

Digital Music Group, Inc.
Form PREM14A
September 14, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a)
of the Securities Exchange Act of 1934

Filed by the Registrant

Filed by a party other than the Registrant

Check the appropriate box:

- Preliminary Proxy Statement
- Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material Pursuant to §240.14a-12

Digital Music Group, Inc.
(Name of registrant as specified in its charter)

(Name of person(s) filing proxy statement, if other than the registrant)

Payment of Filing Fee (Check the appropriate box):

- No fee required.
- Fee computed on table below per Exchange Act Rules 14a6-(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:
Common Stock of Digital Music Group, Inc.

(2) Aggregate number of securities to which transaction applies:
13,553,271

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(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):
2.77 (average of high and low prices reported on September 12, 2007)

(4) Proposed maximum aggregate value of transaction:
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.. Fee paid previously with preliminary materials.

.. Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount previously paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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DIGITAL MUSIC GROUP, INC.

2151 River Plaza Drive, Suite 200

Sacramento, California 95833

MERGER PROPOSED YOUR VOTE IS IMPORTANT

Digital Music Group, Inc. (*DMGI*) and The Orchard Enterprises Inc. (*Orchard*) have agreed to a merger whereby a subsidiary of DMGI, DMGI New York, Inc. (*DMGI NY*), will merge with and into Orchard, and Orchard will become a wholly-owned subsidiary of DMGI. The Board of Directors of DMGI is proposing this merger to our stockholders because we believe the combined strengths of the two companies will enable us to create a global leader in the digital media industry.

When the merger is completed, DMGI will issue to Orchard's common and preferred stockholders and holders of Orchard deferred stock awards an aggregate of 9,064,941 shares of DMGI common stock and 448,833 shares of DMGI Series A Preferred Stock or the right to receive such shares, as applicable, for all of their ownership interests in Orchard, representing approximately % and 100% of the outstanding shares of DMGI common stock and Series A Preferred Stock, respectively, immediately following the merger. DMGI's existing stockholders will continue to hold their shares. On , 2007, the closing price of DMGI common stock, as reported on the Nasdaq Global Market System under the trading symbol *DMGI* , was \$ per share.

This proxy statement provides detailed information concerning DMGI and Orchard and the merger and proposals related to the merger. We encourage you to carefully read this proxy statement, including the section entitled RISK FACTORS that begins on page 8.

After careful consideration, including receiving advice from legal and financial advisors, the DMGI Board of Directors approved an Agreement and Plan of Merger (the *merger agreement*), the merger, and the issuance of shares of DMGI common stock and DMGI Series A Preferred Stock in connection with the merger, and declared that the transactions contemplated by the merger agreement were advisable and in the best interests of DMGI's stockholders. **The Board of Directors recommends that DMGI stockholders vote FOR the proposal to approve the merger, and FOR the adjournment proposal as described in this proxy statement.**

Your vote is very important, regardless of the number of shares you own. Whether or not you plan to attend the special meeting, please submit a proxy as soon as possible to make sure your shares are represented at the special meeting. To submit your proxy, follow the instructions presented in this proxy statement.

Clayton Trier, Chairman

Neither the Securities and Exchange Commission (SEC) nor any state securities commission has approved or disapproved the merger, passed upon the merits of fairness of the merger agreement or the transactions contemplated thereby, including the proposed merger, or passed upon the adequacy or accuracy of the information contained in this document. Any representation to the contrary is a criminal offense.

Proxy Statement dated , 2007 and first

mailed to stockholders on or about , 2007

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DIGITAL MUSIC GROUP, INC.

2151 River Plaza Drive, Suite 200

Sacramento, California 95833

A special meeting of stockholders of Digital Music Group, Inc. will be held at _____, on _____, 2007, at _____ m., local time, for the following purposes:

- (1) to approve the Agreement and Plan of Merger, dated as of July 10, 2007, by and among Digital Music Group, Inc., DMGI New York, Inc. and The Orchard Enterprises Inc., pursuant to which DMGI New York, Inc. will merge with and into Orchard, Orchard will become a wholly-owned subsidiary of DMGI and DMGI will issue to Orchard stockholders and holders of Orchard deferred stock awards 9,064,941 shares of its common stock and 448,833 shares of a new series of preferred stock, as more fully described in the enclosed proxy statement;
- (2) to consider and vote upon an adjournment of the special meeting, if necessary, to solicit additional proxies if there are not sufficient votes in favor of the foregoing proposals; and
- (3) to transact such other business as may properly come before the special meeting or any postponements or adjournments of the special meeting.

Only DMGI stockholders of record at the close of business on _____, 2007 are entitled to vote at the special meeting or any postponements or adjournments thereof. The approval of the merger agreement and the amended and restated certificate of incorporation requires the affirmative vote of at least a majority of the outstanding shares of DMGI's stock entitled to vote thereon.

DMGI'S BOARD OF DIRECTORS RECOMMENDS THAT DMGI STOCKHOLDERS VOTE FOR ALL OF THE PROPOSALS DESCRIBED ABOVE.

Each stockholder, whether or not he or she plans to attend the special meeting, is requested to sign, date and return the enclosed proxy without delay in the enclosed postage-paid envelope. Any proxy given by the stockholder may be revoked by filing with DMGI's corporate secretary a written revocation or a duly executed proxy bearing a later date. Any stockholder present at the special meeting may revoke his or her proxy and vote personally on each matter brought before the special meeting. However, if you are a stockholder whose shares are not registered in your own name, you will need additional documentation from your record holder to vote personally at the special meeting.

By Order of the Board of Directors,

Clayton Trier

Chairman of the Board

_____, 2007

Sacramento, California

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DIGITAL MUSIC GROUP, INC.

2151 RIVER PLAZA DR., SUITE 200

SACRAMENTO, CALIFORNIA 95833

The Board of Directors of DMGI solicits your proxy for use at a special meeting of the stockholders to be held on _____, 2007, or at any adjournment thereof. We will begin sending this proxy statement, the attached Notice of Special Meeting and enclosed proxy card on or about _____, 2007, to all stockholders entitled to vote, as of _____, 2007.

SUMMARY

This summary highlights selected information from this proxy statement. It may not contain all of the information that is important to you. To better understand the merger and its potential impact on you, we urge you to carefully read this entire document and the other documents to which this document refers you or that are incorporated by reference herein in order to fully understand the merger. The merger agreement is attached as ANNEX A to this proxy statement. DMGI encourages you to read the merger agreement, as it is the legal document that governs the merger. The information contained in this proxy statement speaks only as of the date indicated on the cover of this proxy statement unless the information specifically indicates that another date applies.

Questions and Answers about the Merger

The following questions and answers are intended to address briefly some commonly asked questions regarding the DMGI special meeting and the combination of DMGI and Orchard. These questions and answers may not address all of the information that may be important to you. Please refer to the more detailed information contained elsewhere in this proxy statement, the annexes to this proxy statement and in the documents referred to or incorporated by reference in this proxy statement.

Q: What is the merger?

A. DMGI, DMGI NY and Orchard have entered into an Agreement and Plan of Merger, dated as of July 10, 2007, that contains the terms and conditions of the proposed business combination of DMGI and Orchard. Under the merger agreement, Orchard and DMGI NY will merge, with Orchard surviving as a wholly-owned subsidiary of DMGI (referred to as the merger). The shares of DMGI capital stock issued to Orchard stockholders in connection with the merger would represent approximately 50% of the outstanding shares of DMGI common stock and 100% of the outstanding shares of DMGI Series A Preferred Stock immediately following the closing of the merger (or approximately 60% of the outstanding shares of DMGI common stock on an as converted basis). For more details regarding the merger, see the merger agreement attached as ANNEX A.

Q: Why are DMGI and Orchard merging?

A. DMGI believes that combining the two companies will expand and better serve the emerging digital media market and result in greater long-term growth opportunities than either company has operating alone. DMGI believes that completion of the merger will provide the combined company with the scale, size and flexibility to better compete in the marketplace and position the combined company to:

facilitate an increase in revenue and gross profit from a broader and more extensive combined catalog of music and video recordings, an increased number of relationships with digital entertainment services, and cross-selling of Orchard's ancillary services to DMGI's catalog owners;

better serve record labels and other digital content owners by offering more retail channel outlets and enhanced content management and reporting systems;

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better serve the digital entertainment services its sells through with a larger and more attractive collective catalog of recordings;

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broaden its geographic reach within the global digital media industry;

achieve improvements to its operating results by reducing redundant operating expenses; and

achieve a greater increase in critical mass and visibility within the capital markets.

Q: Why am I receiving this proxy statement?

A. You are receiving this proxy statement because you have been identified as a stockholder of DMGI. This proxy statement is being used to solicit proxies on behalf of the DMGI Board of Directors for the special meeting. This proxy statement contains important information about the merger and the special meeting, and you are encouraged to read it carefully.

Q: What is required to complete the merger?

A. To complete the merger, DMGI stockholders must approve the merger agreement and authorize the issuance of 9,064,941 shares of common stock and a new series of 448,833 shares of Series A Preferred Stock. The merger agreement provides that the approval of the merger agreement (Proposal No. 1), must be approved in order for the merger to be consummated. In addition to obtaining stockholder approval, DMGI and Orchard must satisfy or waive all other closing conditions set forth in the merger agreement. For a more complete discussion of the conditions to the closing, see the section entitled "THE MERGER AGREEMENT - Conditions to Complete the Merger" on page 45.

Q: What happens to existing shares of DMGI capital stock in the merger?

A. The shares of DMGI capital stock held by DMGI stockholders will not be changed by the merger and DMGI stockholders will continue to hold their existing shares following completion of the merger. However, such shares will be diluted by the shares received by shareholders of Orchard (or the right to receive such shares by holders of its deferred stock awards) in the merger and will represent a smaller percentage (approximately %) of the combined company.

Q: What will Orchard stockholders be entitled to receive pursuant to the merger?

A. If the merger is completed, Orchard stockholders and holders of Orchard's deferred stock awards will be entitled to receive an aggregate of:

9,064,941 shares of DMGI common stock; and

448,833 shares of DMGI Series A Preferred Stock.

For a more complete description of what Orchard stockholders will receive in the merger, see the section entitled "THE MERGER AGREEMENT - Consideration to be Received in the Merger" on page 40.

Q: Do the directors, executive officers, principal stockholders and affiliates of DMGI have interests in the merger that are different from mine?

A. In considering the DMGI Board of Directors' recommendation that you vote to approve Proposals 1 and 2, you should be aware that some DMGI officers, directors, principal stockholders and affiliates may have interests in the merger that are different from, or in addition to, your interests and that may present actual or potential conflicts of interest. For example, Karen Davis, our interim chief executive officer and chief financial officer, and Tuhin Roy, our chief strategy officer, are parties to restricted stock awards, stock options and warrant agreements that will fully vest upon closing of the merger. Also, all the independent members of the board of directors of DMGI hold options to acquire shares of DMGI common stock, the unvested portions of which will accelerate and vest upon closing of the merger. Additionally, in connection with the anticipated execution of the merger agreement, on July 10, 2007, Mitchell Koulouris, a member of the board of directors, submitted to DMGI a letter of resignation as chief executive officer.

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Our board was aware of the foregoing interests and the anticipated resignation of Mr. Koulouris and considered them, among other matters, in approving and adopting the merger agreement and the transactions contemplated thereby, including the merger, and in determining to recommend that our stockholders vote FOR the approval of the merger agreement, and the merger. You should consider these and other interests of our directors and executive officers that are described in this proxy statement.

Q: What are the material federal income tax consequences of the merger?

A. The merger is not a taxable event with respect to shares of DMGI capital stock currently outstanding. The merger has been structured to qualify as a tax-free reorganization within the meaning of Section 368(a) of the Internal Revenue Code, as amended, and it is a closing condition to the merger that DMGI and Orchard receive opinions of their respective counsel regarding such qualification. For more information, see the section entitled MATERIAL FEDERAL INCOME TAX CONSEQUENCES on page 52.

Q: When do you expect the merger to be completed?

A. We anticipate that the closing of the merger will occur on or about _____, 2007, the same day as the special meeting, assuming (i) the requisite stockholder approvals are received and (ii) the other conditions to closing of the merger are satisfied or waived. For more information, see THE MERGER AGREEMENT Conditions to Complete the Merger on page 45.

Q: Am I entitled to appraisal rights?

A. Holders of DMGI capital stock are not entitled to appraisal rights under the Delaware General Corporation Law in connection with the merger. For more information, see the section entitled THE MERGER Appraisal Rights on page 39.

Q: Who may vote at the Special Meeting?

A. Holders of record of common stock at the close of business on _____, 2007 are entitled to notice of and to vote at the special meeting. At the record date, _____ shares of common stock of DMGI were issued and outstanding. A list of stockholders eligible to vote at the meeting will be available for your review during our regular business hours at our headquarters in Sacramento, California for at least ten days prior to the meeting for any purpose related to the meeting.

Q: How many votes do DMGI stockholders have?

A. Each holder of record of DMGI common stock as of _____, 2007 will be entitled to one vote for each share of common stock held on that record date. The holders of the common stock of DMGI vote as a single class with respect to all matters subject to the vote of stockholders at the special meeting.

Q: What stockholder approvals are required for DMGI?

Proposal No. 1: The affirmative vote of holders of a majority of the votes cast at the special meeting is required to approve Proposal No. 1 regarding the approval of the merger agreement and consummation of the merger.

Proposal No. 2: The affirmative vote of holders of a majority of the votes cast at the special meeting is required to approve Proposal No. 2 regarding adjournment of the special meeting, if necessary, to solicit additional proxies if there are not sufficient votes in favor of Proposal No. 1.

All other actions considered at the meeting may be taken upon the favorable vote of a majority of the votes present in person or represented by proxy at the meeting.

Q: What constitutes a quorum?

A. A quorum of stockholders is necessary to hold a valid meeting. If stockholders entitled to cast at least a majority of all the votes entitled to be cast at the special meeting are present in person or by proxy, a quorum will

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exist. Proxies submitted by brokers that do not indicate a vote for some or all of the proposals because the brokers do not have discretionary voting authority and have not received instructions from you as to how to vote on those proposals (so-called broker non-votes) and abstentions are considered shares present for purposes of determining whether a quorum exists. If a quorum is not present, the meeting will be adjourned until a quorum is obtained.

Q: What happens if I abstain from voting or do not instruct my broker to vote my shares of common stock?

A. If you abstain from voting with respect to Proposals No. 1 and 2, it will have the same effect as if you voted against such proposal.

Broker non-votes with respect to Proposals No. 1 and 2 will have no effect on the outcome of such proposals but will reduce the number of votes required to approve those proposals.

Q: How does DMGI's board of directors recommend that I vote?

A. After careful consideration, DMGI's board of directors recommends that DMGI stockholders vote:

FOR Proposal No. 1 to approve the merger agreement and the consummation of the merger;

FOR Proposal No. 2 to adjourn the special meeting, if necessary, to solicit additional proxies if there are not sufficient votes in favor of the foregoing proposals.

Q: When and where is the special meeting?

A. The special meeting will be held on _____, 2007 at _____ .m. local time, at DMGI's headquarters located at 2151 River Plaza Dr., Suite 200, Sacramento, California 95833.

Q: What do I need to do now and how do I vote?

A. We encourage you to read this proxy statement carefully, including its annexes, and then vote your proxy for the relevant proposals.

You may vote by proxy or in person at the meeting. To vote by proxy, you may use one of the following methods if you are a registered holder (that is, you hold your stock in your own name):

Telephone voting, by dialing _____ and following the instructions on the proxy card; or

Mail, by completing and returning the proxy card in the enclosed envelope. The envelope requires no additional postage if mailed in the United States; or

Internet voting, by visiting www.proxyvote.com and following the instructions on the proxy card.

If your shares are held in street name by a broker or other nominee, you should check the voting form used by that firm to determine whether you may vote by telephone or Internet. The deadline for the submission of voting instructions by telephone or electronically is 11:59 p.m., Pacific Time, on _____, 2007. Please also see the instructions included with the enclosed proxy card.

Regardless of whether you return your proxy card, you may attend the special meeting and vote your shares in person. If you plan to attend the special meeting and vote in person, we will give you a ballot when you arrive. However, if your shares are held in the name of your broker, bank or other nominee, you must bring an account statement or letter from the nominee indicating that you are the beneficial owner of the shares on _____, 2007, the record date for voting.

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Giving your proxy means that you authorize us to vote your shares at the special meeting in the manner you direct. If you sign the proxy card but do not make specific choices, your proxy will vote your shares as recommended by the Board as described above.

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If any other matter is presented, your proxy will vote in accordance with his best judgment. At the time this proxy statement went to press, we knew of no matters that needed to be acted on at the special meeting, other than those discussed in this proxy statement.

Q: Do I hold my shares of record or in street name?

A. If on the record date, your shares were registered directly in your name with DMGI's transfer agent, U.S. Stock Transfer Corporation, then you are a stockholder of record. As a stockholder of record, you may vote in person at the meeting or vote by proxy. If on the record date your shares were held in an account at a brokerage firm, bank, dealer or similar organization, then you are the beneficial owner of shares held in street name and these proxy materials are being forwarded to you by that organization. The organization holding your account is considered the stockholder of record for purposes of voting at the special meeting. As a beneficial owner, you have the right to direct your broker or other agent on how to vote the shares in your account. You are also invited to attend the special meeting. However, because you are not the stockholder of record, you may not vote your shares in person at the meeting unless you request and obtain a valid proxy from your broker or other agent.

Q: If my DMGI shares are held in street name by my broker, will my broker vote my DMGI shares for me?

A. Brokers cannot vote your DMGI shares on the merger-related Proposals No. 1 and 2. Therefore, it is important that you follow the directions provided by your broker about how to instruct your broker to vote your shares. If you do not provide instructions to your broker about how to vote your shares on these proposals, your shares will be treated as broker non-votes with respect to these proposals.

Q: How are votes counted?

A. The inspector of elections for the special meeting will tabulate the votes.

Q: May I change my vote after I have submitted my proxy?

A. Yes. You may revoke your proxy at any time before your proxy is voted at the special meeting. You can do this in any of three ways:

First, you can send a written, dated notice to the Secretary of DMGI stating that you would like to revoke your proxy.

Second, you can complete, date and submit another proxy with a later date.

Third, you can attend the meeting and vote in person. Your attendance alone will not revoke your proxy. If you have instructed a broker to vote your shares, you must follow directions received from your broker to change those instructions.

Q: Who is paying for this proxy solicitation?

A. DMGI is conducting this proxy solicitation and will pay the cost of soliciting proxies. The fees and expenses associated with the filing, printing and mailing of this proxy statement will be borne by DMGI. In addition to mailing proxy-soliciting material, our directors and employees may also solicit proxies in person, by telephone or by other electronic means of communication for no additional compensation. DMGI may also reimburse brokerage houses and other custodians, nominees and fiduciaries for their costs of forwarding proxy and solicitation materials to beneficial owners. If you choose to submit your proxy by telephone, you are responsible for any related telephone charges you may incur.

Q: What stockholder approvals are required for Orchard?

A. Pursuant to the Stockholder Voting Agreement dated as of _____, 2007, Dimensional Associates, LLC agreed to, among other things, vote to approve the merger and not revoke or modify its vote in favor of the merger.

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Q: Who can help answer my questions?

A. If you would like to receive additional copies of this proxy statement, without charge, or if you have questions about the special meeting, including the procedures for voting your shares, you should contact _____ :

You may also obtain additional information about DMGI from the documents they file with the SEC or by following the instructions in the section entitled WHERE YOU CAN FIND MORE INFORMATION on page 118.

Other Information Regarding the Merger

In the merger, DMGI NY, a wholly-owned subsidiary of DMGI, will merge with and into Orchard, and Orchard will become a wholly-owned subsidiary of DMGI. Following the merger, holders of Orchard common stock, Series A Preferred Stock and Series B Preferred Stock, and holders of Orchard deferred stock awards will become holders of DMGI common stock and Series A Preferred Stock or the right to receive such stock, as applicable.

Merger Consideration. The merger consideration was determined as part of the extensive negotiations between the parties with respect to the terms of the merger agreement, including corporate governance matters. Upon completion of the merger, the holders of Orchard capital stock and deferred stock awards will receive (or have the right to receive, in the case of holders of deferred stock awards) an aggregate of 9,064,941 shares of DMGI common stock and 448,833 shares of DMGI Series A Preferred Stock in exchange for their ownership interests in Orchard (referred to as the merger consideration). Orchard stockholders (including holders of deferred stock awards) will hold (or have the right to receive) approximately _____ % of the outstanding shares of DMGI common stock and 100% of the outstanding shares of DMGI Series A Preferred Stock immediately following the closing of the merger. The aggregate liquidation value of the shares of DMGI Series A Preferred Stock to be issued to Orchard stockholders as a result of the merger is \$25 million. The aggregate value of the shares of DMGI common stock to be issued to Orchard stockholders as a result of the merger is approximately \$36.2 million based on the \$3.99 per share closing price of DMGI common stock as reported on the Nasdaq Global Market System on July 10, 2007, the day prior to the announcement of the merger and \$ _____ based on the \$ _____ per share closing price of DMGI common stock as reported on the Nasdaq Global Market System on _____, 2007, the most recent practicable date prior to the mailing of this proxy statement. You are urged to obtain a recent price quotation for DMGI common stock. Because the merger consideration is fixed in the merger agreement, the market value of the DMGI common stock that Orchard stockholders receive in the merger is likely to vary from that implied by current trading prices, as reflected above.

Treatment of Outstanding DMGI Stock Options, Restricted Shares and Warrants. All unvested options to acquire shares of DMGI common stock will vest and become exercisable and all restrictions on unvested restricted stock awards will lapse upon consummation of the merger. As of June 30, 2007, there were 314,000 unvested options outstanding at exercise prices ranging from \$4.02 to \$9.75 per share and a weighted average exercise price of \$6.54 per share, and there were 35,000 unvested restricted shares. A warrant to acquire 150,000 shares of DMGI common stock at \$5.57 per share held by an officer/director of DMGI will also vest, but such warrant will terminate unless exercised upon consummation of the merger.

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The Merger Agreement

DMGI, DMGI NY and Orchard entered into an Agreement and Plan of Merger on July 10, 2007, which was amended and restated on September 13, 2007, providing for the merger of DMGI NY with and into Orchard whereby Orchard will become a wholly-owned subsidiary of DMGI. The merger agreement was entered into after extensive negotiations between the parties. A copy of the merger agreement as amended and restated is attached to this proxy statement as ANNEX A. We encourage you to read it carefully as it is the legal document that contains all of the terms and conditions of the merger.

The Companies

Digital Music Group, Inc., or DMGI, is a content owner and global leader in the digital distribution of independently owned music and video content, including music recordings and music, television, film and other video content. As of June 30, 2007, DMGI had approximately 353,000 individual music recordings and over 4,000 hours of video content under management.

The Orchard Enterprises Inc, or Orchard, is a leading global digital distributor and marketer of music. As of June 30, 2007, Orchard had approximately 600,000 individual music recordings available for sale. Additionally, Orchard estimates it currently has under license, but has not yet made available, a substantial number of additional tracks. Orchard currently has agents or employees in over 25 countries and controls a catalog sourced from over 75 countries, covering thousands of labels and a broad and deep array of music genres and eras. Orchard supplies music and video to the leading digital music stores and mobile operators throughout the world, and executes global marketing and promotion programs locally, with experts in major music territories managing initiatives tailored to each country's unique dynamic situation.

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RISK FACTORS

You should be aware that the combined company will be subject to a number of risks and uncertainties, many of which also apply to your existing investment in DMGI stock. There are a number of other risks and uncertainties relating to the merger, in addition to the risks and uncertainties associated with the digital media industry generally and the business of DMGI and Orchard specifically, that you should consider in making your voting decision regarding the merger. Many of these risks and uncertainties could affect the combined company's future financial results and may cause its future earnings and financial condition to be less favorable than management's expectations. This section summarizes those risks.

