side.

THIS PROXY WILL BE VOTED AS DIRECTED OR, IF NO CONTRARY DIRECTION IS INDICATED, WILL BE VOTED FOR THE APPROVAL OF THE SECOND AMENDED AND RESTATED AGREEMENT AND PLAN OF MERGER AND THE APPROVAL OF THE AMENDMENT TO THE DIGITAL MUSIC GROUP, INC. AMENDED AND RESTATED CERTIFICATE OF INCORPORATION AND IN THE DISCRETION OF THE DESIGNATED PROXIES ON SUCH OTHER MATTERS AS MAY PROPERLY COME BEFORE THE SPECIAL MEETING.

**PLEASE MARK, SIGN, DATE AND RETURN THIS PROXY CARD PROMPTLY USING THE ENCLOSED ENVELOPE.**

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**DIGITAL MUSIC GROUP, INC.**

Using a **black ink** pen, mark your votes with an **X** as shown in this example. Please do not write outside the designated areas.

**X**

**Special Meeting Proxy Card**

Ú PLEASE FOLD ALONG THE PERFORATION, DETACH AND RETURN THE BOTTOM PORTION IN THE ENCLOSED ENVELOPE. Ú

**A Proposals** The Board of Directors recommends a vote **FOR** Proposals **1 4**.

|   | <b>For</b> | <b>Against</b> | <b>Abstain</b> |   | <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|---|------------|----------------|----------------|---|------------|----------------|----------------|
| 1. Approval of the Second Amended and Restated Agreement and Plan of Merger by and among Digital Music Group, Inc., The Orchard Enterprises Inc. and DMGI New York, Inc., pursuant to which we will issue up to 9,064,941 shares of common stock and 448,833 shares of Series A Preferred Stock, as described in the Notice Of Special Meeting and Proxy Statement. | "          | "              | "              | 2. Approval of an amendment to our Amended and Restated Certificate Of Incorporation to effect a reverse stock split in a ratio ranging from one-for-two to one-for-five of all issued and outstanding shares of our Common Stock, as described in the Notice of Special Meeting and Proxy Statement. | "          | "              | "              |
| 3. Approval of adjournments of the Special Meeting, if necessary, to permit further solicitation of proxies if there are not sufficient votes at the time of the special meeting to approve and adopt Proposals No. 1 and 2.  | "          | "              | "              | 4. In their discretion, the proxies will vote upon any other matter or matters, which may properly come before the Special Meeting or any adjournment or adjournments of the Special Meeting.   | "          | "              | "              |

**B Authorized Signatures** This section must be completed for your vote to be counted. **Date and Sign Below**

(This proxy should be marked, dated and signed by the stockholder(s) exactly as his or her name appears on this proxy, and returned promptly in the enclosed envelope. Persons signing in a fiduciary capacity should so indicate. If shares are held by joint tenants or as community property, both should sign.)

Date (mm/dd/yyyy) Please print date below.

Signature 1 Please keep signature within the box. Signature 2 Please keep signature within the box.

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Ú PLEASE FOLD ALONG THE PERFORATION, DETACH AND RETURN THE BOTTOM PORTION IN THE ENCLOSED ENVELOPE. Ú

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**Proxy DIGITAL MUSIC GROUP, INC.**

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**SPECIAL MEETING OF STOCKHOLDERS**

**TO BE HELD NOVEMBER 13, 2007**

**THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS**

The undersigned stockholder of DIGITAL MUSIC GROUP, INC., a Delaware corporation, acknowledges receipt of the notice of special meeting of stockholders and proxy statement, each dated October 5, 2007 and hereby appoints Barth Ballard and Cliff Haigler and each of them, proxies and attorneys-in-fact, with full power to each of substitution, on behalf and in the name of the undersigned, to represent the undersigned at the special meeting to be held on November 13, 2007 at 10:00 a.m. local time, at the office of Digital Music Group, Inc., 2151 River Plaza Drive, Suite 200, Sacramento, California 95833 and at any adjournment or adjournments of the special meeting, and to vote all shares of common stock which the undersigned would be entitled to vote if then and there personally present, on the matters set forth on the reverse side.

THIS PROXY WILL BE VOTED AS DIRECTED OR, IF NO CONTRARY DIRECTION IS INDICATED, WILL BE VOTED FOR THE APPROVAL OF THE SECOND AMENDED AND RESTATED AGREEMENT AND PLAN OF MERGER AND THE APPROVAL OF THE AMENDMENT TO THE DIGITAL MUSIC GROUP, INC. AMENDED AND RESTATED CERTIFICATE OF INCORPORATION AND IN THE DISCRETION OF THE DESIGNATED PROXIES ON SUCH OTHER MATTERS AS MAY PROPERLY COME BEFORE THE SPECIAL MEETING.

**PLEASE MARK, SIGN, DATE AND RETURN THIS PROXY CARD PROMPTLY USING THE ENCLOSED ENVELOPE.**