Risk Factors Relating to the Merger

Each of DMGI and Orchard have a limited operating history, have experienced net losses to date and may not be able to become profitable or generate positive cash flow in the future.

You should consider the combined company's business and prospects in light of the risks, expenses and difficulties encountered by companies in their early stage of development in a rapidly evolving industry. DMGI was formed in April 2005 and had no revenue producing operations until February 2006. Orchard was formed in September 2000, but did not begin to generate significant digital revenue until 2004. DMGI has experienced net losses of approximately \$6.7 million from inception through June 30, 2007, and has not yet been able to generate positive cash flow from operations. Orchard has experienced net losses since inception and had an accumulated deficit of approximately \$18.7 million as of June 30, 2007, and has not yet been able to generate positive cash flow from operations. We cannot be certain that the combined company will be able to generate net income and positive cash flow from operations in the future.

The failure to integrate the businesses and operations of DMGI and Orchard in a timely and efficient manner could adversely affect the business of the combined company and the ability of the combined company to realize expected synergies.

The merger involves risks related to the integration and management of technology, operations and personnel of two companies. The integration of the businesses of DMGI and Orchard will be a complex and expensive process and may disrupt their respective businesses if not completed in a timely and efficient manner. Following the merger, DMGI and Orchard intend to operate as a combined organization utilizing common information and communications systems, operating procedures, financial controls and human resources practices.

DMGI and Orchard may encounter substantial difficulties, costs and delays in integrating their operations, including:

integration of the extensive databases and information systems of each company into a single technology platform and database that serves both internal and external needs for timely and accurate information;

integration of the content acquisition and processing functions in one location;

potential loss of key employees and/or the diversion of management's attention from other ongoing business opportunities or concerns;

inability to implement uniform standards, controls, procedures and policies;

potential resource constraints for accounting personnel;

potential adverse changes in business focus perceived by third-party constituencies, including independent record labels and other clients, digital entertainment services and other important relationships; and

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potential conflicts between business cultures.

DMGI and Orchard may not be successful in overcoming other problems encountered in connection with the integration of the companies.

The merger consideration is based in part on the expectation that Orchard will significantly contribute to the combined company's financial performance. If DMGI does not realize the expected synergies or perform as well as it expects financially on a combined basis following the merger, it will effectively have paid too much in merger consideration.

The success of the merger will depend, in part, on DMGI's ability to realize the anticipated synergies, cost savings and growth opportunities from integrating the businesses of Orchard with those of DMGI. It is possible that the integration process could result in adverse ramifications as discussed above. In addition, successful integration of the companies will require the dedication of significant management and employee resources, which may temporarily detract attention from the day-to-day businesses of the combined company. Even if DMGI is able to integrate the business operations of DMGI and Orchard successfully, this integration may not result in the realization of the level of synergies, cost savings and growth opportunities that it currently expects or these benefits may not be achieved within the anticipated time frame.

The costs associated with the merger are difficult to estimate, may be higher than estimated and may detract from the financial results of the combined company to an unexpected degree. DMGI and Orchard currently estimate that they will incur direct and indirect costs and expenses, including integration costs, of approximately \$4.0 million associated with the merger.

The combined company will also incur costs associated with consolidation and integration of operations, which are difficult to accurately estimate at this time. Additional costs may include:

costs of employee redeployment, relocation and retention, including salary increases or bonuses;

accelerated amortization of deferred equity compensation and severance payments;

costs of reorganization or closure of facilities;

costs of relocation of equipment and disposition of excess equipment; and

costs of termination of contracts that provide redundant or conflicting services.

If the total costs of the merger exceed estimates or the benefits of the merger do not exceed the total costs of the merger, the financial results of the combined company could be adversely affected. In addition, the closing of the merger could be delayed beyond the expected timeline of DMGI and Orchard, adding costs and diverting management resources, which could adversely affect the combined company's business, operations and financial results.

Additionally, the completion of the merger may not result in improved earnings per share of DMGI or a financial condition superior to that which would have been achieved by DMGI on a stand-alone basis. If anticipated synergies, savings, growth opportunities and other anticipated benefits are not realized, the merger could have an adverse impact on the results of operations.

The combined company's future financial performance may be worse than the performance reflected in DMGI's historical financial information included in this proxy statement, which may adversely affect the combined company's stock price.

The historical financial information included in this proxy statement does not reflect what the results of operations, financial position and cash flows would have been had DMGI and Orchard been a combined, independent company during the periods presented or be indicative of what their results of operations, financial position and cash flows may be in the future when they are a combined independent company. The combined company's future financial performance may be worse than the performance implied by the historical financial

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information that DMGI and Orchard have presented in this proxy statement, which may adversely affect the combined company's stock price. For example, the market price of DMGI's common stock could decline as a result of the combined company's failing to achieve its business strategy of becoming the leading digital distributor and marketer of entertainment content in the digital media industry. In addition, the rapidly evolving nature of the digital media industry makes forecasting quarterly and annual operating results difficult, and the combined company may fail to achieve the combined financial results or the perceived benefits of the merger as rapidly as, or to the extent, anticipated by financial or industry analysts. For additional information about the past financial performance of DMGI's or Orchard's business and the basis of the presentation of the DMGI and Orchard historical financial statements, see "Selected Financial Data," and "Management's Discussion and Analysis of Financial Condition and Results of Operations" for each of DMGI and Orchard, included elsewhere in this proxy statement.

Neither entity has completed its analysis of how much of its net operating loss carryforwards will be available to the combined company, and the combined company's net operating loss carryforwards may be limited as a result of the merger.

As of December 31, 2006, DMGI had estimated net operating loss carryforwards for federal income tax purposes of \$4.7 million and Orchard had estimated net operating loss carryforwards for federal income tax purposes of \$15.8 million. Both entities have provided full valuation allowances for the tax benefit of such losses as well as certain tax credit carryforwards. Utilization of these net operating loss and credit carryforwards are dependent upon the combined company achieving profitable results following the merger. As a consequence of the merger, as well as earlier business combinations and issuances of common stock consummated by both companies, utilization of the tax benefits of these carryforwards are subject to limitations imposed by Section 382 of the Internal Revenue Code. The determination of the limitations is complex and requires significant judgment and analysis of past transactions. Neither entity has completed the analyses required to determine what portion, if any, of these carryforwards will have their availability restricted or eliminated by that provision. Accordingly, it is not certain how much of the existing net operating loss carryforwards will be available to the combined company to offset any future taxable income.

The combined company will incur expenses to remediate significant deficiencies that together constitute a material weakness in Orchard's present internal controls over financial reporting and to document, test and certify to its combined system of internal controls. The inability to do so in a timely manner may result in the inability to detect or prevent material misstatements in its financial statements and could also result in the loss of investor confidence.

In connection with the most recent audit of Orchard's financial statements, its independent auditors identified certain significant deficiencies that together constitute a material weakness in Orchard's internal controls over financial reporting. These significant deficiencies relate to Orchard's accounting for fixed assets, its tracking and accounting for hard drives and its lack of a formal period-end accrual process. In addition to the material weakness, Orchard's independent auditors also identified significant deficiencies with respect to its procedures for the re-issuance of royalty checks as well as its journal entry process. Although Orchard is taking steps to remediate the material weakness and significant deficiencies in its internal controls over financial reporting, its management cannot provide assurances that such steps will be successful. For more information relating to Orchard's material weaknesses and significant deficiencies, see "THE COMPANIES" The Orchard Enterprises Inc. Management's Discussion and Analysis of Financial Condition and Results of Operations Internal Controls Over Financial Reporting. If the combined company is not able to integrate financial reporting and accounting systems, or remediate Orchard's existing internal control weaknesses and deficiencies, the combined company may not have adequate, accurate or timely financial information. Further, material errors in the consolidated financial statements of the combined company may go undetected and the combined company may be unable to meet its reporting obligations or comply with the requirements of the SEC, which may subject it to sanctions or investigation by regulatory authorities, such as the SEC. If this occurs, there could be an adverse reaction in the financial markets due to a loss of confidence in the reliability of the combined company's financial statements.

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In addition to remedying Orchard's internal controls over financial reporting, the combined company will also need to bring Orchard's financial reporting procedures up to public-company standards so as to allow management of the combined company to report on, and the independent registered public accountants of the combined company to attest to, its internal controls over financial reporting as required by Section 404. As a result, the combined company will incur additional expenses and diversion of management's time in this area.

DMGI, as a publicly-traded company subject to Section 404, is in the process of documenting, evaluating and testing its internal controls over financial reporting (and performing any necessary remediation) in order to allow management to report on such controls, as required by Section 404 for the year ending December 31, 2007. In the course of its ongoing evaluation, DMGI may identify areas of its internal controls requiring improvement, and management plans to design enhanced processes and controls to address such issues that might be identified through this process. DMGI is currently incurring and expects to continue to incur certain first-time expenses and diversion of management's time on this project, whether or not the merger with Orchard is completed, and such actions are adversely affecting DMGI's reported results for 2007. DMGI cannot be certain as to the timing of completion of its documentation, evaluation, testing and remediation actions or the impact of the same on its operations and may not be able to ensure that the process is effective or that the internal controls are or will be effective in a timely manner. If this occurs, there could be an adverse reaction in the financial markets due to a loss of confidence in the reliability of the combined company's financial statements.

The combined company will be required to incur costs in documenting, evaluating, testing and remediating its internal control systems, including the hiring of consultants or additional personnel. Such actions, while necessary and beneficial, will adversely affect the combined company's results.

The executive management team of the combined company will not be fully determined until after the merger is completed, and the loss of key personnel or our failure to attract, assimilate and retain highly qualified personnel in the future could cause a disruption in our business.

Greg Scholl, the chief executive officer of Orchard, will continue to serve in such position for the combined company after the merger. The other members of the executive management team, including the chief financial officer, have not yet been determined and will be appointed by the board of directors of the combined company after the merger. Although we will have an employment agreement with Mr. Scholl to be effective at the closing of the merger and with certain of our current senior executive officers, they may decide to terminate their employment or otherwise cease to be employed by us. The combined company's success will depend in part upon its ability to recruit, hire, train and retain skilled and experienced management personnel, both new and current. Employment and retention of qualified personnel is important due to the competitive nature of the rapidly developing digital media industry. The loss of the services of any of our key personnel or our inability to hire and retain personnel with the requisite skills could impair our ability to manage and operate our business effectively and cause a disruption in our relationships with digital entertainment services and content owners.

Certain of DMGI's current executive officers and directors may have conflicts of interest as it relates to the recommendation that DMGI stockholders vote to approve the proposals relating to the merger.

Certain executive officers and directors of DMGI may have interests in the merger that are different from, or are in addition to, those of DMGI stockholders generally. You should be aware of these interests when you consider the DMGI board's recommendation that you vote in favor of the proposals relating to the merger. See THE MERGER—Interests of Certain DMGI Executive Officers and Directors in the Merger—beginning on page 38.

Upon completion of the merger, current stockholders will be subject to significant dilution of their voting power.

After the merger is complete, the former stockholders of Orchard will own approximately 60% of the outstanding shares of the voting capital stock of DMGI. As a result of the merger, the current stockholders of

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DMGI would experience immediate and substantial dilution of their ownership and voting influence. This dilution could have an adverse impact on the trading price of DMGI's common stock.

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's stockholders.

If the merger is completed, Dimensional Associates, LLC (*Dimensional*) will hold approximately % of DMGI's outstanding shares of voting capital stock. Dimensional would therefore have the ability to exert substantial influence or actual control over DMGI's management policies and strategic focus, would control the outcome of any matter submitted to DMGI's stockholders and would have the ability to elect or remove all of DMGI's directors. There is a risk that the interests of Dimensional will not be consistent with the interests of other holders of DMGI common stock. See THE MERGER Board of Directors and Executive Officers of DMGI after Completion of the Merger on page 39.

Dimensional will have significant control over DMGI's business and significant transactions after the closing of the merger. In addition to the effects described above, Dimensional's control of DMGI could make it more difficult for DMGI to raise capital by selling stock or for DMGI to use its stock as consideration in acquisitions. This concentrated ownership also might delay or prevent a change in control and may impede or prevent transactions in which stockholders might otherwise receive a premium for their shares.

The merger consideration is fixed, so the value received by Orchard stockholders will change as the market price of DMGI common stock goes up or down.

The merger consideration is fixed at an aggregate of 9,064,941 shares of DMGI common stock and 448,833 shares of DMGI preferred stock and will not be adjusted in the event of changes in the market prices of DMGI common stock. If the market price of DMGI common stock changes, the value of the consideration to be received by the Orchard stockholders will also change. For instance, if the market price of DMGI common stock decreases, the value of the consideration to be received by Orchard stockholders and holders of its deferred stock awards will also decrease. On the other hand, if the market price of DMGI common stock increases, the value of the consideration to be received by Orchard stockholders and holders of its deferred stock awards will increase correspondingly and the amount that DMGI shall have paid for Orchard shall have effectively increased. None of DMGI, DMGI NY or Orchard may terminate the merger agreement or elect not to complete the merger because of changes in DMGI's stock price. During the 12-month period ended , 2007, the high and low sale prices for DMGI common stock ranged from \$ to \$ per share.

The market prices of DMGI common stock on the date of the merger may be different from the market prices on the date of the merger agreement, the date of this proxy statement or the date of the special meeting. Stock price changes may result from a variety of factors, including general market and economic conditions, changes in the recorded music and video industries or their digital market segments and changes in DMGI's businesses, operations and prospects. Many of these factors are beyond DMGI's control. See also RISK FACTORS Risk Factors Relating to the Underlying Business of DMGI and Orchard beginning on page 14. You are encouraged to obtain current market quotations for DMGI common stock.

Sales of DMGI common stock by Dimensional after the merger could cause the trading price of DMGI's common stock to decline.

At the closing of the merger, DMGI will enter into a registration rights agreement with Dimensional and the other stockholders of Orchard requiring DMGI, under certain circumstances, to register all of the shares of common stock that will be beneficially owned by them as a result of the merger. See OTHER AGREEMENTS Form of Registration Rights Agreement on page 48 of this proxy statement. The exercise of these registration rights, or sales by Dimensional in the public market pursuant to any such registration, could cause the market price of DMGI's common stock to decline.

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DMGI common stock could be delisted from the Nasdaq Global Market if we do not comply with its initial listing standards at the time of the merger.

We have been informed by the Nasdaq Global Market that the merger is deemed to constitute a reverse merger and would require the combined company to submit an initial listing application and, at the time of the merger, meet all of the criteria applicable to a company initially requesting listing. We have applied for listing on Nasdaq Global Market under the symbol . While we intend to obtain listing status for the combined company and maintain the same, no guarantees can be made about our ability to do so. For additional information about the listing status of the combined company, see THE MERGER Stock Exchange Listing on page 39.

The combined company does not anticipate paying dividends.

The combined company does not anticipate paying dividends in the foreseeable future. The combined company intends to retain future earnings, if any, to finance the expansion of its operations and for general corporate purposes, including future acquisitions. In addition, the combined company's future financings may contain restrictions on its ability to pay dividends on its capital stock.

The failure to close, in timely manner or at all, the merger may adversely affect DMGI's business and operations and the market price of DMGI common stock.

Consummation of the merger is subject to a number of closing conditions, including approval by DMGI stockholders. If these conditions are not satisfied and the merger is not completed, the price of DMGI stock may decline. In addition, if the merger is not completed, the results of operations of DMGI would suffer adverse consequences, without the benefits of having completed the merger, including:

DMGI will remain liable for significant fees for professional services and other transaction costs.

Under certain circumstances described under THE MERGER AGREEMENT Termination of Merger Agreement beginning on page 45, DMGI or Orchard, respectively, would be required to pay a termination fee to the other party in the amount of approximately \$1.11 million, plus up to \$500,000 in expenses. For instance, DMGI would be required to pay the termination fee, plus expenses, to Orchard if approval of the DMGI stockholders is not obtained, the merger agreement is terminated and DMGI enters into an agreement with respect to another acquisition proposal in the twelve months after termination of the merger agreement.

Matters relating to the merger, including integration planning, have required substantial commitments of time and resources by DMGI, which could otherwise have been devoted to other opportunities that may have been beneficial to DMGI and its business.

Capital investments and content and business acquisitions previously contemplated by DMGI may have been delayed due to the pending transaction, and may not be available or may need to be renegotiated if the merger were not completed, potentially on an accelerated timeframe, which could prove costly and more difficult to implement.

Additionally, if the merger is not completed for any reason, the market price of DMGI's common stock may decline to the extent that the current market price reflects a market assumption that the merger will be completed. In addition, DMGI may be subject to a number of material risks, including financing issues and costs and expenses related to the merger, which are substantial, and must be paid even if the merger is not completed.

Risk Factors Relating to the Underlying Business of DMGI and Orchard

In addition to the risk factors described above relating to the merger, the underlying business of DMGI and Orchard is subject to the following risks.

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If the Internet and portable digital music and video players and mobile phones cease to be the medium accepted by the mass market for digital music and video content, our business could be affected adversely.

Our success depends to a substantial extent on the willingness of consumers to increase their use of digital entertainment services as a method of purchasing music and video content or viewing ad-supported content. The use of the Internet and wireless, cable and mobile networks to select and download purchased music and video content is growing rapidly but is still evolving, and offering ad-supported video content is in its infancy. It is uncertain whether these markets will achieve and sustain high levels of demand and market acceptance. If the use of the Internet and wireless, cable and mobile networks to select and purchase music and video content or view ad-supported content does not gain in popularity and market acceptance, our business could be adversely affected. Much of our revenue is currently tied to the popularity of portable digital music players like the iPod by Apple Inc. and other digital music listening and video viewing devices, including mobile phones. If the market penetration by these devices does not continue, the number of consumers purchasing digital music and video content may decrease or not grow, which could result in a reduction in our revenue.

Piracy is likely to continue to negatively impact our potential revenue.

Our revenue comes from the sale of our digital content over the Internet and wireless, cable and mobile networks, which is subject to unauthorized consumer copying and widespread dissemination on the Internet without an economic return to us. Global piracy is a significant threat to the entertainment industry generally and to us. Unauthorized copies and piracy have contributed to the decrease in the volume of legitimate sales of music and video content and have put pressure on the price of legitimate sales.

Because of our limited experience in the acquisition, processing and distribution of digital video content, we may not be able to earn an adequate return on our video content.

The approach DMGI and Orchard have taken to date in acquiring, processing and marketing music content may not work as well for video content. The distribution of digital video content through digital entertainment services is a relatively new extension of the digital entertainment marketplace. During the second half of 2006, DMGI entered into its first long-term agreements to digitally distribute video content and currently has over 4,000 hours of video content under management which it has recently begun to process, make available for sale and market through selected digital entertainment services. Orchard has currently entered into four video distribution agreements, although only a limited amount of content has been delivered to date. Orchard is in the process of implementing a video acquisition and distribution strategy and intends to begin widespread distribution of video content in the fourth quarter of 2007.

Because this is a new area of the market for DMGI, Orchard and the industry, we may not be able to determine the proper valuation for the acquisition or licensing of digital rights to video content. We will continue to be substantially dependent on digital entertainment services for the distribution of our video content and DMGI currently has only a limited number of such distribution agreements in place. If we are unable to enter into additional video distribution agreements on commercially favorable terms, this could limit our future revenue. Additionally, DMGI's existing agreements with certain digital entertainment services are based on sharing advertising revenue associated with the video content it will make available through such partners. Advertising-supported revenue models associated with the distribution of video content are evolving, with many of our partners still in the test-marketing phase of developing their video distribution services. There can be no assurances as to the potential revenue that the combined company may receive under these models. In addition, our success in digitally distributing video content depends on the market demand for digital video recordings and our ability to acquire and offer for purchase or advertising-supported viewing, video content that appeals to consumers' tastes and preferences. Consumers' tastes are subject to frequent, significant and sometimes unpredictable changes. We cannot accurately assess or control consumer demand for our digital video content. In addition, digital video distribution is in its infancy and technical requirements are evolving. The process for digitally encoding video content and packaging it for delivery to meet the technical requirements of our digital

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entertainment service partners is more complex and time consuming than processing music content. The technical requirements continue to evolve and we may encounter unexpected difficulties in adapting our processes or in meeting the technical requirements of the digital entertainment services as they continue to be refined. If this is the case, we may have to make significant investments in our technology and operating cost structure to meet evolving technical requirements. Any delay in processing and delivering video content to the digital entertainment services may cause delays in expected revenue growth and any significant changes to current processing requirements could increase our costs and delay or impede our ability to achieve a profit from the distribution of video content. Additionally, based on DMGI's experience to-date, a number of digital entertainment services providers have initially limited the amount and type of video content they will accept based on their capacity constraints and/or content selection criteria. If digital entertainment services continue to limit the types or amount of video content they will accept and we are unable to exploit all of the video content we have under contract, our revenue potential could be significantly reduced and we may have to record write-downs of certain royalty advances made by DMGI to secure long-term video distribution agreements.

If the music content we provide to digital entertainment services does not appeal to consumers' tastes and preferences, our revenue will decrease.

Our success depends on our ability to acquire or license digital rights and offer to consumers, digital music content that appeals to consumers' tastes and preferences. Consumers' tastes are subject to frequent, significant and sometimes unpredictable changes. We cannot accurately assess or control consumer demand for our music content. The historical revenue of DMGI and Orchard is based on the number of music recordings available for purchase at digital entertainment services, which remained relatively small in numbers until late in 2006 for DMGI, and until late 2005 for Orchard. Seasonality and other trends in consumer demand for music have been difficult to assess from this limited historical data. In the future, our current music content and the additional music content we make available to consumers may not experience similar demand. Any reduction in the popularity of our music content with consumers will cause a reduction in our revenue.

Our business involves identifying and locating the holders of digital rights to additional music and video content, and failure to do so will limit our revenue growth.

Our goal is to continue to acquire digital rights to music and video content in order to increase our revenue. Ownership of music and video content is highly fragmented and not organized in a common marketplace. There is no registry or directory of the holders of content owners and finding them can be difficult and time-consuming. DMGI and Orchard currently rely on their respective business development personnel, on networks of relationships and on market research to locate content owners, as well as their respective reputations in the industry and targeted advertising to attract content owners seeking to access the digital market. In the future, the combined company's ability to continue to identify, locate and attract such content owners will have a significant impact on the amount of content it is able to acquire.

Our inability to enter into agreements to acquire additional digital rights to music and video content on commercially favorable terms could impede our growth and increase our expenses.

The growth of our respective businesses is dependent, in large part, on our respective abilities to acquire or license digital rights to additional music and video content. Even if we are able to locate additional content owners, they may not be willing to sell or license their digital rights or we may not be able to negotiate terms that are commercially favorable to us. While we believe that our experience and knowledge in the music industry, and DMGI's reliance on consultants with expertise in the television and film video industries, allows us to determine commercially reasonable prices for music and video content, we may be unable to objectively determine fair market value for the digital rights to such content that we acquire because of unknown consumer demand for such content, unknown number of additional owners of digital rights to such content in certain cases and absence of independent valuations for music and video content. If content owners are unwilling to sell or license their rights on terms that we have determined are commercially favorable to us, we will not be able to substantially increase our revenue.

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We face competition from companies seeking to acquire the digital rights to music and video content, which could negatively impact our ability to acquire additional digital rights.

The market for acquiring digital rights from content owners is competitive, especially for the distribution of music catalogs owned by independent labels. The number of commercialized music and video recordings available for acquisition is large, but limited, and many of the more desirable music recordings are already subject to digital distribution agreements or have been directly placed with digital entertainment services. We face competition in our pursuit to acquire additional music and video content, which may limit the amount of available music and video content for sale or license and may lead to higher acquisition prices. Our competitors may from time to time offer better terms of acquisition to content owners. Recently, subsidiaries of the four major record labels, which have always aggressively competed to provide physical distribution for independent labels, have become increasingly active in the digital market segment. These companies have the ability to offer the consolidation of both physical and digital distribution through a major record label, can offer reduced physical distribution fees in order to gain the digital distribution rights from independent labels and other content owners and can condition an agreement to distribute physical content on the inclusion of digital rights, while we are focused only on the digital distribution of music and video content. Some of our competitors have adopted, and may continue to adopt, aggressive pricing policies and devote substantial resources to acquiring digital rights to music and video recordings. In addition, our competitors may form strategic alliances with record labels and digital entertainment services that could result in increased competition for the acquisition of music recordings, service offerings or favorable terms with the digital entertainment services. Increased competition for the acquisition of digital rights to music and video recordings may result in a reduction in our operating margins, market share and brand.

We have entered into multi-year agreements for digital rights to music and video content and if we are unable to renew these agreements on commercially favorable terms as they expire, our revenue could materially decrease.

Our long-term success depends upon, among other things, our ability to renew our non-perpetual rights to music and video content once they expire. For the six months ended June 30, 2007, approximately 70% of each of DMGI's and Orchard's revenue was derived from digital music distributed under short-term distribution agreements that expire in one to five years depending on certain factors. We are aware that our competitors have solicited a number of the record labels we have under short-term distribution agreements, just as we have solicited their record label clients in this highly competitive market. While we do not expect any net material decrease in revenue and gross profit from these activities, if our competition becomes increasingly aggressive or our level of service provided to our record label clients is not superior to our competition, we may experience a higher rate of non-renewal than we have in the past for our short-term digital distribution agreements. If any of our competitors offer better terms, it could cause us to spend more money or grant better terms, or both, to renew the digital rights we currently hold. In addition, the larger and more prestigious independent record labels, which have traditionally accessed the digital music market through distribution companies like us, could seek direct distribution with digital music retailers when their agreements with us expire. If we are unable to renew the non-perpetual rights to our music and video content on commercially favorable terms, our revenue could materially decrease.

Other parties may have digital rights, or claim to have such rights, to our music content, which may result in duplicates of the music recordings we sell to be available for purchase at the digital music services and cause a reduction in our revenue.

We generally acquire or license all of the digital rights that the owner of music content has available to grant; however, the holders of such rights may not possess exclusive rights to those music recordings. We are unable to determine the number of additional holders of rights to our music recordings. Aside from copyright law, the rights to music recordings are contractual in nature. There is no central registry that evidences the chain of title to the rights of music recordings other than copyright registration, which is voluntary. Given the age of many of the music recordings we have acquired or licensed or may acquire or license in the future, there is often

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a lack of documentation to evidence the chain of title. In addition, there is a common practice in the music industry of licensing rights in various formats or in certain compilations and to grant the same rights to different parties for the same or different geographic regions. Our content acquisition and distribution agreements contain representations, warranties and indemnities only with respect to the digital rights granted to us and not with respect to the rights held by other parties. We are aware of numerous instances where other parties have legitimate digital rights to the same music recordings to which we have acquired or licensed the digital rights. If copies of our music recordings are available at the digital music services from alternative sources, our revenue will be reduced to the extent these copies are purchased instead of ours.

We may not receive legal title to the digital rights of music content that we have paid to acquire or license, and any determination that we do not hold such rights may subject us to write-offs, claims for damages and lost profits.

Our acquisition and distribution agreements with content owners contain representations, warranties and indemnities with respect to the digital rights granted to us. In certain instances, we have purchased or licensed digital rights that were determined not to be held by the holder from whom we acquired or licensed those rights. If we were to acquire or make a cash advance for digital content and make available for purchase music recordings from a person who did not actually own such rights and we were unable to enforce or collect on the representations, warranties and indemnities made by such person, our business would be adversely affected. We would be required to write-off the cost of the acquisition or advance, lose the rights to sell such music and might be subject to copyright infringement lawsuits for selling such music recordings without the right to do so. Such lawsuits could subject us to damages, which could be significant. Finally, these situations could adversely impact our reputation with content owners and our relationships with digital music services, which could adversely affect our business.

If content owners fail to deliver, or if there are long delays in the time it takes to receive the music and video content that we acquire rights to, our revenue growth will be negatively impacted and our cash flow will be affected adversely.

Implementation of our business plan and growth strategy depends on increasing the amount of music and video content we have available to consumers at digital entertainment services. Our purchase and long-term distribution agreements typically require the owners to deliver to us their music and video content under an agreement delivery timetable. Under our short-term distribution agreements, there is generally no specific delivery timetable, although the content owner is generally required to digitally distribute their entire catalog through us and promptly provide all the master recordings and metadata to us for processing after execution of the agreement. Some of the content we acquire may be in older physical formats such as audio tape or vinyl records in the case of music recordings, or film, tape or other incompatible digital format in the case of video recordings, that require processing onto compact disc or digital video disc prior to being delivered to us. In addition, our agreements require that certain descriptive information required by the digital entertainment services for each music and video be delivered with the content, such as recording title, album title, artist name, genre, copyright information, label name, unique product identifier, artwork, biographical information, sales information and date of release. Historically, it has at times taken several months or longer after we have entered into an agreement before we have received delivery of the music and video content acquired. In addition, in some cases the quality of the music and videos and metadata initially delivered is not sufficient or the data is not complete and follow-up work and effort is required to receive proper and complete delivery, although even with such extra efforts there are no assurances such problems can be cured. Although we generally specify delivery dates and make cash payments by us conditional upon delivery, we do not control the timing for complete receipt of the music and video content we have acquired. In addition, in certain cases, content owners have over delivered and in others have been unable to deliver all of the content specified in our agreements. During the first quarter of 2007, DMGI determined that one content owner that had granted it long-term distribution rights would be unable to deliver approximately 13,000 music recordings under contract and that an additional 10,000 music recordings previously delivered would not be able to be posted for sale due to various reasons. These factors

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reduced the contract from a total of 75,000 music recordings to approximately 52,000 music recordings that DMGI expects to be able to make available for sale. We are typically not required to pay additional consideration for deliveries in excess of contract amounts and are not required to make cash payments for any content that is not delivered, or is defective or otherwise non-usable. However, our expected revenue growth rate is negatively impacted when we do not receive all the content we have contracted for. If there are long delays in the time it takes for the owners to deliver to us the music and video content in physical format or complete data format and the related complete descriptive information, it will delay our ability to begin the process of converting the content into the digital formats required by digital entertainment services. It could also cause inefficiencies in the utilization of our operations personnel who process these recordings. Any delay in making our music and video content available for purchase at the digital entertainment services will delay our revenue growth, and inefficiencies caused by such delays could cause a reduction in our cash flow in the interim.

We are substantially dependent on a limited number of digital entertainment services, in particular Apple iTunes Store, for the sale of our content.

We derive our revenue from a small number of leading digital entertainment services that make our content available to consumers. We generally deliver our music and video content to these digital entertainment services in priority of their significance to us. For the six months ended June 30, 2007 and for the year ended December 31, 2006, DMGI received 63% and 71% of its revenue, and Orchard received 53% and 51% of its revenue, from Apple iTunes, respectively. For the same periods, Orchard received 11% and 12% of its revenue from its affiliate, eMusic, respectively. Our respective agreements with Apple iTunes have terms of three years, which end in April 2010 for DMGI and in October 2009 for Orchard. DMGI's wholly-owned DRA subsidiary has separate agreements with Apple iTunes that expire in December 2008. If we are not able to continue to renew our relationships with Apple iTunes and other digital entertainment services that make our music and video content available to consumers on similar economic terms, our ability to generate revenue will be significantly reduced.

Our accounts receivable are concentrated with a limited number of digital entertainment services, particularly Apple iTunes, which subjects us to substantial payment risk.

We rely on reports from digital entertainment services detailing download and other activity to determine our revenue, and such reports are typically provided to us within 30 to 45 days following the end of the reporting period, generally monthly. We receive payment at approximately the same time as we receive these detailed revenue reports. Our accounts receivable therefore consists of approximately one month's revenue (or one quarter in the case of certain digital entertainment services that report quarterly). As of June 30, 2007, accounts receivable from Apple iTunes Store represented (i) 40% of DMGI's total accounts receivable, compared to 51% of its total accounts receivable as of December 31, 2006, and (ii) 28% of Orchard's total accounts receivable, compared to 35% of its total accounts receivable as of December 31, 2006. Additionally, for Orchard, accounts receivable from its affiliate, eMusic, represented 15% of total accounts receivable at June 30, 2007 and December 31, 2006. The concentration of our accounts receivable among a small number of digital entertainment services is likely to continue and we expect our accounts receivable to become larger as we grow. DMGI has not had a bad debt loss since inception and maintains no allowance for doubtful accounts, and Orchard had a \$75,387 allowance as of June 30, 2007. However, if any significant digital entertainment services are unable to pay us as due each month (or quarter, as the case may be), it could disrupt our business and cause us to report a bad debt loss in excess of amounts provided for potential doubtful accounts.

The digital music industry is evolving and we are vulnerable to discounting, price-reductions, pricing structure and stocking changes that may evolve in the industry and, as a result, cause a reduction in our revenue.

We receive revenue based on the wholesale prices determined by the digital music retailers based, to a large extent, on the price they charge to consumers. Currently, the largest digital music retailer, Apple iTunes, charges

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consumers \$0.99 to \$1.29 per music recording downloaded in the United States and at comparable rates in local currency for consumers outside the United States. We have limited ability to influence the pricing models of the digital entertainment services. While the major record labels were unsuccessful in their recent attempt to change the pricing structure, there is no assurance that they will not attempt to change the pricing structure in the future or that the digital music retailers will not initiate such a change that could result in lower pricing or tiered pricing that could reduce the amount of revenue we receive. In addition, the popularity of digital music retailers that offer digital music through subscription and other pricing models is increasing. For example, eMusic, a subscription-based music service and affiliate of Orchard, is now the second largest digital music retailer in the world. Currently, the revenue we earn per individual music recording is generally less under these subscription models than what we receive from Apple iTunes, although we expect it will increase as more subscribers are added. Additionally, digital music services at present generally accept all the music content that we and other distributors deliver to them. However, to the extent the digital music services limit the types or amount of music recordings they will accept from content owners and distributors like us, or substantially limit the number of music recordings they will post for sale, or change their current stocking plans, for instance by removing music recordings that do not meet minimum sales thresholds or other criteria, our revenue could be significantly reduced.

Any extended delay by digital entertainment services in processing and making our music and video content available to consumers causes a delay in our ability to earn revenue from such content.

Following receipt of music and video content from the owners, we convert them into the specific digital formats required by digital entertainment services. We then deliver the music and video content in digital format, together with their associated descriptive information and artwork, to the digital entertainment services to be made available to consumers in the specific territories where we have acquired the digital rights. The digital entertainment services must then review our music and video content, descriptive information and artwork to ensure that they are in the proper format for their store or service. The content is only made available to consumers once the digital retailer or service has completed its review, encrypted the content with the particular retailer's (if applicable) digital rights management protection and other retailer or service-specific coding, and posted the digital files on the retailer's or services' computer servers. We are subject to the digital entertainment services' internal processing timing and priorities. Our agreements with the digital entertainment services do not provide for a fixed processing time. DMGI's experience has been that the review and posting process by the digital entertainment services takes several weeks to several months. Any extended delay in making our music and video content available to consumers causes a delay in when we can begin to earn revenue and return on investment from our content.

We may acquire record labels or other companies that own master rights to music or video content, and if we are unable to successfully acquire or integrate these companies, we may not be able to acquire additional content or grow our revenue.

We may attempt to acquire record labels or other companies that own master rights to music or video content for purposes of acquiring their digital rights. If we are not able to successfully acquire such companies, we may not be able to grow our revenue as rapidly as anticipated. In the event we are able to acquire such record labels or other companies, we may be subject to a number of risks related to the integration and management of such companies, including failure to obtain valid consents to assignment of contracts, including contracts granting rights to music content, failure of the business of the acquired company to achieve expected results, diversion of our management's attention, and failure to retain key personnel of the acquired company. In addition, if we undertake an acquisition of a company that owns digital and other rights to music and video content, we may attempt to operate the non-digital businesses or sell the non-digital rights to another person or entity, and we may not be able to do so in a manner or on terms favorable to us.

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If we are not able to integrate and scale our reporting and payment processes, we may experience delays providing reports to the content owners and paying required royalties that could have a negative effect on our brand identity.

We receive regular sales reports from digital entertainment services that contain sales information for our music and video content. Based on these reports, we provide summary reports to the content owners. When we acquire the perpetual digital rights to music content and in certain of our distribution agreements, we may assume the obligations of the content owner to pay any required royalty payments to the artists according to the terms of the existing agreements. In addition, we may be required to pay statutory publishing royalties on behalf of the content owner according to the terms of our agreements. As we integrate the extensive databases and information systems of DMGI and Orchard and acquire digital rights to additional music and video content, we may experience difficulties in preparing and distributing sales reports for the content owners or processing and paying artist and publishing royalties in a timely fashion. If we are not able to successfully expand our processing capability or introduce technology to allow us to determine and pay royalty amounts due and automate these tasks, we may experience delays as we increase the volume of our music and video content, which could have a negative effect on our relationships with content owners and brand identity.

We may need to raise additional capital to accomplish our objectives and, if we are unable to raise such funds as needed, our growth would be limited.

We may use our common stock in addition to our cash for the consideration for future acquisitions of digital rights to additional music and video content and/or for the acquisition of other businesses in the digital media industry. If our common stock does not maintain a sufficient market value or content and business owners are unwilling to accept common stock as part of the consideration for the sale of the digital rights to their music and video content or their businesses or as consideration for licensed rights to their music and video content, we may be required to utilize more of our cash resources, if available. We intend to be more aggressive in this area and may require additional financing in the future. If we do not have sufficient cash resources, our ability to acquire additional rights to music and video content and ancillary businesses could be limited unless we are able to obtain additional capital through future debt or equity financings. Our ability to obtain financing will depend, among other things, on our development efforts, business plans, operating performance and condition of the capital markets at the time we seek financing. Additional financing may not be available to us on favorable terms when required, or at all. Using cash to finance acquisitions could substantially limit our financial flexibility and using debt could result in financial covenants that limit our operations and financial flexibility. If we raise additional funds through the issuance of equity, equity-linked or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our common stockholders may experience dilution.

We face a potential loss of music content if it is determined that recording artists have a right to recapture rights in their content under the U.S. Copyright Act.

The U.S. Copyright Act provides authors and their heirs a right to terminate licenses or assignments of rights in their copyrighted works that were not works made for hire. If any of our music content were determined not to be works made for hire, then the recording artists or their heirs could have the right to terminate the rights we hold. These residual author rights generally survive for five years after the end of the 35-year period from the date of a post-1977 license or assignment, and in the case of a pre-1978 grant in a pre-1978 recording, five years after the end of the 56-year period from the date of creation or January 1, 1978, whichever is later. Any termination of our rights to our music content could have a material reduction in our revenue.

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Provisions in DMGI's charter documents and under Delaware law could discourage a takeover that stockholders may consider favorable.

DMGI's charter documents may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable because they:

authorize its board of directors, without stockholder approval, to issue up to 1,000,000 shares of undesignated preferred stock; and

establish advance notice requirements for proposing matters to be approved by stockholders at stockholder meetings.

As a Delaware corporation, DMGI is also subject to the Delaware anti-takeover provisions contained in Section 203 of the Delaware General Corporation Law. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. DMGI's board of directors could rely on this provision to prevent or delay an acquisition of DMGI.

DMGI's stock price is subject to fluctuation and could decline.

The price at which DMGI common stock has traded since its initial public offering in February 2006 has fluctuated significantly. The price is likely to continue to fluctuate significantly due to the following factors, some of which are beyond DMGI's control:

imbalances between the market supply and demand for shares of its stock due to the limited number of shares available in the public float;

variations between DMGI's actual operating results and the expectations of securities analysts, investors and the financial community;

announcements of developments affecting DMGI's business, systems or expansion plans by DMGI or others; and

conditions and trends in online commerce industries and the mobile communications industry, particularly as they relate to the digital entertainment services and mobile carriers.

As a result of these and other factors, investors in DMGI's common stock may not be able to resell their shares at or above their purchase price.

In addition, sales of substantial amounts of DMGI common stock by its existing stockholders in the public market may adversely affect the future market price of its common stock. Shares issued upon the exercise of outstanding options granted to DMGI's employees and directors also may be sold in the public market. Such sales could create the perception to the public of difficulties or problems with DMGI's business. As a result, these sales might make it more difficult for DMGI to sell securities in the future at a time and price that DMGI deems necessary or appropriate.

In the past, securities class action litigation often has been instituted against companies following periods of volatility in the market price of their securities. DMGI maintains directors and officers liability insurance for this type of litigation. However, if such litigation is directed at DMGI, it could result in substantial costs, including the deductible amount under DMGI's insurance policy and other indirect costs and a diversion of management's attention and resources.

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FORWARD-LOOKING STATEMENTS

Some of the statements contained or incorporated by reference in this proxy statement, including those relating to DMGI, Orchard and the combined company's strategies and other statements that are predictive in nature, that depend upon or refer to future events, conditions or financial performance, or that include words such as should, may, likely, expects, anticipates, intends, plans, believes, estimates, continues and similar expressions as well as the negative of these terms, are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Forward looking statements include the information concerning possible or assumed future results of operations of DMGI, Orchard and the combined company as set forth under THE MERGER DMGI's Reasons for the Merger; Recommendation of DMGI's Board of Directors. These statements are not historical facts but instead represent only expectations, estimates and projections regarding future events. These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to predict, which may include the risk factors set forth below and other market, business, legal and operational uncertainties discussed elsewhere in this document and the documents which are incorporated herein by reference. Those uncertainties include, but are not limited to those described or incorporated by reference under RISK FACTORS including:

revenue and earnings expectations which are difficult to predict because of the companies' limited operating histories and emerging nature of the digital media industry;

the companies' ability to successfully integrate operations and realize expected synergies and cost reductions;

the companies' ability to successfully identify, acquire for a commercially reasonable valuation, and process additional catalogs of sound and video recordings;

the companies' ability to successfully enter into new sales channel relationships;

competitive and economic conditions in the digital media industry;

acceptance and adoption of the digital format by consumers and potential changes in consumers' tastes and preferences in music and video, and the extent to which the companies' content will appeal to consumers;

the companies' limited operating history in the acquisition, processing and sale of digital video recordings;

the companies' limited ability to influence the pricing models of digital entertainment services;

the companies' dependence on digital entertainment services to review, process and make all of its digital offerings available on a comprehensive and timely basis for purchase by consumers;

the companies may not have proper legal title to the digital rights associated with music recordings the companies purchase or license, or others may claim to have such rights;

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potentially long delays in receiving the master recordings and videos that the companies acquire rights to;

the companies' ability to renew multi-year agreements for digital rights to music and video content as they expire;

music and video piracy;

differing interpretations of and potential ambiguities in U.S. copyright laws;

availability, terms and use of capital to continue to grow the companies' business; and

maintaining adequate internal operating and financial controls over the companies' business and financial reporting.

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Many of the factors listed above are and will be outside of and beyond the companies' control. DMGI's, Orchard's and/or the combined company's actual results and financial conditions may differ, perhaps materially, from management's current expectations and the anticipated results and financial conditions in any forward-looking statements, and, accordingly, readers are cautioned not to place undue reliance on such statements.

For more information concerning factors that could affect DMGI's, Orchard's and/or the combined company's future results and financial conditions, see RISK FACTORS beginning on page 8 and THE COMPANIES Digital Music Group, Inc. Management's Discussion and Analysis of Financial Condition and Results of Operations beginning on page 68 of this proxy statement and in each of DMGI's annual and quarterly reports incorporated by reference into this proxy statement. DMGI undertakes no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise. See WHERE YOU CAN FIND MORE INFORMATION.

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THE SPECIAL MEETING OF DMGI STOCKHOLDERS

This document constitutes a proxy statement of DMGI and is being mailed by DMGI to DMGI stockholders of record on or about _____, 2007, together with the notice of the special meeting of stockholders of DMGI and a proxy solicited by DMGI's Board of Directors for use at the special meeting and at any adjournments or postponements of the meeting.

General

The special meeting will be held at _____ located at _____, _____ at _____ .m., local time, on _____, 2007. Only DMGI stockholders of record at the close of business on _____, 2007 will be entitled to receive notice of and to vote at the special meeting. As of the record date, there were _____ shares of common stock, outstanding and entitled to vote, with each such share entitled to one vote.

Purpose of the DMGI Special Meeting

At the special meeting, DMGI stockholders will be asked to consider and vote on the following proposals:

- (1) to consider and vote upon a proposal to approve the merger agreement and the merger; and authorize the issuance of 9,064,941 shares of common stock and a new series of 448,833 shares of Series A Preferred Stock; and
- (2) to adjourn the special meeting, if necessary, to solicit additional proxies if there are not sufficient votes in favor of the foregoing proposals.

Proposal 1 Approval of the merger agreement.

DMGI and Orchard entered into an Agreement and Plan of Merger on July 10, 2007, which was amended and restated on September 13, 2007, pursuant to which DMGI NY will merge with and into Orchard and DMGI will issue to Orchard stockholders and holders of Orchard deferred stock awards 9,064,941 shares of common stock and 448,833 shares of a new series of preferred stock. For a detailed summary of the merger agreement, please see the section of this document entitled "THE MERGER AGREEMENT" beginning on page 40.

To complete the merger, DMGI stockholders must approve the amended and restated certificate of incorporation. DMGI's Board of Directors believes that the proposed amended and restated certificate of incorporation is desirable in order that the merger be consummated.

Proposal 2 To adjourn the special meeting, if necessary to solicit additional proxies if there are not sufficient votes in favor of the foregoing proposals.

DMGI stockholders may be asked to vote on a proposal to adjourn or postpone the special meeting, which could be used to allow more time for soliciting additional votes to approve the merger agreement. Each copy of this proxy statement mailed to DMGI stockholders is accompanied by a proxy card for use at the special meeting.

Record Date

Each holder of record of DMGI common stock as of _____, 2007 will be entitled to one vote for each share of common stock held on that record date.

As of the record date, directors and executive officers of DMGI and their affiliates as a group beneficially owned and were entitled to vote approximately _____ shares of DMGI common stock, representing approximately _____ % of the votes entitled to be cast at the special meeting. All of these directors and executive officers of DMGI have entered into Voting Agreements, as described below under "Vote Required," to

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vote their shares of DMGI common stock in favor of the merger and the amending and restating of the certificate of incorporation of DMGI and all the merger related proposals, subject to the directors' fiduciary duties.

Vote Required

General. Approval of the merger agreement and the amended and restated certificate of incorporation requires the affirmative vote of at least a majority of the outstanding shares of DMGI's common stock entitled to vote thereon, voting together as a single class. On the record date, there were _____ outstanding shares of DMGI common stock, each of which is entitled to one vote at the special meeting. The presence, in person or by proxy, of shares of DMGI common stock representing a majority of DMGI's outstanding shares entitled to vote at the special meeting is necessary in order for there to be a quorum at the special meeting. A quorum must be present in order for the vote on the merger agreement and the amendment to the certificate of incorporation to occur.

Assuming a quorum is present, shares represented by a properly signed and dated proxy will be voted at the special meeting in accordance with the instructions indicated on the proxy. Proxies that are properly signed and dated but that do not contain voting instructions will be voted FOR Proposal 1 to approve the merger and the issuance of DMGI capital stock in connection with the merger, and FOR Proposal 2 to adjourn the special meeting, if necessary, to solicit additional proxies if there are not sufficient votes in favor of the foregoing proposals.

As of the record date, neither Orchard nor any of its affiliates owned any shares of DMGI common stock. As of the same date, the directors and officers of DMGI beneficially owned a total of approximately _____% of the outstanding shares of DMGI common stock. Pursuant to a voting agreement dated July 5, 2007, all of the directors and executive officers of DMGI who owned shares of common stock at such date, consisting of five directors and one executive officer of DMGI (Karen Davis, Terry Hatchett, John Kilcullen, Mitchell Koulouris, Tuhin Roy and Clayton Trier), as well as six additional stockholders of DMGI, have agreed to vote their shares of DMGI common stock (representing in the aggregate approximately 27% of the shares of DMGI common stock outstanding as of the record date) in favor of the merger and the amended and restated certificate of incorporation, subject to the directors' fiduciary duties.

Abstentions. DMGI will count a properly executed proxy marked "abstain" with respect to a particular proposal as present for purposes of determining whether a quorum is present. If you "abstain" from voting with respect to the foregoing proposals, it will have the same effect as if you voted "against" such proposal.

Broker Non-Votes. Proxies submitted to brokers that do not indicate a vote for some or all of the proposals because the brokers do not have discretionary voting authority and have not received instructions from you as to how to vote on those proposals (so-called "broker non-votes") are considered "shares present" for purposes of determining whether a quorum exists. Broker non-votes with respect to the proposals will have no effect on the outcome of such proposals but will reduce the number of votes required to approve those proposals.

Voting Shares in Person that are Held through Brokers. If your shares are held of record by your broker, bank or another nominee and you wish to vote those shares in person at the special meeting, you must obtain from the nominee holding your shares a properly executed legal proxy identifying you as a DMGI stockholder, authorizing you to act on behalf of the nominee at the DMGI special meeting and identifying the number of shares with respect to which authorization is required.

Recommendation of the Board of Directors

DMGI's Board of Directors has approved the merger agreement, the transactions contemplated in the merger agreement and the issuance of 9,064,941 shares of common stock and a new series of 448,833 shares of Series A Preferred Stock. DMGI's Board of Directors believes that the merger and the amended and restated certificate of incorporation are in the best interests of DMGI and its stockholders, and recommends that DMGI stockholders vote FOR Proposal 1 approval of the merger agreement.

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In the course of evaluating the merits of this merger and ultimately reaching its decision to approve the merger agreement and the transactions contemplated therein, DMGI's Board of Directors, among other things, consulted with its legal counsel and financial advisors regarding the terms of the merger agreement. For a discussion of the factors considered by DMGI's Board of Directors in reaching its conclusion, see THE MERGER DMGI's Reasons for the Merger; Recommendation of DMGI's Board of Directors.

DMGI stockholders should note that certain of DMGI's directors and executive officers have interests in, and may derive benefits as a result of, the merger that are in addition to their interests as stockholders of DMGI. See THE MERGER Interests of Certain DMGI Executive Officers and Directors in the Merger.

The DMGI Board of Directors has further determined that approving a proposal to adjourn the special meeting, if necessary, to solicit additional proxies is in the best interests of DMGI and its stockholders. The DMGI Board of Directors recommends that DMGI stockholders vote FOR Proposal 2 to adjourn the special meeting, if necessary, to solicit additional proxies if there are not sufficient votes in favor of the foregoing proposals. DMGI does not currently intend to seek an adjournment of its meeting unless such an adjournment is necessary to solicit additional votes.

Revocability of Proxies

The grant of a proxy on the enclosed proxy card does not preclude you from voting in person or otherwise revoking a proxy. You may revoke a proxy at any time prior to its exercise by delivering to the Secretary of DMGI either a duly executed revocation or a proxy bearing a later date. In addition, you may revoke a proxy prior to its exercise by voting in person at the special meeting. All written notices of revocation and other communications with respect to the revocation of DMGI proxies should be addressed to Digital Music Group, Inc., 2151 River Plaza Drive, Suite 200, Sacramento, California 95833, Attention: Corporate Secretary. Attendance at the special meeting will not in and of itself constitute revocation of a proxy.

Attending the Special Meeting

DMGI will hold a special meeting of stockholders at _____ on _____, 2007 at _____:00 am local time to consider and vote upon the proposals described in this proxy statement.

Voting Electronically or by Telephone

Delaware law permits electronic submission of proxies through the Internet or by telephone, instead of submitting proxies by mail on the enclosed proxy card. Thus, stockholders of record and many stockholders who hold their shares through a broker or bank will have the option to submit their proxies or voting instructions electronically through the Internet or by telephone. Please note that there are separate arrangements for using the Internet and telephone depending on whether your shares are registered in DMGI's stock records in your name or in the name of a broker, bank or other holder of record. If you hold your shares through a broker, bank or other holder of record, you should check your proxy card or voting instruction card forwarded by your broker, bank or other holder of record to see which options are available.

Solicitation of Proxies

DMGI will pay all of the costs of soliciting proxies in connection with its special meeting and all of the costs of filing, printing and mailing this proxy statement. The extent to which any proxy soliciting efforts will be necessary depends upon how promptly proxies are received. You should send in your proxy by mail without delay or vote by telephone or using the Internet. DMGI also reimburses brokers and other custodians, nominees and fiduciaries for their expenses in sending these materials to you and getting your voting instructions. A more complete description of how to send your proxy is included on the proxy accompanying this proxy statement.

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No person is authorized to give any information or to make any representation not contained in this proxy statement and, if given or made, such information or representation should not be relied upon as having been authorized by DMGI or any other person. The delivery of this proxy statement does not, under any circumstances, create any implication that there has been no change in the business or affairs of DMGI since the date of the proxy statement.

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THE MERGER

Background of the Merger

On December 6, 2006, Cliff Haigler, a substantial shareholder and the former chief financial officer of DMGI, contacted Daniel Stein, chief executive officer of Dimensional, the majority owner of Orchard, for the purpose of discussing a possible merger of the two companies. Mr. Stein was receptive to a meeting for this purpose, as was Clayton Trier, chairman of DMGI, and such meeting took place in New York on December 18, 2006, subject to a Confidentiality and Non-Disclosure Agreement between the parties dated December 6, 2006.

In attendance for at least some portion of this initial meeting from DMGI were Mr. Trier and Mitchell Koulouris and Tuhin Roy, the chief executive officer and chief strategy officer, respectively, of DMGI. Representing Dimensional and Orchard were Mr. Stein, Joe Samberg, the majority owner of Dimensional and a director of Orchard, and Greg Scholl, chief executive officer of Orchard. Mr. Haigler also attended a portion of the meeting to facilitate introductions and provide an independent perspective. The parties each presented their business strategy and organizational structure, shared selected financial information and discussed the merits of a possible merger, but did not agree on any specific merger structure or terms.

In February 2007, Mr. Trier followed up with a phone call to Mr. Stein to discuss certain management changes taking place at DMGI and inquire whether Orchard wanted to resume the merger discussions. Mr. Stein suggested that they wait until after DMGI's annual financial statements for 2006 were available and possibly until the first quarter of 2007 was completed.

On May 14, 2007, four founding stockholders of DMGI, Mr. Haigler and Messrs. Steve Colmar, Craig Colmar and Richard Rees, were all in New York on other business when they paid an unscheduled visit to Mr. Stein for the purpose of renewing merger discussions between Orchard and DMGI. Each of these four individuals entered into a confidentiality and non-disclosure agreement with Orchard, and Mr. Scholl attended a portion of this meeting to provide an update on Orchard's business. During this meeting, the framework for a merger, including structure and terms, was discussed and a preliminary term sheet was drafted.

On May 16, 2007, Messrs. Haigler and Colmar called Mr. Trier to inform him of their meeting with Mr. Stein and to discuss a preliminary term sheet. In addition, Mr. Stein called Mr. Trier later that evening to ask if he would be receptive to reviewing a draft term sheet for a business combination transaction between DMGI and Orchard. Mr. Trier expressed concern about the manner in which the term sheet was developed, but said that he would review and discuss it with DMGI's Board of Directors. Mr. Trier made it clear that Messrs. Haigler, Colmar, Colmar and Rees had no authority to negotiate or agree to anything on behalf of DMGI, and Mr. Stein stated that he already understood and appreciated that fact. It was agreed that any future merger negotiations should be held directly between Mr. Stein, representing the majority shareholder of Orchard, and Mr. Trier, as chairman of the board of directors of DMGI.

Mr. Stein sent a draft term sheet to Mr. Trier after their phone conversation on May 16th. Between May 17 and May 21, 2007, Mr. Trier (i) engaged legal counsel to advise DMGI and its board of directors on this matter, (ii) met with legal counsel to evaluate the term sheet and better understand the responsibilities of the DMGI board in these circumstances, and (iii) contacted each of the DMGI directors to inform them of this development and seek their initial reaction to the merger proposal and the term sheet.

On May 21, 2007, Mr. Trier called Mr. Stein to inform him that the DMGI board of directors were agreeable to discussing the concept of a merger between the companies and generally agreeable to certain provisions in the term sheet, such as having the combined company named The Orchard, having its headquarters in New York and having Mr. Scholl as the chief executive officer for the combined company. However, the DMGI board of directors unanimously rejected the draft term sheet, primarily because a substantial portion of the consideration to Orchard stockholders was proposed to be in the form of a three-year convertible debt and the total amount of stock consideration proposed to be issued for Orchard. Messrs. Trier and Stein discussed various alternative structures and terms that might potentially overcome the concerns of the DMGI directors. At Mr. Stein's

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invitation, Mr. Trier agreed to come to New York to discuss the proposed merger structure and company valuations directly with Mr. Stein.

On May 23, 2007, Mr. Trier met with Messrs. Stein, Samberg and Scholl in Rye, New York. Mr. Haigler was also present for continuity from the previous discussions. At the conclusion of that meeting, the parties agreed that the merger had substantial business merit, but they did not reach agreement on the form and amount of consideration to be paid for Orchard. They agreed to continue discussions and negotiations in this regard by telephone.

From May 24 to May 26, 2007, there were several telephone conversations and negotiations between Messrs. Trier and Stein. Mr. Trier also maintained an active dialogue during this period with Messrs. Koulouris and Roy, two substantial DMGI stockholders and senior executive officers of DMGI, and with other DMGI directors. Mr. Stein maintained active communications with Mr. Samberg. In addition, Mr. Haigler participated in negotiations during this period as an intermediary attempting to assist the parties to reach compromise solutions.

Discussions and negotiations between Messrs. Trier and Stein culminated on May 26, 2007, in their agreement to a merger structure and specific terms that Mr. Trier agreed to present to the entire board of directors at its regularly scheduled meeting in Sacramento on June 5, 2007. It was also agreed that Mr. Scholl would accept Mr. Trier's invitation to make a presentation to the board of directors on the afternoon of June 4, 2007, concerning Orchard and its business as well as Mr. Scholl's vision and plans for the combined company.

The proposed merger, structure, terms and consideration, reasons for the merger, timing for Mr. Scholl's presentation in Sacramento and other important factors concerning the proposed transaction were conveyed to the board of directors by Mr. Trier in a package of information distributed to the directors on May 27, 2007.

On May 31, 2007, after obtaining proposals from two qualified firms, Mr. Trier selected SMH Capital, Inc. (**SMH**) to act as financial advisor to the DMGI board of directors and to render a fairness opinion on the proposed transaction. Mr. Trier sent an email to the DMGI directors that evening explaining the rationale for such selection and describing the scope of work to be performed and fees to be charged by SMH. He also informed the directors that representatives from SMH would be present in Sacramento to hear Mr. Scholl's presentation and advise the DMGI board of directors on the financial aspects and merits of the proposed transaction.

On June 4, 2007, Mr. Scholl met with the DMGI board of directors and its legal counsel and financial advisor to make a presentation and respond to numerous questions concerning Orchard's business and future prospects, the advantages that Mr. Scholl envisioned in combining the companies and his preliminary merger integration plans. Thereafter, the DMGI directors and their advisors met privately to informally discuss the proposed merger. The following morning, June 5th, the DMGI board of directors met again with its advisors to review the proposal further and, upon completion of all discussion, unanimously approved moving forward with due diligence and negotiation of a definitive merger agreement along the lines as presented at the board meeting.

On June 7 and 8, 2007, principals and legal and financial advisors for both parties met in New York to plan the due diligence and discuss and negotiate the key non-financial terms of the merger agreement. From this time through July 10, 2007, the parties exchanged detailed information as necessary to perform their respective due diligence procedures and counsel for the companies negotiated the specific merger terms and covenants and exchanged numerous drafts of a definitive merger agreement and other ancillary agreements, exhibits and schedules thereto.

During this five-week process, there were never any substantive changes to the consideration as agreed between Messrs. Trier and Stein and as presented to and approved by the DMGI board of directors. DMGI held board meetings on June 12 and 19, 2007 for the purpose of keeping the directors informed on the progress of the diligence, financial analysis and merger agreement drafting. Mr. Trier also remained in close contact with the DMGI directors and management by email and telephone.

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During this time period, SMH held meetings with senior management from both companies, performed the financial analysis described in their report included elsewhere in this proxy statement, and was present at each DMGI board meeting to advise the DMGI directors on their specific findings and the financial aspects of the transaction. In addition, Messrs. Trier and Stein negotiated the specific terms of an employment agreement between Mr. Scholl and DMGI, for Mr. Scholl to become the chief executive officer of DMGI, effective upon consummation of the merger.

During this period, Mr. Trier and John Kilcullen, an independent director of DMGI and chair of its compensation committee, had several discussions with Mr. Koulouris, who had expressed a desire to leave DMGI when the merger agreement was signed. In a meeting held on June 27, 2007, DMGI's compensation committee approved accepting Mr. Koulouris' resignation as a termination without cause, to be effective at such time as the merger agreement with Orchard was signed. The compensation committee also approved (i) increases in compensation for Karen Davis, chief financial officer of DMGI, and certain other key management personnel, (ii) a temporary increase in Mr. Trier's retainer for serving as chairman of DMGI, (iii) a retention bonus plan for DMGI employees as submitted by management, and (iv) a recommendation to the DMGI board of directors that Ms. Davis be appointed as the interim chief executive officer of DMGI after Mr. Koulouris' departure.

The parties and their advisors met again in New York, beginning on July 5, 2007, for the purpose of finalizing all remaining open issues and signing the merger agreement. On July 6, 2007, the DMGI board of directors met to hear reports (i) from management on the results of due diligence procedures, (ii) from legal counsel on the key terms of the merger agreement and the other ancillary documents and agreements incidental to and necessary for the merger, and (iii) from SMH on their financial analysis and why they believed that the merger terms were fair from a financial standpoint to the stockholders of DMGI. In addition, Mr. Trier reviewed the key points in Mr. Scholl's employment agreement and Mr. Kilcullen covered the Compensation Committee's actions and recommendations. At the conclusion of these presentations, the seven DMGI board members present at the meeting voted unanimously to authorize Mr. Trier to sign the merger agreement and other necessary merger-related documents on behalf of DMGI and for management and counsel to prepare a proxy statement to go to stockholders of DMGI soliciting their approval of the transaction. The DMGI Board of Directors also accepted Mr. Koulouris' resignation, effective upon signing of the merger agreement, appointed Ms. Davis as interim chief executive officer, and promoted two other DMGI managers to become vice presidents.

On July 10, 2007, the board of Orchard met and approved the transaction and entering into the merger agreement. They also authorized management and counsel to assist DMGI in preparing information describing Orchard and its financial results for inclusion in the proxy statement to go to stockholders of DMGI.

On July 10, 2007, the parties signed the merger agreement in New York.

On September 13, 2007, the parties amended and restated the merger agreement to eliminate contingencies to the closing of the Merger previously set forth in the Merger Agreement that were not required by applicable law.

DMGI's Reasons for the Merger; Recommendation of DMGI's Board of Directors

DMGI's board of directors believes that the merger is fair to, and in the best interest of, DMGI and its stockholders. DMGI's board of directors believes that the combination of DMGI and Orchard will result in greater long-term growth opportunities than DMGI has operating alone, primarily because the combined company will be able to offer complementary distribution and marketing services that DMGI does not presently provide, will substantially broaden the geographic scope of DMGI's operations and will have the potential for financial and operating synergies. Following the merger, the combined company will have enhanced scale and

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scope of operations, which we believe will provide it with the opportunity to reduce costs, attract new, and enhance existing, business relationships with music and video content owners and digital entertainment services, access capital markets, and take greater advantage of opportunities for organic and external growth than neither DMGI or Orchard could have on a standalone basis.

The DMGI board of directors has (1) concluded that the merger agreement, including the merger and the other transactions contemplated by the merger agreement, is fair to, advisable and in the best interests of DMGI and its stockholders, (2) approved the merger agreement and the merger, and (3) determined to recommend that DMGI's stockholders vote in favor of adoption of the merger-related proposals at the special meeting.

In concluding to approve the merger, the board of directors of DMGI consulted with its management, as well as with its financial and legal advisors, and considered a variety of factors, including the following:

The expectation that the combined company's results of operations should be able to grow at a more rapid rate than either DMGI's or Orchard's results of operations are likely to grow on an independent basis;

The expectation that the combined company should be able to achieve a greater increase in critical mass and visibility within the capital markets than either DMGI or Orchard is capable of achieving on an independent basis;

The expectation that the combined company should be able to improve its results of operations by reducing redundant operating expenses presently incurred by both DMGI and Orchard;

The anticipated ability of the combined company to facilitate an increase in revenue and gross profit from a broader and more extensive combined catalog of music and video recordings, an increased number of relationships with digital entertainment services, and cross-selling of Orchard's ancillary services to DMGI's catalog owners;

The anticipated ability of the combined company to better serve independent record labels and other digital content owners by offering more retail channel outlets and enhanced content management and reporting systems;

The anticipated ability of the combined company to better serve the digital entertainment services it sells through with a larger and more attractive collective catalog of recordings;

The anticipated ability of the combined company to broaden its geographic reach within the global digital media industry;

The complementary nature of DMGI's and Orchard's respective business, management and employee cultures and skill sets;

The similarity of the industry visions and values held by the respective boards and management teams of DMGI and Orchard;

The enhanced liquidity that an increase in publicly traded securities and a broader stockholder base could provide for DMGI stockholders after the merger;

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The tax free nature of the merger for DMGI stockholders; and

The fairness opinion from a financial point of view of SMH, with respect to the acquisition of Orchard and issuance of shares in consideration thereof.

The actual benefits to be derived from the merger, costs of integration and ability of the combined company to achieve expected cost reductions and business synergies could differ materially from the estimates and expectations discussed above. Accordingly, the potential benefits described above or the potential benefits described elsewhere in this proxy statement may not be realized. In considering the merits of the merger, DMGI's board of directors considered these negative factors and the related risks involved, including the following:

The possibility that the anticipated benefits from the merger are not received by DMGI;

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The risks arising from the short-term nature of certain of DMGI's and Orchard's respective agreements with content providers and the possibility that content providers may opt not to renew their agreements or otherwise continue their relationships with the combined company after the merger;

The risks associated with the digital media industry in general, including its highly competitive nature;

The costs of bringing Orchard's financial reporting procedures and accounting controls to public company standards and the risks of failing to do so in a timely manner;

The costs of the merger, including costs associated with the integration of the businesses, technology, content, channel relationships and employees of DMGI and Orchard;

The possibility of the loss of key employees following the merger; and

The significant dilution of the stockholders of DMGI as a result of the merger consideration.

For additional information concerning the above risks, see **RISK FACTORS** beginning on page 8 and **FORWARD-LOOKING STATEMENTS** beginning on page 23.

The discussion of the information and factors considered by DMGI's board of directors is not intended to be exhaustive but includes many of the factors the board considered. In reaching the determination to approve and recommend the merger, DMGI's board of directors did not assign any relative or specific weights to the foregoing factors, and individual directors may have given differing weights to different factors.

Opinion of SMH Capital, Inc., Financial Advisor to DMGI

On or about June 1, 2007, DMGI retained SMH Capital, Inc. to act as a financial advisor to the DMGI board of directors during negotiations with Orchard and to render its opinion as to the fairness, from a financial point of view, of the merger to the stockholders of DMGI. On July 6, 2007, SMH provided to DMGI's board of directors an oral opinion to the effect that, as of that date, the merger was fair, from a financial point of view, to the stockholders of DMGI subject to receipt and review of the audited financial statements of Orchard for the year ended December 31, 2006. On August 6, 2007, SMH delivered to DMGI its written opinion, attached as ANNEX B to this proxy statement and incorporated in this document by reference, which describes the assumptions made, general procedures followed, matters considered and limitations on the scope of review conducted by SMH in rendering its opinion. DMGI stockholders are urged to, and should, read SMH's opinion carefully and in its entirety. SMH's opinion is directed only to the fairness, as of the date of the opinion and from a financial point of view, of the merger to the stockholders of DMGI and does not constitute a recommendation to you as to how you should vote with respect to the merger agreement. In addition, the opinion addresses only the financial fairness of the terms of the transaction to the stockholders and does not address the relative merits of the transaction or any alternatives, the underlying decision of the board to engage in the transaction or any other aspect of the transaction.

In conducting its analyses, SMH also held discussions with members of DMGI's and Orchard's senior management regarding the past and current business operations, financial condition and future prospects of DMGI and Orchard. SMH assumed, and the management of each of DMGI and Orchard has represented, that the information provided by DMGI and Orchard, respectively, including projections, had a reasonable basis and reflected the best currently available estimates and judgments of management as to the recent and likely future performance of DMGI and Orchard. SMH also relied on representations of DMGI's and Orchard's management that they were not aware of any information or fact that would make the information provided to SMH incomplete or misleading.

In rendering its opinion, SMH assumed and relied upon, without independent verification, the accuracy and completeness of all information reviewed by it for the purposes of its opinion. SMH assumed that the transaction would be consummated on the terms set forth in the merger agreement and that, in the course of obtaining necessary regulatory and third-party consents for the transaction, no restriction would be imposed that would have a material adverse effect on the future results of operations or financial condition of DMGI or Orchard.

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SMH did not make any independent valuation or appraisal of the assets or liabilities of DMGI or Orchard. SMH's opinion was necessarily based on economic, market, financial and other conditions as they existed on, and on the information made available to SMH as of, the date of such opinion. It should be understood that, although subsequent developments may affect its opinion, SMH does not have any obligation to update, revise or reaffirm its opinion.

In arriving at its opinion, SMH was not authorized to solicit, and did not solicit, indications of interest from any potential buyers of part or all of DMGI nor did it have discussions with any party with respect to the acquisition of DMGI or any of its assets. Furthermore, SMH was not authorized to negotiate the terms of the transaction and has based its opinion solely on the terms of the merger agreement as negotiated by others. SMH did not attribute any particular weight to any analysis or factor it considered. Accordingly, SMH's analysis must be considered as a whole and selecting portions of its analyses, without considering all analysis, would create an incomplete view of the process underlying SMH's opinion.

In preparing its opinions, SMH performed a variety of analyses, including those described below. The summary of SMH's valuation analyses is not a complete description of the analyses underlying SMH's opinions. The preparation of an opinion regarding fairness is a complex process involving various quantitative and qualitative judgments and determinations with respect to the financial, comparative and other analytic methods employed and the adaptation and application of these methods to the unique facts and circumstances presented. As a consequence, neither an opinion regarding fairness nor its underlying analyses is readily susceptible to partial analysis or summary description. SMH arrived at its opinions based on the results of all analyses undertaken by it and assessed as a whole and did not draw, in isolation, conclusions from or with regard to any individual analysis, analytic method or factor. Accordingly, SMH believes that its analyses must be considered as a whole and that selecting portions of its analyses, analytic methods and factors or focusing on information presented in tabular format, without considering all analyses and factors or the narrative description of the analyses could create a misleading or incomplete view of the processes underlying its analyses and opinions.

In performing its analyses, SMH considered general business, economic, industry and market conditions, financial and otherwise, and other matters as they existed on, and could be evaluated as of, July 6, 2007 and August 6, 2007, respectively. No company, transaction or business used in SMH's analyses for comparative purposes is identical to DMGI or Orchard or the proposed transaction. SMH made judgments and assumptions with regard to digital media industry performance, general business, economic, regulatory, market and financial conditions and other matters, many of which are beyond the control of DMGI, such as the impact of competition on the business of DMGI and Orchard and on the digital media industry generally, industry growth and the absence of any adverse material change in the financial condition and prospects of DMGI or Orchard or the industry or in the markets generally. SMH believes that mathematical analyses (such as determining average and median) are not by themselves meaningful methods of using comparable company data and must be considered together with qualities, judgments and informed assumptions to arrive at sound conclusions. The implied reference range values indicated by SMH's analyses are illustrative and not necessarily indicative of actual values or predictive of future results or values, which may be significantly more or less favorable than those suggested by the analyses. In addition, any analyses relating to the value of assets, businesses or securities do not purport to be appraisals or to reflect the prices at which businesses or securities actually may be sold, which may depend on a variety of factors, many of which are beyond our control and the control of SMH. Much of the information used in, and accordingly the results of, SMH's analyses are inherently subject to substantial uncertainty.

SMH's oral opinion was provided in connection with its consideration of the proposed transaction and was only one of many factors considered by our board of directors in evaluating the merger. Neither SMH's oral opinion nor its analyses were determinative of the consideration in the transaction or of the views of our board of directors or management with respect to the transaction.

The following is a summary of the analyses performed by SMH in connection with its opinion. The summary set forth below does not purport to be a complete description of the analyses performed by SMH in

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rendering its opinion to DMGI and is qualified in its entirety by reference to the full text of the opinion attached as ANNEX B. DMGI stockholders are urged to read the opinion carefully in its entirety.

In conducting its investigation and analysis and in arriving at its opinion, SMH reviewed information and took into account financial, economic and market factors it deemed relevant under the circumstances. In rendering its opinion, SMH, among other things:

- (1) Reviewed a draft of the Agreement and Plan of Merger dated July 10, 2007;
- (2) Reviewed 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 for the year ended December 31, 2006 and its quarterly report on Form 10-Q for the quarter ended March 31, 2007;
- (3) Reviewed and analyzed certain financial and operating information with respect to the respective businesses, operations, and prospects of DMGI and Orchard, respectively, including financial and operating projections furnished by the managements of DMGI and Orchard and in particular (a) projected revenue, cost of goods sold, 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) Compared 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) Compared the financial terms of the merger with the financial terms of certain other transactions that we deemed relevant;
- (6) Reviewed published estimates of independent research analysts with respect to the future financial performance of companies comparable to DMGI and Orchard;
- (7) Derived net present values of the businesses, based on its projected cash flows for DMGI and Orchard on a stand-alone basis and as a combined company;
- (8) Analyzed the potential pro forma impact of the merger on the future financial performance of DMGI;
- (9) Analyzed the potential pro forma impact of the merger on the current financial condition of DMGI;
- (10) Analyzed the relative contributions of DMGI and Orchard to the current and future financial performance of the combined company on a pro forma basis;
- (11) Analyzed the views of the respective managements of the strategic impacts of the acquisition on the business, operations, assets, financial condition and strategic opportunities of DMGI;

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(12) Analyzed DMGI's management's opinions regarding the merger structure relating to the preservation of net operating losses; and

(13) Reviewed such other financial studies and analyses and performed such other investigations as SMH deemed appropriate.

The following is a summary of the material analyses prepared in connection with SMH's oral opinion rendered on July 6, 2007 and written opinion rendered as of August 6, 2007. The order of the analyses does not represent relative importance or weight given to those analyses by SMH. The fact that any specific analysis has been referred to in the summary below is not meant to indicate that such analysis was given greater weight than any other analysis. The analyses summarized below include information presented in tabular format. The tables alone do not constitute a complete description of the analyses. Considering the data in the tables below without considering the full narrative description of the analyses, as well as the methodologies underlying and the assumptions, qualifications and limitations affecting each analysis, could create a misleading or incomplete view of SMH's analyses.

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For purposes of its analyses, SMH reviewed a number of financial and operating metrics including:

Enterprise Value generally the value as of a specified date of the relevant company's outstanding equity securities (taking into account its outstanding warrants and other convertible securities) plus the value of its net debt (the value of its outstanding indebtedness, preferred stock and capital lease obligations less the amount of cash on its balance sheet) as of a specified date; and

EBITDA generally the amount of the relevant company's earnings before interest, taxes, depreciation, and amortization for a specified time period.

Unless the context indicates otherwise, enterprise values used in the selected companies analysis described below were calculated using the closing price of the common stock of the selected digital content management companies, which we refer to as DCM, listed below as of July 10, 2007, and the enterprise values for the target companies used in the selected transactions analysis described below were calculated as of the announcement date of the relevant transaction based on the purchase prices paid in the selected transactions. Accordingly, this information does not necessarily reflect current or future market conditions. Estimates of 2007 and 2008 revenue, 2007 and 2008 EBITDA adjusted to exclude nonrecurring items, which we refer to as adjusted EBITDA, and 2007 and 2008 price earnings ratios for DMGI and Orchard were based on estimates provided by DMGI and Orchard management, respectively. Estimates of 2007 and 2008 revenue, adjusted EBITDA and price earnings ratios for the selected DCM companies listed below were based on publicly available research analyst estimates for those companies.

Selected Companies Analysis. SMH calculated multiples of enterprise value and price and considered certain financial data for DMGI, Orchard and selected DCM companies.

The calculated multiples included:

Enterprise value as a multiple of latest 12 months, or LTM, revenue and estimated 2007 and 2008 revenue;

Enterprise value as a multiple of LTM adjusted EBITDA and estimated 2007 and 2008 adjusted EBITDA; and

Price as a multiple of LTM earnings per share and estimated 2007 and 2008 earnings per share.

The selected DCM companies were:

EMI Group plc;

Warner Music Group Corp.;

Lions Gate Entertainment Corp.;

RealNetworks Inc.;

InfoSpace Inc.; and

Buongiorno SpA

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The selected companies analysis indicated the following:

Multiple Description	Low	High	Mean	Median
Enterprise Value as a multiple of:				
LTM Revenue	1.1x	1.8x	1.5x	1.6x
2007E Revenue	1.2	1.8	1.4	1.4
2008E Revenue	1.1	1.8	1.4	1.3
LTM EBITDA	9.2	41.8	25.5	30.9
2007E EBITDA	8.5	14.1	12.3	13.4
2008E EBITDA	7.7	11.8	10.0	10.3
Price as a multiple of:				
LTM earnings/share	27.9	132.6	60.5	40.8
2007E earnings/share	30.7	72.3	46.3	36.0
2008E earnings/share	23.0	30.1	25.5	23.3

SMH applied multiple ranges based on the selected companies analysis to corresponding financial data for DMGI and Orchard, including estimates provided by management of DMGI and Orchard. The selected companies analysis indicated an implied reference range equity value for DMGI of \$32.8 million to \$64.2 million and for Orchard from \$37.9 million to \$78.3 million.

Precedent Transactions Analysis. SMH calculated multiples of enterprise value to certain financial data based on the purchase prices paid in selected publicly-announced transactions.

The calculated multiples included:

Enterprise value as a multiple of LTM, revenue; and

Enterprise value as a multiple of LTM EBITDA.

The selected transactions were:

Acquiror

Getty Images, Inc.
Terra Firma Capital Partners
RealNetworks, Inc.
Accenture Holdings BV
Lions Gate Entertainment Corp.
RealNetworks, Inc.
Digital Music Group, Inc.
Warner Music Group Corp.
Baker Capital

Target

Pump Audio, Inc.
EMI Group plc
Sony NetServices
Digiplug S.A.S.
Magna Pacific (Holdings) Limited
WiderThanCo., Ltd
Digital Rights Agency LLC
Ryko Corporation
MusicNet, Inc.

The selected transactions analysis indicated the following:

Multiple Description	Low	High	Mean	Median
Enterprise Value as a multiple of:				
LTM Revenue	0.8x	2.9x	1.7x	1.7x

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LTM EBITDA	4.2	18.5	13.8	12.2
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SMH applied multiple ranges based on the selected transactions analysis to corresponding financial data for DMGI and Orchard. The selected transactions analysis indicated an implied reference range equity value for DMGI of \$26.3 million to \$66.3 million and for Orchard of \$27.2 million to \$93.2 million.

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Discounted Cash Flow Analysis

SMH also calculated the net present value of both DMGI's and Orchard's unlevered, after-tax debt-free cash flows based on estimates provided by management of DMGI and Orchard. For purposes of this analysis, SMH used discount rates of 18%, 20% and 22% based on terminal EBITDA multiples of 7.0x, 8.0x and 9.0x. The discounted cash flow analysis indicated an implied reference range equity value for DMGI of \$46.4 million to \$60.8 million and for Orchard of \$83.8 million to \$116.9 million.

SMH's opinions were subject to the assumptions and conditions contained therein and were based upon market, economic, financial and other conditions as they existed and could be evaluated on, and on the information available to SMH as of July 6, 2007 and August 6, 2007, respectively. SMH assumed no responsibility for updating or revising its opinions based on circumstances or events occurring after either July 6, 2007 or August 6, 2007. SMH's opinions were 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 SMH's prior written consent, provided, however, that SMH consented to the inclusion of the text of its written opinion in its entirety in any filing by us with the SEC that is required by law.

DMGI selected SMH to render its opinion based on its reputation and experience in mergers and acquisitions. DMGI paid, or has agreed to pay, to SMH a maximum fee of \$275,000 for its financial advisory services and a fee of \$100,000 for its additional services related to forming and issuing an opinion on the financial fairness of the transaction. In addition, DMGI agreed to reimburse SMH for its reasonable out-of-pocket expenses incurred in performing its services up to a maximum of \$25,000 and to indemnify SMH from and against certain liabilities and expenses which may arise out of or relate to its engagement.

Interests of Certain DMGI Executive Officers and Directors in the Merger

In considering the recommendation of DMGI's board of directors to vote in favor of adoption of the merger agreement, DMGI stockholders should be aware that certain members of the DMGI's board of directors and certain of DMGI's executive officers have interests in the merger that are different from, or are in addition to, the interests of DMGI stockholders generally and that may create potential conflicts of interest. During its deliberations in determining to recommend to its stockholders that they vote in favor of the merger proposal, the DMGI board was aware of these interests.

All independent directors of DMGI hold options to acquire shares of DMGI common stock, the unvested portions of which will accelerate and vest upon closing of the merger. Messrs. Altschul, Biscay, Csathy, Hatchett and Kilcullen each hold options to acquire up to 30,000 shares of DMGI common stock (11,000 options unvested for each director as of August 31, 2007) and Mr. Trier holds options to acquire up to 36,000 shares of DMGI common stock (11,000 options unvested as of August 31, 2007). Annual option grants to independent directors are automatic as to date of grant, number of shares and monthly vesting terms, and the exercise price is the fair market value of the DMGI common stock at date of grant. The majority of the unvested options held by independent directors are exercisable at \$9.75 per share. Karen Davis, interim chief executive officer and chief financial officer, holds options to acquire up to 100,000 shares of DMGI common stock (73,438 options unvested as of August 31, 2007) and has previously been awarded 45,000 shares of restricted common stock (35,000 shares unvested as of August 31, 2007). The unvested portions of Ms. Davis' options and restricted shares will accelerate and vest upon closing of the merger. Tuhin Roy, chief strategy officer, holds a seven-year warrant to acquire up to 150,000 shares of DMGI common stock at \$5.57 per share, which will accelerate and become fully vested, but expire if not exercised in cash, upon closing of the merger.

Directors. At the effective time of the merger, three current DMGI directors, Clayton Trier (Chairman), David Altschul and Terry Hatchett, will continue as directors of the combined company. See "THE MERGER" Board of Directors and Executive Officers of DMGI after Completion of the Merger on page 39.

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Insurance. The merger agreement obligates DMGI to cause the individuals serving as officers and directors of DMGI and Orchard or any of their subsidiaries immediately prior to the effective time of the merger 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 Orchard (in the case of officers and directors of Orchard) (provided that DMGI and 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 of the merger 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 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. However, 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 date of the merger agreement to maintain or procure insurance coverage pursuant to the merger agreement. If DMGI is unable to maintain or obtain the insurance called for by the merger agreement, DMGI shall obtain as much comparable insurance as is available, subject to the 200% cap of costs.

Board of Directors and Executive Officers of DMGI after Completion of the Merger

After the merger, the board of directors of the combined company shall consist of four Orchard nominees, Daniel Stein, Viet D. Dinh, Michael Donahue and Greg Scholl, and three DMGI nominees, Clayton Trier (Chairman), David Altschul and Terry Hatchett. Each director will remain in office until his or her successor is duly elected or approved and qualified in accordance with DMGI's amended and restated certificate of incorporation and bylaws or as otherwise provided by applicable law. Additional information regarding each of the Orchard director designees is set forth on ANNEX C hereto and incorporated herein by reference.

After the merger, Greg Scholl will serve as chief executive officer of the combined company pursuant to an employment agreement described in ANNEX C hereto. The other executive officers have not yet been determined and will be appointed by the board of directors of the combined company after the merger.

Stock Exchange Listing

DMGI common stock is currently listed on the Nasdaq Global Market. Subject to our compliance with the continuing listing standards of the Nasdaq Global Market, we intend to continue to list our common stock on the Nasdaq Global Market until the closing of the merger. We have been informed by the Nasdaq Global Market that the merger is deemed to constitute a reverse merger and will require the combined company to submit an initial listing application and, at the time of the merger, meet all of the criteria applicable to a company initially requesting listing. We have applied for listing on Nasdaq Global Market under the symbol . See RISK FACTORS Risk Factors Relating to the Merger DMGI common stock could be delisted from the Nasdaq Global Market if we do not comply with its continued listing standards at the time of the merger.

Appraisal Rights

Under Delaware law, holders of DMGI capital stock are not entitled to appraisal rights with respect to the matters to be considered at the DMGI special meeting.

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THE MERGER AGREEMENT

The following is a description of the material aspects of the amended and restated merger agreement, or the merger agreement. While we believe that the following description covers the material terms of the merger agreement, the description may not contain all of the information that is important to you. You should carefully read this entire document and the other documents we refer to for a more complete understanding of the merger agreement. In particular, the following summary is not complete and is qualified in its entirety by reference to the copy of the merger agreement attached to this proxy statement as ANNEX A and incorporated by reference herein. You should read the merger agreement carefully and in its entirety for a complete understanding of the terms of the merger.

The Merger

The merger agreement provides that, if all of the conditions set forth in the merger agreement are satisfied or waived, DMGI NY will merge with and into Orchard, with Orchard remaining in existence as the surviving corporation in the merger and a wholly-owned subsidiary of DMGI.

Effective Time and Completion of the Merger

If the merger agreement is approved by the requisite votes of the stockholders of DMGI and all other consents and approvals are received, and if the other conditions to the obligations of the parties to consummate the merger are satisfied or waived (as permitted), the merger will be consummated and effected on the date and time the Certificate of Merger reflecting the merger becomes effective with the Department of State of the State of New York.

Assuming satisfaction of all of the conditions to consummation of the merger, the merger is expected to be consummated on _____, 2007, the same day as the special meeting.

Board of Directors and Executive Officers of DMGI after Completion of the Merger

The merger agreement provides that, after the merger, the board of directors of the combined company shall consist of Clayton Trier (Chairman), Daniel Stein, Viet D. Dinh, Michael Donahue, Greg Scholl, David Altschul and Terry Hatchett. Each director will remain in office until his or her successor is duly elected or approved and qualified in accordance with DMGI's amended and restated certificate of incorporation and bylaws or as otherwise provided by applicable law. See THE MERGER Board of Directors and Executive Officers of DMGI after Completion of the Merger on page 39.

Additionally, the merger agreement provides that, after the merger, Greg Scholl will serve as chief executive officer of the combined company pursuant to an employment agreement between Mr. Scholl and DMGI that becomes effective upon the consummation of the merger. The other executive officers are not set forth in the merger agreement and will be appointed by the board of directors of the combined company after the merger.

Consideration to be Received in the Merger

Upon completion of the merger, the holders of Orchard common and preferred stock and deferred stock awards will receive an aggregate of 9,064,941 shares of DMGI common stock and 448,833 shares of DMGI Series A Preferred Stock or the right to receive such shares, as applicable, in exchange for their ownership interests in Orchard (referred to as the merger consideration). Orchard stockholders would receive approximately _____% of the outstanding shares of DMGI common stock and 100% of the outstanding shares of DMGI Series A Preferred Stock immediately following the closing of the merger. The aggregate liquidation value of the shares of DMGI Series A Preferred Stock to be issued to Orchard stockholders as a result of the merger is \$25 million.

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The aggregate value of the shares of DMGI common stock to be issued to the Orchard stockholders as a result of the merger is approximately \$36.2 million based on the \$3.99 per share closing price of DMGI common stock as reported on the Nasdaq Global Market System on July 10, 2007, the day prior to the announcement of the merger and \$ based on the \$ per share closing price of DMGI common stock as reported on the Nasdaq Global Market System on , 2007, the most recent practicable date prior to the mailing of this proxy statement. You are urged to obtain a recent price quotation for DMGI common stock. Because the merger consideration is fixed in the merger agreement, the market value of the DMGI common stock that Orchard stockholders receive in the merger is likely to vary from that implied by current trading prices, as reflected above.

Conversion of Shares; No Exchange of Certificates

The shares of DMGI common stock currently outstanding will not be effected by the merger and DMGI stockholders are not required to surrender their certificates. DMGI will be required to deliver certificates representing shares of DMGI capital stock to each holder of record of Orchard capital stock whose shares will be converted into the right to receive shares of DMGI capital stock pursuant to the merger agreement.

Representations and Warranties

The merger agreement contains customary and substantially reciprocal representations and warranties made by DMGI and DMGI NY, on the one hand, and Orchard, on the other, relating to, among other things:

due organization, good standing and corporate power;

capitalization;

corporate authorization to execute and deliver the merger agreement and performance of obligations under the merger agreement and the enforceability of the merger agreement and other related transaction documents;

absence of any conflict with or violation of corporate charter documents, applicable law or contracts as a result of the execution, delivery and consummation of the transactions contemplated by the merger agreement;

accuracy of financial statements;

absence of undisclosed liabilities;

absence of an event or events that would have a material adverse effect and certain other events since March 31, 2007;

absence of litigation;

accuracy of tax returns and timely payment of taxes;

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employees, employee relations and employee benefit plans;

valid ownership and possession of properties;

absence of undisclosed liabilities;

compliance with laws;

compliance with regulatory matters;

broker's or finder's fees;

proper preparation and timely filing of tax returns and timely payment of taxes;

employee benefit matters;

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intellectual property matters;

environmental liabilities and compliance with environmental laws;

material contracts;

labor relations; and

inapplicability of state anti-takeover laws to the merger and merger agreement.

In addition, the merger agreement contains the following additional representations made by DMGI:

absence of untrue statements of material fact or omissions of material facts in all documents filed with the SEC;

opinion of DMGI financial advisor;

DMGI's stockholders' registration rights; and

formation and organization and operation of DMGI NY.

Conduct of Business Pending Merger

Under the merger agreement, both DMGI and Orchard agreed, subject to certain exceptions, to, and to cause their respective subsidiaries to:

conduct its business in the ordinary course;

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

take no action that would reasonably be expected to adversely affect or delay the ability of either DMGI or Orchard to obtain any necessary approvals required for the merger or to perform its covenants and agreements under the merger agreement or to consummate the transactions contemplated therein.

Additionally, during the pendency of the merger, DMGI and Orchard agreed, with certain exceptions, not to, and not to allow their respective subsidiaries to:

incur any indebtedness or assume, guarantee, endorse or otherwise become responsible for the obligations of any other individual, corporation or other entity, or make any loan or advance;

adjust, split, combine or reclassify any capital stock;

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 into or exchangeable for any shares of its capital stock;

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;

issue any additional shares of capital stock except pursuant to the exercise of stock options or warrants outstanding as of the date of the merger agreement;

sell, transfer, mortgage, encumber or otherwise dispose of any of its material properties or assets to any individual, corporation or other entity, or cancel, release or assign any indebtedness owed to or from any such person or any claims by or against any such person;

except for transactions in the ordinary course of business consistent with past practices or pursuant to contracts or agreements in force at the date of or permitted by the merger agreement, make any material

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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;

terminate, or waive any material provision of, any contract or make any change in any instrument or agreement governing the terms of any of its securities, or material lease or contract;

increase in any manner the compensation or fringe benefits of any of 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, or accelerate the vesting of, or the lapsing of restrictions with respect to, any stock options or other stock-based compensation;

settle any material claim, action or proceeding;

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 Internal Revenue Code, as amended (the *Code*);

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

take any action that is intended or expected to result in any of its representations and warranties being or becoming untrue in any material respect, or in any of the conditions to the not being satisfied or in a violation of any provision of the merger agreement;

implement or adopt any change in its accounting principles, practices or methods, other than as may be required by U.S. generally accepted accounting principles (*GAAP*); or

agree to take, make any commitment to take, or adopt any resolutions of its board of directors in support of, any of the foregoing actions.

No Solicitation of Alternative Transactions

No Solicitation. The merger agreement contains detailed provisions prohibiting DMGI and Orchard from seeking other offers to the merger. DMGI agreed that subject to specific exceptions, it would not, prior to the effectiveness of the merger:

initiate, solicit, encourage or knowingly facilitate inquiries or proposals with respect to any acquisition transaction;

engage or participate in any negotiations concerning any acquisition transaction;

provide any confidential or nonpublic information or data to any person in connection with an acquisition transaction;

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have, or engage or participate in, any discussions with any person relating to any acquisition transaction;

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;

withdraw, modify or qualify in any manner adverse to Orchard the recommendation by such party's board of directors of the merger 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; or

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 the merger. For purposes of the merger agreement, an acquisition transaction means any transaction where any person acquires beneficial ownership of more than 15% of the outstanding equity interests of such party, a merger, share exchange, business combination, consolidation, sale of all or substantially all of the assets, liquidation,

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dissolution or similar transaction, any transaction where any person acquires more than 15% of the fair market value of all the assets, net revenues or net income of such party, or any other consolidation, business combination, recapitalization or similar transaction.

Change of Recommendation. Either DMGI's or Orchard's board of directors shall be permitted to (i) make, withdraw, qualify, amend or modify its recommendation to approve the merger agreement and the transactions contemplated thereby or (ii) approve, endorse or recommend the approval of an acquisition transaction, if all of the following conditions are met:

the stockholders have not approved the merger;

the party has received an unsolicited bona fide written offer regarding an acquisition transaction from a third party;

the board of directors determines in good faith that such action is required by its fiduciary duties under applicable law;

at least twenty-four hours prior to providing any nonpublic information to the offeror, the party receiving the offer provides the other party with written notice of the identity of the offeror and the receiving party's intention to participate in negotiations;

prior to providing any nonpublic information to the offeror, the receiving party enters into a confidentiality agreement with the offeror and provides a copy to the other party;

at least twenty-four hours prior to furnishing nonpublic information to offeror, the receiving party furnishes such information to the other party (to the extent not previously delivered or made available); and

the receiving corporation promptly notifies the other party in writing at least five business days before taking such action, of its intention to so change its recommendation.

Employee Matters

After the effectiveness of the merger, unless otherwise agreed, the benefit plans of DMGI and Orchard in effect at the time of the agreement shall remain in effect with respect to their respective employees until such time as DMGI or Orchard shall modify any existing plans or adopt new benefit plans with respect to employees of the combined company. It is the intention of DMGI and Orchard, to the extent permitted by applicable law, to combine existing benefit plans or develop new benefit plans covering all employees, as soon as reasonably practicable after the effective date of the merger.

Indemnification and Insurance

The merger agreement provides that in the event of any threatened or actual action, whether civil, criminal or administrative, including any such action in which any of DMGI's or Orchard's present or former directors or any of their respective subsidiaries is, or is threatened to be, made a party based whole or in part on, or arising in whole or in part out of, or pertaining in whole or in part to, (i) the fact that he is or was a director, officer or employee of DMGI, Orchard or any of their respective subsidiaries or (ii) the merger agreement or any of the transactions contemplated therein, DMGI will, from and after the effective time of the merger, indemnify such persons for any claims made or threatened related to actions or omissions by such person in such capacity taken prior to the effective time of the merger. DMGI agrees to indemnify such officer or director from and after the effective time of the merger to the fullest extent permitted by applicable law.

DMGI has also agreed to cause the individuals serving as officers and directors of DMGI and Orchard or any of their subsidiaries immediately prior to the effective time of the merger to be (i) covered for a period of two years by the directors' and officers' liability insurance policy

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maintained by DMGI (in the case of officers and directors of DMGI) and Orchard (in the case of officers and directors of Orchard) with respect to acts or

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omissions occurring prior to the effective time or (ii) if such insurance cannot be obtained, covered for a period of five years by a tail policy on Orchard's and DMGI's existing directors' and officers' liability insurance policies, as the case may be.

In no event shall DMGI be required to expend more than 200% per year of the amount currently expended by DMGI per year for coverage as of the date of the merger agreement. If DMGI is unable to maintain or obtain the insurance called for by the merger agreement, DMGI will obtain as much comparable insurance as is available, subject to the 200% cap on cost.

Conditions to Complete the Merger

The respective obligations of the parties to complete the merger are subject to satisfaction or waiver of the following conditions:

approval 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 Orchard capital stock entitled to vote thereon;

the authorization of the shares of DMGI common stock to be authorized for listing on the Nasdaq Global Market System, subject to official notice of issuance.

the applicable waiting period under the HSR Act has expired or been terminated, and all other approvals of governmental entities required have been obtained and shall remain in full force and effect and all statutory waiting periods shall have expired.

no order, injunction or decree has been issued or other legal restraint or prohibition exists that prevents the consummation of the transactions contemplated by the merger agreement and no statute, rule, regulation, order, injunction or decree exists that would prohibit or make illegal consummation of the merger.

In addition, the obligations of DMGI and DMGI NY are subject to satisfaction or waiver of the following conditions:

the representations and warranties of Orchard are true and correct in all respects or all material respects, as applicable, 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 Orchard by its chief executive officer to the foregoing effect.

Orchard shall have performed in all material respects the obligations required to be performed by it under the merger agreement, and DMGI shall have received a certificate signed on behalf of Orchard by its chief executive officer to such effect.

Orchard shall taken such action as necessary to appoint Greg Scholl as Chief Executive Officer, President, Assistant Treasurer and Assistant Secretary of DMGI.

DMGI shall have received the opinion of counsel reasonably satisfactory to DMGI that the merger will qualify as a reorganization within the meaning of Section 368(a) of the Code.

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DMGI shall have received from each affiliate of Orchard an executed letter agreement for purposes of Rule 145 of the rules and regulations of the Securities Exchange Act.

DMGI shall have received from each of Orchard's stockholders an executed release.

In addition, the obligations of Orchard are subject to the satisfaction or waiver of the following conditions:

the representations and warranties of DMGI are true and correct in all respects or all material respects, as applicable, other than representations and warranties that expressly speak as of a specific date or time

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(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). Orchard shall have received a certificate signed on behalf of DMGI by its chief executive officer to the foregoing effect.

DMGI shall have performed in all material respects the obligations required to be performed by it under the merger agreement, and Orchard shall have received a certificate signed on behalf of DMGI by its chief executive officer to such effect.

DMGI shall have taken all such actions as shall be necessary so that (i) the DMGI Certificate of Incorporation shall have been amended and restated, and (ii) resolutions have been adopted:

- (i) appointing Greg Scholl as an officer of DMGI;
- (ii) appointing Daniel Stein, Viet D. Dinh, Michael Donahue, Clayton Trier (Chairman), David Altschul and Terry Hatchett as the directors of DMGI; and
- (iii) appointing Greg Scholl as a director of Orchard, as the surviving subsidiary corporation.

All resignations of officers and directors of DMGI as requested by Orchard shall have been submitted to DMGI.

Orchard shall have received the opinion of counsel reasonably satisfactory to Orchard 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 Orchard common stock as a result of the exchange of their shares, and no gain or loss should be recognized by the stockholders of Orchard preferred stock as a result of the exchange of their shares.

DMGI shall have executed and delivered a registration rights agreement.

DMGI shall have secured the termination of all liens as requested by Orchard and shall have provided Orchard with evidence of the termination of such liens.

Termination of Merger Agreement

The merger may be terminated upon the following occurrences:

by mutual written consent of DMGI and Orchard;

by either party if any governmental entity that must grant approval has denied approval of the merger and such denial has become final and nonappealable or any governmental entity shall have issued a final nonappealable order permanently enjoining or otherwise prohibiting the consummation of the transactions contemplated by the merger agreement, unless the failure to obtain such approval shall be due to the failure to perform or observe the covenants and agreements of the party seeking to terminate the merger agreement;

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by either party if the merger is not consummated on or before December 31, 2007, unless the failure of the closing to occur by such date shall be due to failure to perform or observe the covenants and agreements of the party seeking to terminate the merger agreement;

by either party if there shall have been a breach of any of the covenants or agreements or any of the representations or warranties by the other party, which breach, either individually or in the aggregate, would constitute the failure of any of the conditions to closing, and which is not cured within 30 days following written notice to the party committing such breach;

by either party if either party shall have failed to obtain the requisite affirmative vote of its stockholders;

by Orchard, if the board of directors of DMGI shall have 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 within 10 business days after the commencement of such tender or exchange offer; and

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by DMGI, if the board of directors of Orchard shall have effected a change in recommendation, or resolved to do so. If the merger agreement is terminated by either party because of a pre-termination takeover proposal event, or if terminated because of a material breach of the merger agreement by the other party, or the failure by the other party to consummate the merger and within twelve months of such termination, the non-terminating party consummates an alternative transaction, the non-terminating party shall pay to the terminating party a termination fee in the amount of \$1.1 million dollars plus expenses, not to exceed \$500,000.

If the merger agreement is terminated by either party because of a change of recommendation by the other party, the non-terminating party shall pay to the terminating party a termination fee in the amount of \$1.11 million dollars plus expenses, not to exceed \$500,000.

For purposes of the merger agreement, a pre-termination takeover proposal event means any transaction where any person acquires beneficial ownership of 40% or more of the outstanding equity interests of such party or 40% or more of the fair market value of all the assets, net revenues or net income of such party, or any other consolidation, recapitalization or similar transaction. A pre-termination takeover proposal event does not include any transaction where (i) holders of shares of the participating party immediately prior to such transaction would continue, in the aggregate, to own at least a majority of the outstanding shares of common stock and voting power of the resulting entity immediately after the consummation of the transaction and (ii) such party would retain at least a majority of the resulting entity's board of directors.

Amendment, Waiver and Extension of the Merger Agreement

The merger agreement may be amended at any time before or after approval of the merger by the stockholders of DMGI and Orchard. After any approval by the respective stockholders of DMGI or Orchard, there may not be, without further approval of such stockholders, any amendment of the merger agreement that changes the amount or the form of the consideration to be delivered to the stockholders of Orchard. In order to amend the merger agreement, the parties must sign an instrument in writing.

To the extent legally allowed, the parties may (i) extend the time for the performance of any of the obligations or other acts of the other party, (ii) waive any inaccuracies in the representations and warranties and (iii) waive compliance with any of the agreements or satisfaction of any conditions; provided, however, that after approval of the transactions by the stockholders of DMGI or Orchard, there may not be, without further approval of such stockholders, any extension or waiver of the merger agreement or that reduces the amount or changes the form of the consideration to be delivered to the stockholders of Orchard. Any agreement regarding an extension or waiver shall be valid only if set forth in writing and signed on behalf of party granting the extension or waiver. Any extension or waiver or failure to insist on strict compliance with an obligation, covenant, agreement or condition shall not operate as a waiver of, or estoppel with respect to, any subsequent or other failure.

Costs and Expenses

All costs and expenses incurred in connection with the merger agreement and the transactions contemplated therein are to be paid by the party incurring such expense; provided, however, any filing fee required under the HSR Act in connection with the merger shall be shared equally by DMGI and Orchard.

Restrictions on Resales by Affiliates

Any subsequent transfer of shares of DMGI common stock by any person who is an affiliate of Orchard at the time the merger is submitted for a vote or consent of the stockholders of Orchard will, under existing law, require either:

the further registration under the Securities Act of the shares of DMGI common stock to be transferred;

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compliance with Rules 144 and 145 promulgated under the Securities Act (permitting limited resales under certain circumstances); or

the availability of another exemption from registration.

An affiliate of Orchard, as defined by the rules promulgated pursuant to the Securities Act, is a person who directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with Orchard. Orchard has agreed that it will use its reasonable efforts to cause each person or entity that is an affiliate for purposes of complying with Rule 145 to enter into a written agreement relating to such restrictions on sale or other transfer.

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OTHER AGREEMENTS

Stockholder Voting Agreements

In connection with the execution of the merger agreement, Orchard, five directors and one executive officer of DMGI (Terry Hatchett, John Kilcullen, Mitchell Koulouris, Tuhin Roy, Clayton Trier and Karen Davis) and six additional stockholders of DMGI entered into that certain Stockholder Voting Agreement dated July 5, 2007, whereby:

the parties agreed to vote their shares of DMGI common stock in favor of the merger and the amended and restated certificate of incorporation (subject to the directors' fiduciary duties); and

each party agreed, until the consummation of the merger or the termination of the merger agreement in accordance with its terms, not to sell any shares of DMGI common stock except to Orchard or, with Orchard's consent, to another stockholder party to the agreement.

Form of Registration Rights Agreement

The merger agreement requires that at the effective time of the merger DMGI, Orchard and certain stockholders of Orchard enter into a Registration Rights Agreement pursuant to which DMGI will agree to the following:

if, at any time commencing six months after the consummation of the merger, DMGI receives a request from the holders of a majority of DMGI common stock owned by the former Orchard stockholders, that DMGI file a registration statement covering all of the DMGI common stock held in the aggregate by such person(s), DMGI must, subject to certain conditions, use commercially reasonable efforts to register all of the shares of DMGI common stock held by the former Orchard stockholders (provided, that the former Orchard stockholders will be entitled to only two such requests);

if, at any time after the first anniversary of the merger, DMGI chooses to register any of its capital stock for its own account or on account of any of its stockholders, DMGI shall invite the former Orchard stockholders to piggyback on such registration; and

pay all fees associated with any registration required to be made by it pursuant to the registration rights agreement other than underwriters' discounts and commissions.

The foregoing descriptions of the forms of Stockholder Voting Agreement and the form of Registration Rights Agreement are qualified in their entirety by reference to the complete terms and conditions of the Stockholder Voting Agreement and the form of Registration Rights Agreement, which are attached as ANNEX D hereto and incorporated herein by reference and Exhibit D to ANNEX A hereto, respectively.

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ACCOUNTING TREATMENT

Although in legal form DMGI will be acquiring Orchard, Orchard's former stockholders will hold a majority of the voting stock of the combined company after the merger. Accordingly, for accounting purposes, the merger will be treated as a reverse acquisition of DMGI by Orchard, and Orchard will be deemed the acquiror for the purposes of combined financial reporting subsequent to the merger and applying the purchase method of accounting pursuant to U.S. generally accepted accounting principles.

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REGULATORY APPROVALS

United States Antitrust

To complete the merger, DMGI and Orchard must make filings and obtain approvals or clearances from antitrust regulatory authorities. DMGI must also comply with applicable federal and state securities laws in connection with the issuance of the DMGI common stock and Series A Preferred Stock pursuant to the merger and the filing of this proxy statement with the SEC.

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MATERIAL FEDERAL INCOME TAX CONSEQUENCES

The following discussion summarizes the material United States federal income tax consequences of the merger that are generally applicable to U.S. holders of DMGI common stock. This discussion is based on the Code, Treasury Regulations, administrative rulings and court decisions in effect as of the date of this proxy statement, all of which may change at any time, possibly with retroactive effect.

The merger is not a taxable event with respect to shares of DMGI capital stock currently outstanding. The merger has been structured to qualify as a tax-free reorganization within the meaning of Section 368(a) of the Code and it is a closing condition to the merger that DMGI and Orchard receive opinions of their respective counsel regarding such qualification. For information relating to the conditions to closing of the merger, see THE MERGER AGREEMENT Conditions to Complete the Merger on page 45.

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THE COMPANIES

Digital Music Group, Inc.

Overview

Digital Music Group, Inc. is a content owner and global leader in the digital distribution of independently owned music and video content, including music recordings and music, television, film and other video content. As of June 30, 2007, we had approximately 353,000 individual music recordings under management and over 4,000 hours of video content.

We acquire or license the digital rights to music and video content from record labels, artists, television and film production companies, and other content owners. We digitally encode the content into multiple formats for distribution to digital entertainment services operating over the Internet and wireless, cable and mobile networks. Consumers can then listen, view and/or purchase the content for use on their personal computers, digital music and video players, and music and video-enabled mobile phones. As of December 31, 2005, we had approximately 31,000 music recordings available for sale through digital music retailers, whereas as of December 31, 2006, we had approximately 220,000 music recordings available for sale through digital music retailers and mobile services and approximately 335,000 music recordings under management.

During the first half of 2007, we acquired digital rights to approximately 28,000 additional music recordings. Also during this period, we made a net reduction of 10,000 to the total number of music recordings under management due to (i) a reduction of 23,000 music recordings as a result of one content owner's inability to deliver approximately 13,000 out of the 75,000 music recordings under contract, plus certain other adjustments related to the contract; and (ii) a net increase of approximately 13,000 music recordings under management due to deliveries by content owners in excess of contracted amounts and other adjustments. Under our contract terms, we are not required to pay for the music recordings that are not delivered to us and typically are not required to pay additional consideration or make additional royalty advances for deliveries in excess of contracted amounts. As a result of these transactions, our total music recordings under management increased from approximately 335,000 as of December 31, 2006 to approximately 353,000 as of June 30, 2007. As of June 30, 2007, we had approximately 261,600 music recordings available for sale through digital entertainment services. The remaining music records under contract had either (i) been processed and transmitted to one or more digital entertainment services where they were awaiting review and processing by the services before being posted for sale, (ii) were in various stages of our digitization process or (iii) had not yet been delivered to us by the content owners. As of June 30, 2007, we were in the early stages of processing and delivering our video content to digital entertainment services.

Our digital entertainment service partners make our content available to consumers through two primary business models: permanent copies of entire albums, individual recordings or ringtones on a pay-per-download basis, or broad access to a substantial quantity of content on a subscription basis. We receive revenue from the digital entertainment services based on the number of times our content is downloaded or streamed by consumers. Beginning in 2007, we are delivering certain of our video content to advertising-supported Internet sites where it will be available without charge to consumers, and we will share in a percentage of the advertising revenue based on the number of times our video content is viewed by consumers.

Our digital entertainment service partners include online music stores and mobile carriers and mobile aggregators, such as: Apple iTunes, Napster, RealNetworks, eMusic (an affiliate of Orchard), Wal-Mart Music, MusicNet, Verizon, Sprint, Moderati, Zingy, 9 Squared, and many others. We are making our video content available, beginning in 2007, through Apple iTunes, Google Video, YouTube, AOL/In2TV, Movielink, BitTorrent and other digital entertainment services.

Over the past four years, the recorded music industry has experienced increasing demand for music in digital format, driven by the proliferation of personal music players and music-enabled mobile phones and the ability to offer large selections of music recordings for consumption at any time. Like the music industry in 2004,

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We believe the television and film industries have recently begun a migration from sales and rental of content in physical formats such as digital video discs to digital distribution. However, only a relatively small percentage of known music and video content is currently available for purchase in digital format. We believe that many content owners have yet to make their content available in digital format because of the time, effort and cost involved. In addition, we believe many digital entertainment services are reluctant to enter into relationships with smaller content owners because of the administrative costs involved.

We actively seek out the owners of music and video content to acquire their digital rights through purchase, long-term license or short-term distribution agreements. Such acquisitions are pursued based upon the quality and commercial marketability of the content, our ability to negotiate appropriate consideration and terms, and our available financial resources. We have acquired digital rights to music and video content that represents a wide variety and mix of genres and time periods to appeal to many different interest groups. The music recordings that we own or control under long-term agreements are generally not current mainstream and popular hits, but consist primarily of back catalog, out-of-print recordings, past hits, world music, classical music performances, previously unreleased music recordings, live performances, and other music that may not be readily available from traditional music retailers. The music recordings that we distribute under short-term arrangements consist primarily of more contemporary recordings by independent record label artists. The video content we have acquired consists of music videos, live music performances, classic episodic television shows no longer in wide syndication, vintage feature and short films, cartoons and other animated features, stand-up comedy performances, action shorts, reality programming, sports events, and programs focused on children or special-interest groups.

Our strategy is to fulfill basic needs of each of the market participants in the rapidly growing and evolving digital media industry. We provide consumers with access to music and video content, much of which is not readily accessible in traditional brick-and-mortar retailers or otherwise available in digital format. In addition, we provide a means for content owners to make their content available to consumers at digital entertainment services with minimal effort on their behalf. Further, we reduce the burden for digital entertainment services of managing individual relationships with numerous smaller content owners.

On February 7, 2006, we completed our 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. The majority of the proceeds were earmarked for digital content acquisitions. Concurrently with the closing, we completed the acquisition of Digital Musicworks International, Inc., a California corporation, focused on acquiring or licensing digital rights to catalogs of music recordings, and certain digital distribution assets of Rio Bravo Entertainment LLC, a Delaware limited liability company doing business as Psychobaby. On September 8, 2006, we completed the acquisition of Digital Rights Agency LLC, a California limited liability company and a leading digital music distributor focused on independent record labels. On July 10, 2007, we entered into the merger agreement with Orchard, which was amended and restated on September 13, 2007. See THE MERGER AGREEMENT beginning on page 40.

Market Overview

The Digital Music Market

We believe the recorded music industry has been undergoing significant change, with the primary means of distribution transitioning from physical formats like compact disc to digital formats accessed over the Internet and wireless, cable and mobile networks. We believe this change is occurring as a result of the popularity and proliferation of personal computers, music-enabled mobile phones and portable digital music players like the Apple iPod, and consumer acceptance and the music industry's endorsement of legitimate digital music sales. We believe this transition is continuing and the market share of digital music will continue to increase, particularly through mobile distribution, and digital formats will ultimately become the preferred way consumers purchase and listen to music.

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Since Apple's introduction of the iPod in 2001, approximately 89 million iPods have been sold through January 2007, with over 21 million iPods sold in the last three months of 2006. According to a recent market research report, worldwide sales of portable digital media and music players are projected to grow from approximately 178 million units in 2006 to approximately 268 million units by 2011. Worldwide sales of music-enabled mobile phones are estimated to have exceeded 300 million units in 2006.

The Apple iTunes Store, which was launched in 2003, is the dominant Internet-based digital music retailer with over three billion songs downloaded since inception, although other digital music retailers such as eMusic (an affiliate of Orchard), RealNetworks, Napster, Wal-Mart Music, Yahoo! Music and others offer consumers additional choices. The digital segment of the worldwide recorded music market, which includes use of the Internet and wireless, cable and mobile networks to select and download purchased music, is growing rapidly and accounted for approximately 10% of this \$32 billion total market in 2006. There was an industry-wide decline in sales of physical product (pre-recorded music CDs) experienced during the first six months of 2007, which was larger than the increase in digital music sales for the same period. The early-stage nature of the digital transition presently occurring in the worldwide music industry and our limited operating history have not allowed us to definitively identify specific consumer trends or factors in our business that may affect the timing and extent of digital downloading as a replacement for purchases of music CDs and the resulting impact that such transition is likely to have on our revenue.

The emergence and maturation of digital music as a widely accepted format over the last four years has created new opportunities for both content owners and digital entertainment services. In addition to purchasing music downloads for digital music players, consumers are now consuming digital music in ways that were not envisioned just four years ago, most notably the purchase of digital music downloads for music-enabled mobile phones. Ringtones were the first mass market mobile music product and consumers are now buying mastertones, ringtones that feature the original music recording, and full track downloads to mobile. We believe mobile distribution will be the fastest growing component of the digital music market in the future. According to a recent market research report, worldwide sales of full track downloads to mobile phones alone, are expected to grow to \$15 billion by 2010.

Emergence of the Digital Video Market

We believe the global television and film video industry, like the music industry in 2003, is now experiencing the early stages of a transition from sales and rentals in physical formats such as digital video discs (DVDs), and consumption through subscription cable services and ad-supported broadcast television, to digital consumption through Internet and mobile-based downloading and on-demand subscription services. Apple iTunes introduced television episode downloads in late 2005 and began offering feature-length film downloads in 2006. Through January 2007, Apple iTunes had sold approximately 50 million television episodes and 1.3 million feature length film downloads and currently has a large selection of music videos as well as approximately 550 television shows and 500 motion pictures available for purchase via downloading by consumers. In addition to Apple, a number of other significant digital video retailers, including Google Video, Netflix, Walmart.com, Joost and Amazon.com, have launched video download services, with no one service currently dominating the field. Other digital entertainment services such as YouTube and AOL/In2TV have launched ad-supported video Internet sites, and mobile services such as vCast (Verizon), mSpot (Sprint), Helio, and Amp'd Mobile have launched subscription-based video subscription services, video downloading and video ringtone services for mobile devices. We believe the digital delivery of video to digital video players and video-enabled mobile phones is the first step in this developing market. The recent introduction of Apple's iTV digital entertainment center and similar devices, as well as broadband-enabled plasma televisions, is expected to expand the digital video experience beyond portable devices and video-enabled mobile phones to the home theater experience. While the emergence of the digital video marketplace is in its early stages, we believe that digital distribution of video content will provide revenue opportunities to video content owners and distributors in the form of permanent ownership downloads, subscription services providing access to large catalogs of video content, and advertising-supported free viewing.

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Consumer Demand and Access to Digital Entertainment

Consumers now purchase music and video content in two principal formats: (i) physical formats such as compact disc or digital video disc from traditional retailers, and (ii) in digital formats through pay-per-download or subscription services from digital entertainment services. Purchase of music and video content in digital format offers many advantages to consumers over compact disc or digital video disc. Digital entertainment services offer a larger selection than traditional retailers and also:

offer the ability to sample all of their selections before purchase;

are accessible 24-hours every day;

enable the purchase of music and video content in an easily portable format that is not subject to degradation from use and handling; and

offer the ability to purchase music recordings or video episodes as a single item instead of an entire album or an entire season.

When a consumer purchases digital music, they download a music recording from a digital entertainment service and are then able to listen to the music recording on their computer, transfer the music recording to a portable digital music player or transfer a copy of the music recording to compact disc for listening on compact disc players. Currently, a digital music download in the United States from Apple iTunes, our largest digital music retailer, costs \$.99 to \$1.29 and costs from \$.88 to \$.99 at other major digital music retailers. eMusic, an affiliate of Orchard and the industry's second largest digital music retailer, offers permanent downloads of music on a subscription basis starting at \$9.99 per month for up to 30 music recordings. Digital music retailers, such as Napster, Yahoo! Music and RealNetworks, also offer their music recordings on a subscription basis that allows consumers access to all of that service's recordings for prices that typically range from \$4.99 to \$9.99 per month. Following the termination of their subscription, consumers are not able to play these music recordings.

When a consumer purchases digital video content, they download a video from a digital video retailer and are then able to watch the video on their computer and in some cases are able to transfer the video to a portable digital video player. Currently, a television show episode from Apple iTunes and other major digital video retailers generally costs \$1.99 and a full-length movie generally costs from \$7.99 to \$14.99. However, the digital video industry is in its infancy and the pricing models and quality standards of the digital video retailers are still evolving and subject to rapid change and transition. Other online retailers, such as Joost and AOL/In2TV, are offering streaming online video which is free to watch but is an ad-based model similar to network TV.

Consumers can also purchase digital entertainment through mobile phones. Music can be downloaded as a full-length music recording, ringtone, or ringback tone directly to mobile phones from the consumer's service provider or other mobile services. Typical purchase prices per music recording or ringtone range from \$1.99 to \$2.99. Consumers can also acquire video through their mobile phone by downloading individual video ringtones, individual music video recordings, or short-form media snacks. In addition, certain mobile service providers offer a monthly subscription service that provides on-demand access to a catalog of video content to be viewed from a subscriber's mobile device.

Certain digital entertainment services, such as YouTube, BitTorrent, AOL/In2TV and others, offer video content to consumers for free. Revenue is generated by advertising displayed before, during, or after the content is played. In most cases, a consumer does not have to watch an entire episode or clip for the content owner to get credit for the advertising impression. Combination models are also emerging whereby consumers can watch video content for free on an ad-supported basis, and have the option to download to own (either specific episodes/clips or an entire season), purchase video ringtones for mobile phones (such as the opening theme to a television show), or purchase mobile phone wallpapers (single frame pictures from favorite shows or stars) all in one user experience.

A significant number of music recordings are not currently available for purchase in digital format. Gracenote, the leading industry music database, lists approximately 55 million music recordings in its database.

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However, as of July 2007, only approximately five million music recordings were available at Apple iTunes. We believe that many of the music recordings not currently available are held by a disparate, fragmented group of content owners. Our experience is that these owners possess digital rights to libraries ranging from 100 recordings to tens of thousands of recordings. Additionally, a significant number of video properties, including television shows and full-length feature films, are not yet available in the digital marketplace. Gracenote lists approximately 17,000 DVD titles in its database, but as of January 2007, for example, only 200 television series and 400 feature-length films were available on Apple iTunes.

Accessing the Digital Entertainment Marketplace by Content Owners

The digital marketplace represents a new opportunity for content owners, including record labels, artists, television and film production companies, independent film makers, and other music and video content owners, but it also presents significant challenges.

To access this market, the content owner may be required to enter into separate agreements with each digital entertainment service they wish to distribute their content through. The leading digital entertainment services have taken steps to limit the number of content owners with which they have direct relationships by, in certain cases, increasing the minimum number of music recordings or television episodes or other video content required to establish a relationship. This is particularly true of digital video services. Our experience is that this threshold at the leading digital music retailers is approximately 1,000 music recordings. Based on our experience to-date, the threshold for video content is more subjective and is typically based on the popularity and market demand for the content.

If a content owner is able to enter into an agreement with a digital entertainment service, they must then compile their content with descriptive information. For music, this descriptive information includes: music recording title, album title, artist name, year of original release, copyright information, publisher information and other related information. For video content, this information typically includes: video title, video description, year of original release, length, genre and other information. Content owners must then deliver their content in accordance with the unique digital formats specified by each digital entertainment service. In the case of music, recordings must be grouped into albums and combined with artwork in a digital file before being transferred to the digital music services. For video, each product must be digitally encoded for the specific type of video service and combined with digital artwork before delivery. In addition, much of the original music and video content may exist on older, physical formats that must first be converted to acceptable digital formats before processing.

Once content is available for purchase in digital format, each digital entertainment service delivers sales reports in different unique formats that provide revenue and consumption data. Each of these unique reports must then be integrated into the content owner's accounting system in order for the content owner to make payments to third-parties such as recording artists, publishers and producers. Depending on the available resources of the content owner, these processing and royalty integration steps may be technologically challenging, inconvenient and time consuming. As a result, we believe many content owners have not yet undertaken the digitization and processing efforts necessary to offer their content through digital entertainment services.

Competitive Strengths

We increase the selection of music and video content available to consumers by making it available in digital formats, we provide a means for content owners to access the digital entertainment marketplace with minimal effort on their behalf, and we are a trusted content provider to digital entertainment services. We address the needs of each of these market participants in the following manner:

Consumers. We increase the breadth of music and video content available to consumers by offering it in digital format. We make available vintage content, music and video content that is out-of-print or no longer available or never previously available through traditional bricks-and-mortar retailers, as well as more contemporary music and videos from current artists.

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Content Owners. We offer a convenient means by which record labels, artists, television and film producers, and other music and video content owners can access the digital entertainment marketplace. We process the content owners' physical media containing their music or video content into the unique digital formats required by the multitude of digital entertainment services. When the content begins to generate revenue, we receive the periodic sales reports from the various digital entertainment services and create one summary report for the content owner and pay the required royalties and revenue sharing payments as required by our agreements. All of these processes are performed by us using our proprietary processes and systems, unlike many of our competitors who frequently outsource these critical steps.

Digital Entertainment Services. We act as a volume supplier that aggregates music and video content from numerous content owners for digital entertainment services. We remove the need for digital entertainment services to enter into and maintain relationships with the many independent labels, artists, television and film producers, and other content owners. We also provide a means for the digital entertainment services to rapidly, and inexpensively, increase the amount and diversity of the music and video content they make available to consumers.

In addition to addressing the needs of the digital entertainment marketplace through content aggregation and distribution, we also maintain long-term control over music and video content. Unlike many of our competitors that are primarily focused on the short-term distribution of independently-owned content, we also seek to secure long-term control over content through ownership of master recordings or digital rights or through long-term license arrangements.

Growth Strategy

We seek to own or control through long-term license or short-term distribution agreements the digital rights to as much music and video content as possible, on terms that we deem commercially reasonable, subject to our financial resources. Once acquired, we seek to make our content available to consumers by placing it on leading and selected specialty digital entertainment services.

We attempt to meet these objectives by pursuing the following strategies:

Expand our library of digital music and video content. We actively seek to identify the owners of music and video content and attempt to acquire the exclusive digital rights. Our preference is to gain long-term control of the content through acquisition by purchase or long-term license of the digital rights, but we also enter into short-term distribution agreements for content as a means for generating revenue growth with no initial cash investment in the form of purchase price or royalty advance. We use our network of contacts and consultants with contacts in the music, television and film industries to identify and locate content owners.

Increase sales channels. We generate revenue from our content by entering into agreements with digital entertainment services that make our music and video content available to consumers. We currently have contractual relationships with most leading digital entertainment services. Such services offer our music and video content as digital downloads on a pay-per-download basis and via digital subscription services. Beginning in 2007, we are making some of our video content available through advertising revenue supported Internet sites. We intend to continue to pursue other digital outlets for our music and video content as they become commercially viable.

With the acquisition of Digital Rights Agency LLC (*DRA*) in September 2006, we gained relationships with numerous mobile services. Over 15% of DRA's stand-alone revenue was derived from mobile services during the year ended December 31, 2006, while DMGI had no mobile services revenue prior to the acquisition of DRA. On a consolidated basis, approximately 12% of our revenue for the first half of 2007 was derived from mobile services. We expect mobile distribution to become a more significant portion of our total revenue in the future as we seek to rapidly deliver our music and video content to our mobile service partners.

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Repackaging our music and video content. We create theme-based compilations and other combinations of our music content and make it available at our digital music retailers to increase the number of digital downloads of certain of our music recordings. We have also begun creating unique ringtones and video ringtones for distribution through mobile services. Our experience has been that such efforts have provided a competitive advantage when negotiating distribution agreements with content owners and have increased the placement of our content on certain of the digital entertainment services.

Content Acquisition

We acquire digital rights to music and video content as follows:

Purchase of digital rights. In exchange for the purchase of digital rights, we generally pay a fixed sum of money as the purchase consideration. We could also potentially use a combination of our common stock or debt in addition to cash as the purchase consideration, although we have not done this in any of our digital rights acquisitions to-date. The purchase consideration for digital rights purchases is larger than would be bargained for when we acquire such rights through a long-term license. However, we retain all revenue received with respect to purchased digital rights, after payment of any required artist and publishing royalties. The acquisition costs are amortized on a straight-line basis over seven years.

Purchase of master recordings. When we acquire master music recordings, we pay a fixed cash sum and receive all rights to such recordings, including digital formats, physical formats and licensing for compact disc compilations, motion pictures, television programs and advertisements. Such transactions are typically more costly and time-consuming than the other methods by which we acquire digital rights to music recordings. However, we retain all revenue received with respect to master recordings, after payment of any required artist and statutory publishing royalties, and have additional sources of revenue from physical distribution and synch licensing. We may use our common stock and/or debt in addition to cash for the consideration for any such future acquisitions. The acquisition costs are amortized on a straight-line basis over ten years.

Long-term license. We obtain long-term licenses to digital rights for music and video content. Our licenses currently have terms of five to ten years, typically with renewal options. After the term of the license, all rights revert to the licensor. In exchange for long-term licenses, we generally pay a fixed sum of money in the form of an advance against future sales royalties or fees to be paid to the content owner. After recoupment of our initial fixed payment, we generally continue to pay revenue sharing fees to the content owner in accordance with the terms of our agreements. Legal fees and other direct costs incurred in obtaining these long-term licenses are amortized on a straight-line basis over the shorter of the term of the related agreement or seven years.

Short-term distribution rights. We obtain short-term digital rights through distribution agreements with content owners. After the term of the agreement, which is typically two to three years, we generally do not retain any continuing rights unless the agreement is renewed. Distribution agreements generally do not require us to make upfront or fixed payments. Instead, upon receipt of revenue from digital entertainment services, we pay a fixed revenue sharing percentage to the content owner. We retain a smaller portion of the revenue received from digital entertainment services under such short-term distribution agreements than under long-term license agreements or with respect to digital rights or master recordings we have purchased.

For the year ended December 31, 2006, we generated approximately 10% of our revenue from music content for which we owned the digital rights or master recordings, approximately 42% from music content to which we have long-term licenses, and approximately 48% from music content for which we have short-term distribution rights. Our revenue under short-term distribution agreements has become a larger part of our total revenue as a result of our acquisition of DRA in September 2006 and comprised approximately 70% of our total revenue from music content during the six months ended June 30, 2007.

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Our Content

Our total music recordings under management was approximately 353,000 as of June 30, 2007, of which approximately 261,600, or 74%, were available for sale on that date through digital entertainment services. The remaining music recordings under contract had either (i) been processed and transmitted to one or more digital entertainment services where they were awaiting review and processing, (ii) were in various stages of our digitization process or (iii) had not yet been delivered to us by the content owners. In addition, as of June 30, 2007, we had more than 4,000 hours of video content under long-term distribution agreements and were in the early stages of processing and delivering our video content to various digital entertainment services.

The digital rights that we acquire are contractual and based upon the rights granted to us by the content owner who may not be the original rights owner. Our agreements with the content owners require that they assure us that they have proper title and ownership to the digital rights acquired by us. We perform what we believe to be a reasonable amount of diligence on the ownership of music and video recordings by the record labels, artists and video catalog owners from whom we acquire digital rights. We also rely on representations, warranties and indemnities provided to us by the owners as to legal ownership. Given the contractual nature of our rights and our acquisition of older music recordings, from time-to-time we receive a claim from a third party challenging our rights. In such cases, we typically cease selling the recording until the dispute is investigated and resolved. Depending on the outcome of the rights dispute, we will resume selling the recording and/or seek remedy from the content owner under the representations, warranties and indemnities provided in our agreements.

Our music content is from various genres and time periods and includes back catalog, out-of-print recordings, past hits, world music, classical music performances, previously unreleased music recordings, live performances, and other music that may no longer be readily available from traditional music retailers, as well as current recordings by contemporary independent labels and artists. Other content we may acquire includes music and audio or audio/video from live performances not previously commercially available, radio and television performances, and other sources as they are identified by us. Our preference is to obtain the broadest territorial distribution rights as possible when we acquire or license digital rights or enter into short-term distribution agreements. From time to time, we enter into digital rights agreements with less than world-wide distribution rights and factor this into the purchase price or royalty advance we pay. We make our music content available at leading digital music retailers and mobile services that collectively offer digital music for sale in more than 24 countries. Our music content was offered in some, but not all, of these countries, depending in part on the territorial distribution rights obtained in our agreements with content owners. For the six months ended June 30, 2007 and the year ended December 31, 2006, 83% and 79%, respectively, of our revenue was generated in the United States, with the remaining 17% and 21%, respectively, coming from digital music retailers serving customers outside the United States.

Our video content includes music videos and live music performances, classic episodic television shows, vintage feature-length films, short films, cartoons and other animated features, stand-up comedy performances, action shorts, reality programming, sports events and programs focused on children or special-interest groups. Genres include children's programming, comedy, classic television shows, sports, action shorts, reality programming, and other vertical interest categories. We are currently making our video content available at Apple iTunes, Google Video, YouTube, AOL/In2TV, Joost, mSpot, Veoh, BitTorrent, Movielink and other mobile and digital entertainment services as we add new video distribution partners.

We are responsible under our agreements with content owners for certain payments based on the periodic sales reports received from digital entertainment services. Based on the specific agreement with the content owner, these can consist of royalties to artists and/or publishers (which includes songwriters) and revenue sharing payments to the content owner. When we acquire digital rights to music recordings, we have no influence over the terms as stipulated in the original recording contract between the content owner and artists or publishers. Our experience in acquiring digital rights on a perpetual basis is that the content owner will typically require us to assume and pay these royalty obligations to artists and publishers. The artist royalty obligations in these situations have historically been between 0% and 15% of the revenue attributable to a specific track or album.

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The publisher royalties are generally paid at a statutory rate in the United States, which was \$.085 per music recording sold during 2005, and increased to \$.091 as of January 2006. Our experience in acquiring digital rights under a long-term license agreement is that the content owner often requires us to assume and pay the royalties to publishers, whereas the content owner typically retains the artist royalty obligation. For music videos, the publishing license, called a synch license, is negotiated with the publishers and has averaged approximately 10% of the revenue received.

Our distribution agreements for music and video content contain revenue sharing provisions between the content owner and us. In the long-term music license agreements we have entered into through June 30, 2007, the content owners receive 25 to 57% of the gross or net revenue, as defined, over the term of the agreement. In long-term license arrangements for video content, the content owner typically receives 50% of the revenue earned over the term of the agreement. As an inducement to enter into the long-term distribution agreement, we will make a royalty advance to the content owner against the content owner's share of future royalties under this revenue sharing arrangement. Such advances are recouped from the content owner's share of future revenue. In short-term music distribution agreements, we are not responsible for any artists or publishers royalties and we make no upfront or fixed payments to the content owner at the time we enter into the agreement. Therefore, the revenue sharing percentage retained by the content owner (generally 80% to 85%) is substantially higher than under long-term license agreements.

Content Processing and Operations

Upon entering into a digital rights acquisition or digital distribution agreement with the content owner, the following principal steps are involved to make our music and video content available to consumers for purchase:

We must receive the music and video content. The content owner is required to deliver their music or video content to us, along with descriptive data with respect to each unique product. For example, in the case of music, content owners must deliver information such as the music recording title, album title, artist name, copyright information, publisher information, territorial rights and other related information. In the case of video, this information includes the video title, video description, year of original release, copyright information, and other related information. Our perpetual and long-term license rights agreements generally provide for delivery of content in physical formats such as compact discs, DVDs or Beta SP tapes in specific batches over time. We work closely with content owners to assist them in delivering their music and video content and all the necessary descriptive data to us as quickly and efficiently as possible.

The music and video content must be processed by us and delivered to the digital entertainment services. Following receipt of the music and video content in physical format, we convert it into the specific digital formats required by the various digital entertainment services, which can vary widely. We then compile the required descriptive information as specifically required by each digital entertainment service. For music, Apple iTunes and most other digital music retailers require that music recordings be batched together into an album format with artwork for each album. If the music recordings are already grouped into previously-issued albums when we receive them, we retain this album concept and utilize album cover artwork provided by the content owner. However, if the individual music recordings are not grouped into an album, such as previously unreleased studio music recordings or a live concert recording, we bundle the various music recordings into albums and develop artwork for the newly created album.

Our digital video service partners typically require that we deliver our video content as individual television episodes, full-length feature films, short features, and separate components of live performances of comedians, music concerts, sporting events and other video content, as well as packaged in compilations such as a full season of a television series. In addition, certain digital entertainment services require that we re-master the video content and upgrade the resolution and audio/video quality in order to meet their specifications. Consequently, the processing of our video content is substantially more complex, time consuming and costly than processing our music content. Video data

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files also are significantly larger than audio files and require more substantial investments in computer storage equipment.

Once the music or video product processing is complete, we deliver the content in digital format, together with its associated descriptive information and album or video artwork, to one or more individual digital entertainment services to be made available to consumers in the specific territories where we have obtained the digital rights. Each digital entertainment service has its own unique delivery specifications. For example, Apple iTunes requires a digital encoding file format that is completely different than any other digital retailer. In addition, standards for the presentation of informational metadata and the size and resolution of artwork can vary widely from one service to another. Formats and specifications for digital video content are still evolving with no uniform standards. These different formats and specifications require us to repackage and rebundle the basic music or video recordings and associated metadata and artwork each time a delivery is made to a different digital entertainment service. As a result, the total amount of content that we have delivered can vary significantly among the digital entertainment services. We deliver our music and video content to digital entertainment services in priority of their significance to us, or based on specific requests for content by the digital entertainment services, our assessment of market demand, operating efficiencies and other factors. For example, we generally prioritize the delivery of our music content to Apple iTunes, as it is the largest digital music retailer in the world and constitutes the largest percentage of our revenue.

Digital music and video files must be further processed to meet the specifications of mobile service providers in order to make our content available as downloads to mobile devices. We also create ringtones and video ringtones by editing and compiling our content into short clips. In the mobile market, only a limited subset of our overall music and video content is chosen by our mobile service partners to be offered as music and video ringtones due to the limited number of recordings marketable for this purpose, limited space on mobile handset screens and higher per track processing costs related to the many formats that are required for various mobile handset makes and models.

The digital entertainment services make our content available to consumers. Upon receipt, the digital entertainment services review our content deliveries, descriptive information and associated artwork to ensure that they are in the proper format for their particular service. Once approved, the music or video content is then made available to consumers. Our agreements with the digital entertainment services do not provide for a fixed processing time and our experience has been that the review and posting process can vary significantly among services and can take from several weeks to several months.

Digital Entertainment Services

We distribute music and video content, including music recordings and music, television, film and other video content, to digital entertainment services that sell our content to consumers over the Internet and wireless, cable and mobile networks to personal computers, digital music and video players, and music and video-enabled mobile phones. Our digital entertainment service partners make our content available to consumers through a variety of business models including for purchase as a permanent download for a fixed fee or on a subscription basis, by providing access to vast amounts of content for a monthly subscription fee, and by providing free access to advertising-supported video content.

Our digital music service partners include digital music retailers, such as Apple iTunes, Napster, RealNetworks, eMusic and MusicNet, among others, and mobile services such as Verizon and Sprint, and mobile content aggregators such as Moderati, 9 Squared, Zingy, Pocket Group, Ltd., Groove Mobile and InfoSpace. For music that is permanently downloaded from digital music retailers, we typically receive an agreed upon wholesale price for each download. For the six months ended June 30, 2007 and the year ended December 31, 2006, approximately 63% and 77%, respectively, of our total revenue was generated through Apple iTunes, the largest digital music retailer. Our agreements with Apple iTunes have terms of three years ending in December 2008 (for our DRA subsidiary) and April 2010 (for the remainder of our company). Under these agreements, Apple iTunes pays us \$.70 for each individual music recording downloaded and \$7.00 for each album download.

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eMusic, currently the second largest digital music retailer, offers permanent downloads on a subscription basis beginning at \$9.99 per month for up to 30 music recordings. We receive a percentage of eMusic's revenue based on our music content's proportionate share of all eMusic's downloads for the relevant period, which averaged \$.25 per download during 2006. For other subscription-based digital music retailers, such as Napster and RealNetworks, in addition to receiving an agreed upon wholesale price for each a la carte permanent download sold by them, we also receive a percentage of the subscription revenue realized by them based on the number of times our music recordings are listened to or downloaded by subscribers as compared to the total for all music recordings listened to during the relevant time period.

We also distribute our music content through mobile services in the form of full-length downloads of music recordings and ringtones. We negotiate the wholesale rates we receive in advance with each mobile service. Because our mobile service partners include both direct-to-consumer entities such as Verizon and Sprint, as well as mobile content aggregators such as Moderati, 9 Squared, Zingy and others, our wholesale rates can vary widely. During the first half of 2007, we received an average of \$.76 per full-length download and \$.82 per ringtone from our mobile service partners.

We have just begun during 2007 to process and distribute certain of our video content to various digital video retailers such as Apple iTunes and Movielink, and to certain of our mobile service partners. For video content sold through digital retailers, we expect to receive approximately \$1.40 for each music video or television episode downloaded and a stated percentage of the consumer price for other video content. As we begin to distribute video content through our mobile services, we expect the wholesale prices we receive for full-length video content and video ringtones will be greater than the wholesale prices we receive for our music content from such mobile services. We also are in the process of making certain of our video content available at YouTube, BitTorrent, AOL/In2TV, and others. These digital entertainment services offer video content to consumers for free. Revenue is generated by advertising displayed before, during, or after the content is played. In most cases, a consumer does not have to watch an entire episode or clip for the content owner to get credit for the advertising impression. When our content is made available through these advertising-supported Internet sites, we will receive a negotiated percentage, typically 50% of the revenue received by our partners for advertising sold against our video content. The digital distribution of video is evolving rapidly and we expect that video pricing models will continue to be refined based on the nature of the content, length of the video segment, types of digital devices and other factors.

To date, Apple iTunes and other digital music services which sell our music recordings have generally been willing to accept all the music content that we and other distributors deliver to them. Based on our experience thus far with video content, most of our digital entertainment service partners have initially limited the amount and type of video content that they will accept from us based on their capacity constraints and/or content selection criteria. We believe that we will ultimately be able to exploit substantially all of the video content we have under contract as the digital video industry matures and expands to meet the increased consumer demand that we believe will occur in the future.

Pursuant to the terms of our agreements with digital entertainment services, we receive periodic sales and activity reports, generally on a monthly basis within 30 days following the end of the month. Certain services, particularly in the mobile industry, report to us on a quarterly basis, generally within 45 days of the end of each calendar quarter. We receive payment at approximately the same time as we receive these reports.

Distribution and Marketing

We distribute our music and video content to leading digital entertainment services, and we believe we have good business relationships with the digital entertainment services to which we provide content. Historically, certain of our music and video properties have received premium placement on digital entertainment services, and we will continue to work closely with our distribution partners to achieve optimum placement.

The flexibility of the digital format allows us to market our music content in creative ways by mixing-and-matching our individual recordings to create new digital music albums. With this flexibility, we are

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able to offer our music content in new compilation albums to attract consumers of a particular lifestyle or age group or related to an event type, holiday or live music concert, for example. For our video content, we are able to repurpose our content to create new video compilations for specific audiences, such as creating a best-of series of action sports, comedy, or television shows and to create video ringtones and other content specifically for mobile distribution.

We work closely with certain content owners to market their music and video content directly to consumers, who will be encouraged to purchase this content at digital entertainment services. We also intend to consider new ways to market our music and video content directly to consumers. For example, we are test marketing ways to enable consumers to use their mobile devices to text message digital entertainment services that help us deliver content directly to consumers on those devices. In addition, we will continue to market our services to content owners through strategic advertising and media releases, attendance at trade shows and event sponsorships.

Competition

We compete with numerous companies to acquire digital rights to music and video content and with traditional music and video retailers for consumer purchases of our content.

We compete with Orchard, Independent Online Distribution Alliance, IRIS, the independent label distribution subsidiaries of the four major record label groups, Sony/BMG, Universal Music Group, EMI Recorded Music and Warner Music Group, as well as other companies, to acquire digital rights to distribute music recordings. We may also compete with these entities when our existing long-term license and short-term distribution agreements expire and are subject to renewal. We understand that these companies generally seek to enter into short-term distribution agreements with content owners and typically do not offer content owners upfront cash payments and the perpetual or long-term license terms we offer as an alternative to short-term distribution agreements. We compete for distribution rights on the basis of payment terms, processing services, marketing ability and reporting services. We are unable to anticipate which other companies are, or are likely to be, seeking to acquire digital rights to the same music recordings we may wish to acquire.

We have observed a recent increase in the competitive environment for the acquisition of digital rights to music recordings owned by active independent record labels. In particular, subsidiaries of the four major record label groups which have always aggressively competed to provide physical distribution for independent labels, have become increasingly active in the digital market segment. Recently, we were notified by three independent record labels digitally distributing their music through our DRA subsidiary that they intend to shift distribution of their catalogs from us to a subsidiary of a major record label. While we do not expect the decrease in revenue and gross profit from these three labels to be material, we may experience a higher rate of non-renewal than we have in the past for our short-term digital distribution agreements and our ability to enter into new distribution agreements with independent record labels may be adversely impacted if major record label groups and other independent physical distributors use their ability to offer reduced physical distribution fees and other bundled benefits to gain the digital distribution rights from independent labels and content owners. In addition, the larger and more prestigious independent record labels, which have traditionally accessed the digital music market through distribution companies like us, could seek direct distribution with digital music retailers when their agreements with us expire.

The licensing of digital rights to television and film video content is a relatively new business. We are not aware of any major competitors for the long-term licensing of digital distribution rights in independently owned television and film properties, but we expect that significant competitors will emerge as the industry evolves and that there may be competitors at the present time of which we are unaware. Many large television and film companies have begun digitally encoding and digitally distributing their own content and we expect this trend to continue.

There are over five million music recordings currently available at Apple iTunes. We compete at Apple iTunes and other digital music services for consumers' attention and their download and subscription expenditures with the four major labels, which together represent, as of the end of 2006, approximately 72% of

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the U.S. recorded music market, as well as independent labels that place their music recordings in digital music services either directly or through third-party aggregators like Orchard. The music recordings for which we hold long-term digital rights are generally not current mainstream and popular hits, like those held by the major labels and active independent labels. Many of these companies have significantly better brand recognition, longer operating histories and significantly greater financial, marketing and other resources than us, and may be able to enter into strategic or commercial relationships with the digital music retailers and mobile services that are competitively beneficial to them. Likewise, we acquire digital rights to video content from independent owners and will be competing against television and film content made available from large television and film studios. These companies may have content with better brand recognition and greater ability to enter into favorable strategic and commercial relationships with digital entertainment services.

The market for digital music and video content is currently a small percentage of total revenue from the sale of such content. The compact disc and digital video disc remain the predominant media for music and video distribution, although we believe both the recorded music and video industries are transitioning from physical formats to digital formats. We believe that the market share attributable to digital distribution will continue to increase and digital formats will ultimately become the preferred way consumers experience music and video.

New technological requirements are evolving for the digital distribution of video content and existing technologies for digital music distribution continue to be refined and expanded. Other companies may have better, more efficient and cost effective processing capabilities that may also increase competitive pressures on us in the future.

Intellectual Property

We rely on a combination of trade secret, copyright and trademark laws in the United States and other jurisdictions, as well as confidentiality provisions and contractual restrictions, to protect our proprietary rights, including our know-how.

We have filed trademark applications for the names Digital Music Group, Digital Media Group and Digital Musicworks International as well as for the trademarks DMG, DMGI, Digital OnRamp and our logo design.

Employees

As of July 27, 2007, we had 34 full-time employees. Among these employees, three were senior management, five were in business development and marketing, eleven were in accounting and administration, and fifteen were in engineering and operations. None of these employees are covered by a collective bargaining agreement and we have never experienced a work stoppage. We consider our relations with our employees to be good.

Properties

Our executive offices are located in Sacramento, California, where we lease approximately 9,000 square feet under an agreement that expires in 2009. Our DRA subsidiary leases approximately 3,000 square feet in San Francisco, California under an agreement that expires in 2010. We believe our existing facilities are generally adequate for our current operations.

Legal Proceedings

From time to time we become involved in commercial and contractual disputes, disagreements and legal proceedings arising in the ordinary course of business, which we typically seek to resolve through direct negotiations with the principals or representatives of the party involved. Management does not believe that the outcome of these disputes, disagreements or legal proceedings, individually, or in the aggregate, will have a materially adverse effect on our financial condition.

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Other Information

Our principal executive offices are located at 2151 River Plaza Drive, Suite 200, Sacramento, CA 95833 and our telephone number at that location is (916) 239-6010. Our website is located at www.dmgi.com. The contents of our website are not incorporated by reference in this proxy statement.

Our investor relations website is located at <http://investor.dmgi.com>. Copies of our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to these reports are available, free of charge, on our investor relations website under the link "SEC Filings" as soon as reasonably practicable after such material is electronically filed with the SEC. The Securities and Exchange Commission also maintains a website that contains our filings at www.sec.gov. See "WHERE YOU CAN FIND MORE INFORMATION" on page 118.

Table of Contents**Index to Financial Statements****Selected Financial Data**

The following table sets forth selected historical consolidated financial information of DMGI for the periods presented. The selected financial information as of December 31, 2005 and 2006, and for each of the years then ended, has been derived from DMGI's consolidated financial statements, which have been audited by Perry-Smith LLP, independent registered public accountants. The selected financial information as of June 30, 2007 and 2006 and for the six months then ended has been derived from DMGI's unaudited condensed consolidated financial statements which include, in the opinion of DMGI's management, all adjustments, consisting of normal recurring adjustments, necessary to present fairly the results of operations and financial position of DMGI for the periods and dates presented. The results of operations for an interim period are not necessarily indicative of results for the full year or any other interim period. This financial information and other data should be read in conjunction with and is qualified by reference to the audited financial statements of DMGI, including the notes thereto and our independent registered public accounting firm's report thereon, our unaudited interim financial statements, including the notes thereto, and Management's Discussion And Analysis Of Financial Condition And Results Of Operations included below in this proxy statement.

	For the Six Months Ended June 30,		For the Year Ended December 31,		Period from February 26 2004 (inception) to December 31, 2004 Amount
	2007 Amount	2006 Amount	2006 Amount	2005 Amount	
Statement of Operations Data:					
Revenue	\$ 6,543,811	\$ 1,560,187	\$ 5,564,949	\$ 679,975	\$ 37,268
Cost of revenue:					
Royalties and payments to content owners	4,593,191	735,325	3,329,698	232,294	10,703
Amortization of digital rights	394,451	134,848	422,489	22,518	3,041
Write-down of non-productive assets				295,356	
Gross profit	1,556,169	690,014	1,812,762	129,807	23,524
Operating, general and administrative expense	(3,482,509)	(2,294,862)	(5,655,161)	(1,550,424)	(666,831)
Merger-related expenses	(328,844)				
Interest, taxes and other net	409,349	601,540	1,219,965	(136,997)	(1,291)
Net loss	\$ (1,845,835)	\$ (1,003,308)	\$ (2,622,434)	\$ (1,557,614)	\$ (644,598)
Net loss per share - basic and diluted	\$ (0.20)	\$ (0.14)	\$ (0.32)	\$ (0.69)	\$ (0.29)
Weighted average shares outstanding - basic and diluted	9,030,880	7,266,804	8,071,393	2,249,941	2,249,941

	June 30, 2007	2006	December 31, 2005	2004
Balance Sheet Data:				
Cash and cash equivalents	\$ 13,968,883	\$ 20,505,674	\$ 468,490	\$ 735,837
Working capital	14,782,446	21,192,388	556,982	657,121
Total assets	37,684,097	38,325,740	3,017,619	1,206,280
Capital lease obligations	35,809	59,831	44,540	88,553
Stockholders' equity	33,985,495	35,403,988	2,417,256	1,033,658

Table of Contents**Index to Financial Statements****Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion of our financial condition and results of operations should be read in conjunction with our audited financial statements and related notes appearing elsewhere in this proxy statement. This discussion contains forward-looking statements, the accuracy of which involves risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us described in RISK FACTORS.

Overview***Background and Basis of Presentation***

Digital Music Group, Inc. was organized as a Delaware corporation in April 2005 to become a leading owner of digital rights to music and other sound recordings and distributor of these recordings to digital music retailers. On February 7, 2006, we completed our 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, we 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, which has been recorded as a non-cash offering cost. Accordingly, the total net proceeds from our IPO were approximately \$32,600,000.

Concurrently with the closing of our initial public offering on February 7, 2006, we completed the acquisition 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*). We issued an aggregate of 2,274,941 shares of common stock to the stockholders of DMI and to Rio Bravo in connection with the acquisitions. We did not have an operating history separate from the operations of DMI and the digital music distribution operations of Rio Bravo prior to the completion of those acquisitions. In addition, DMI has been identified in these transactions as the acquiror for accounting purposes. Accordingly, DMI's historical financial results are therefore considered to be the historical financial results of Digital Music Group, Inc. The results of Rio Bravo and Digital Music Group, Inc. are included in the consolidated financial statements for periods subsequent to February 7, 2006.

On September 8, 2006, we completed the acquisition of all the ownership interests in DRA, in exchange for \$3,200,000 in cash, 420,000 shares of our common stock, and a warrant to purchase 150,000 shares of common stock at \$5.57 per share. The warrant had an estimated fair value at the date of issuance of \$97,350 which was recorded as acquisition consideration. Under the acquisition agreement, we were obligated to pay up to \$1,155,000 in cash and issue up to 87,000 shares of common stock in additional consideration if certain financial targets were achieved through December 31, 2007. This earn-out obligation was settled in full with the former owners of DRA in June 2007, through the payment of approximately \$705,000 in cash and the issuance of 56,998 shares of common stock. The results of DRA are included in the consolidated financial statements for periods subsequent to September 8, 2006.

Industry Overview

We believe that the recorded music industry has been undergoing a significant change, with the primary means of music distribution transitioning from physical formats (compact discs) to digital formats accessed over the Internet and wireless, cable and mobile networks. We believe this is a direct result of the popularity and proliferation of personal computers, music-enabled mobile telephones and portable digital music players like the Apple iPod, and consumer acceptance and the music industry's endorsement of legitimate digital music sales. We believe this transition is continuing and the market share of digital music will continue to increase, particularly through mobile distribution, and digital formats will ultimately become the preferred way consumers purchase and listen to music.

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Much like the recorded music industry, we believe the television and film video markets have begun a migration from physical distribution (tape and DVDs) to digital distribution through Internet and mobile-based downloading and on-demand subscription services. Personal computers, Apple iPods, video-enabled mobile phones and other devices are now capable of receiving downloads of digital video content. New companies and services such as Google Video, YouTube, AOL/In2TV, Joost, mSpot, Veoh, BitTorrent, Movielink and others, have been launched to focus on digital video distribution, and many of our digital entertainment service partners for music recordings, such as Apple iTunes, have added video distribution capabilities to meet the growing demand for video content. While the emergence of the digital video marketplace is in its early stages, we believe that digital distribution of video content will provide revenue opportunities to video content owners and distributors in the form of permanent ownership downloads, subscription services providing access to large catalogs of video content, and advertising-supported free viewing.

Key Business Metrics

We provide music and video content to digital entertainment services. At June 30, 2007, we had approximately 353,000 individual music recordings under management and over 4,000 hours of music, television and film videos. We purchase or license music and video content from record labels, artists, television and film production companies, and other content owners. We process the content through our digital processing systems for delivery to leading and selected digital entertainment services through which our content becomes available for purchase via downloading or subscription. As of June 30, 2007, we had approximately 261,600 music recordings available through digital entertainment services. The remaining music recordings under contract had either (i) been processed and transmitted to one or more digital entertainment services where they were awaiting review and processing by the services before being posted for sale, (ii) were in various stages of our digitization process, or (iii) had not yet been delivered to us by the content owners. In addition, as of June 30, 2007, we had approximately 4,000 hours of video content under long-term distribution agreements. As of that date, we had processed and delivered over 3,500 episodes from our video catalog to 18 digital entertainment services. We are also a party to short-term distribution agreements for additional recordings that we do not consider to be under management until we receive delivery. Also as of that date, we had just begun processing and delivering our video content to digital entertainment services.

Since our inception through June 30, 2007, our revenue has been derived from the sale or distribution of digital music content. Apple iTunes, the most popular digital music retailer, accounted for approximately 63%, 77% and 87% of our revenue during the six months ended June 30, 2007 and the years ended December 31, 2006 and 2005, respectively. Our digital music revenue is derived from the following sources:

Permanent downloads. In aggregate terms, our permanent download revenue is driven by the number of music recordings we have available for downloading at digital music retailers, multiplied by the average number of times our music recordings are downloaded, multiplied by the fee paid to us by each retailer. The download rates for our music recordings are driven primarily by the overall size and growth of the digital music market, the popularity and demand for the recordings, the number and nature of the digital entertainment services through which we make the recordings available to consumers, and the territorial distribution rights we have. The amount we receive per download is negotiated in advance at the time we enter into an agreement with a digital music retailer. Under our agreements with Apple iTunes, we currently receive \$0.70 per download for distribution in the United States and up to approximately \$0.85 (at current translation rates) per download for distribution outside the United States. For permanent downloads sold through subscription-based services, we receive a percentage of each retailer's total revenue based on the number of times our music recordings are downloaded as a percentage of each retailer's total downloads. The overall average download rate paid to us by all digital music retailers was approximately \$.72, \$.74 and \$.68 for the six months ended June 30, 2007 and for the years ended December 31, 2006 and 2005, respectively. Revenue from permanent downloads comprised approximately 71%, 85% and 97% of our total revenue for the same periods, respectively.

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Subscription fees. Certain digital music retailers distribute our music recordings on a subscription basis. Our subscription revenue is a percentage of each retailer's total subscription revenue based on the number of times our music recordings are listened to by subscribers as compared to the total for all music recordings listened to during the relevant time period. Following the termination of their subscription, consumers are not able to play our music recordings. Subscription-based revenue comprised approximately 15%, 8% and 2% of our total revenue for the six months ended June 30, 2007 and for the years ended December 31, 2006 and 2005, respectively.

Mobile services. With the acquisition of DRA in September 2006, we gained relationships with numerous mobile distribution services. Over 15% of DRA's stand-alone revenue was derived from mobile services for the year ended December 31, 2006. On a consolidated basis, approximately 6% of our revenue for 2006 was derived from mobile services. During the six months ended June 30, 2007, approximately 12% of our revenue was derived from mobile services and we expect the sale of our music recordings through mobile services to become a more significant portion of our revenue in the future. Our revenue from mobile services is derived primarily from downloads of full-length music recordings and ringtones. During the six months ended June 30, 2007, we received an average of \$.76 per full-length download and \$.82 per ringtone from our mobile service partners. Most mobile ringtone services generally make available to consumers a limited selection of ringtones due to the limited space on mobile handset screens and higher per track processing costs related to the many formats that are required for various mobile handset makes and models.

Other. Our other revenue is comprised mainly from the third party licensing of physical distribution rights to our master recordings. We believe, as the digital entertainment marketplace continues to mature and as we begin to realize revenue from our video content, the composition of our revenue will shift from being predominantly driven by permanent downloads of music content from digital music retailers to a more diversified revenue mix consisting of music and video downloads, subscription fees, mobile-sourced revenue and advertising revenue. Due to the disparate nature of these distribution models and the revenue and gross profit results they produce, we believe that appropriate key metrics to measure our results will continue to evolve.

Cost of revenue consists of:

royalties to artists and publishers;

revenue sharing payments based on long-term or short-term distribution agreements with content owners of both music and video recordings;

amortization of costs to acquire master recordings or digital rights to music and video recordings; and

reserves or write-downs of capitalized digital rights, master recordings or royalty advances that may be deemed necessary from time-to-time.

Our cost of revenue and corresponding gross profit is determined by the revenue earned on our music and video recordings and the manner in which we own or distribute the recordings. When we purchase or license the digital rights to recorded music or music videos, we have no influence over the terms as stipulated in the original recording contract between the content owner and artists or publishers. Our experience is that these artist royalty obligations for music recordings have historically been between 0% and 15% of the revenue attributable to a specific track or album. The publisher royalties for music recordings are a statutory rate in the United States of America, which was \$.085 per music recording sold during 2005, which increased to \$.091 in January 2006. The royalties for music video recordings, or synchronization rights, are negotiated by contract with the artist or publisher and typically range between \$.10 and \$.15 per video download. When we acquire the master recordings or digital rights to music or music video recordings, we usually pay certain or all of these artist, publisher and synchronization royalties. We capitalize the acquisition costs, including the purchase price and direct ancillary costs, of our perpetual and long-term digital rights and our master recordings. We amortize these amounts over

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the shorter of seven years or the length of the contract for digital rights and ten years for master recordings, which we believe reasonably relates the amount of amortization to the revenue expected to be generated. When we have acquired our digital rights through long-term license agreements with music and video content owners, our cost of revenue typically includes a revenue sharing arrangement whereby the content owner receives 25% to 57% of the gross or net revenue, as defined, over the term of the agreement. As an inducement to enter into the long-term license agreement, we will make a royalty advance against the content owner's share of future royalties under this revenue sharing arrangement. All such advance royalties are capitalized as a prepaid asset that is amortized as cost of revenue as the related revenue is earned and the cash advances are recouped. In short-term distribution agreements, which typically have terms of two to three years, we are not responsible for any artists, publisher or synchronization royalties and we generally make no upfront or fixed payments to the content owner at the time we enter into the agreement. The revenue sharing percentage retained by the content owner (generally 80% to 85% for music recordings and 70% for video recordings) is substantially higher than under long-term license agreements. Accordingly, higher gross profit margins are achieved from revenue generated from owned content and under perpetual and long-term license agreements and lower gross profit margins are achieved through short-term distribution agreements.

Operating, general and administrative expenses include all costs associated with processing music and video recordings and operating the business. These expenses increased substantially during 2006, primarily because of salary costs associated with additional personnel dedicated to business development, accounting and operations, costs incurred as a result of becoming a public-reporting company in February 2006, and from the addition of our DRA subsidiary on September 8, 2006.

Seasonality

The early-stage nature of the entire digital distribution industry and our limited operating history have not allowed us to categorically identify seasonality in our business, although we suspect that the first and fourth quarters of the calendar year may have seasonally higher sales, just as it is the highest quarter for sales of recorded music and videos in physical format. Based on our brief history, our content that is represented by older, back-catalog and out-of-print recordings has not experienced the same degree of seasonality as our more contemporary content from current artists.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures in the consolidated financial statements. Critical accounting estimates and assumptions are those that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance. We base such estimates and judgments on our experience and on various other factors that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies require our more significant judgments and estimates used in the preparation of our consolidated financial statements. For additional information relating to these and our other accounting policies, see Note 2 to DMGI's consolidated financial statements included in this proxy statement.

Revenue Recognition and Assessing the Collectibility of Accounts Receivable

We derive our revenue from digital entertainment services that distribute to consumers the digital music and video recordings that we have acquired or control through licenses with record labels, artists, publishers or other content owners. We receive revenue from digital entertainment services that charge consumers on a per download basis for each download of a music or video recording. In addition, we receive revenue from subscription-based digital entertainment services calculated as a percentage of the subscription price paid by the

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consumer based on the percentage of times our digital music and video recordings are streamed or downloaded as compared to the total for all available music and video recordings during the relevant time period. Beginning in 2007, we expect to receive revenue from other digital entertainment services based on advertising revenue associated with our video recordings. Each digital entertainment service provides detailed reports of our revenue, generally on a monthly basis (typically within 30 days following the end of the month) although some services, primarily mobile services, report on a quarterly basis (typically within 45 days following the end of each quarter), in all cases pursuant to the terms of our agreements with such services. We recognize revenue in the month the transaction occurs based on these reports from the digital entertainment services. We make monthly estimates for the revenue we receive from the digital entertainment services that report on a quarterly basis and adjust our estimates to actual upon the receipt of each quarterly revenue report. In making these estimates regarding monthly revenues from digital entertainment services which report on a quarterly basis, we consider historic trends of the service, seasonality and our overall catalog performance. While we believe our methodology is sound and provides a reasonable basis for estimating monthly revenue, our assumptions used to arrive at such estimates could be mistaken. If management is not successful in correctly estimating revenue to be received from these digital entertainment services, it could lead to adjustments in our revenue when actual monthly data is received on a quarterly basis.

Because we receive payment at approximately the same time as we receive the detailed revenue reports, our accounts receivable therefore generally consists of approximately one month's revenue for digital entertainment services that report on a monthly basis and one quarter's revenue for digital entertainment services that report on a quarterly basis. In making estimates regarding the collectibility of our accounts receivable, management considers the historic trend and financial stability of the service and its past collection experience. We have never experienced a bad debt and have never recorded a bad debt allowance.

Acquisition Costs for Digital Rights and Master Recordings

We capitalize the costs of acquiring or licensing digital rights and master recordings. Capitalized costs include amounts paid to content owners and our direct ancillary costs such as legal and finders' fees. Digital rights and master recordings are amortized using the straight-line method over the shorter of the term of the related agreement or seven years for digital rights, and ten years for master recordings which we believe reasonably relates the amount of amortization to the revenue expected to be generated. The digital distribution of music and video content is an emerging business and we have limited data upon which to base our amortization assumptions. Based on our results to-date, we believe that our amortization method and terms are reasonable in the circumstances. We will continue to monitor consumption trends for our music and video content and may adjust our amortization methodology, periods and resulting rates in the future if the revenue and cash flow trends are substantially different than anticipated. This could result from changes in consumer demand for our music and video content or general industry conditions. The impact of any such change would be applied prospectively as a change in accounting estimate. Accordingly, the historical reported financial information as reported on this Annual Report on Form 10-K would not be adjusted. However, any such changes could have a material effect in the future.

Royalty Advances

Royalty advances are cash amounts paid to content owners in connection with our contractual agreements for the right to distribute digital music and video content for a specific period of time, usually five to ten years, or the later of the stated term of the agreement or recoupment of the royalty advance. These advances are recorded as prepaid assets. On a monthly basis, as each of our digital entertainment services reports the revenue attributable to each of our music and video recordings, the portion of such revenue due to each content owner under our long-term license agreement is charged to cost of revenue and the royalty advance account is reduced until it is fully recouped.

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Allocation of Acquisition Purchase Price

We allocated the purchase price to acquire DRA to identifiable intangible assets and tangible assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition with the residual amount allocated to goodwill. Intangible assets included DRA's contractual arrangements with the owners of music recordings for the distribution of digital music. The fair value of these contractual arrangements was estimated based on the discounted future cash flow of these arrangements using management's assumptions including, among others, renewal rates and terms, the number of music recordings to be made available for sale to consumers, future download rates and pricing for digital downloads of music recordings, and cash discount rates. Using these assumptions, we estimated that the fair value of the DRA digital distribution agreements was \$775,000, which was capitalized as Digital Rights, and is being amortized over seven years. The use of other assumptions could have produced different results with a corresponding adjustment to Digital Rights and 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. We will test goodwill for impairment on at least an annual basis using a two-step process based on an evaluation of DRA's estimated fair value using market multiples and discounted cash flow modeling. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. Under our guidelines, we will perform our first annual review for impairment in 2007.

Valuation of Capitalized Digital Rights, Master Recordings and Royalty Advances

Total capitalized digital rights, master recordings and royalty advances amounted to approximately \$14.9 million as of June 30, 2007. In addition, we have future obligations of approximately \$3.8 million related to digital rights, master recordings and royalty advance obligations which are not yet reflected in the capitalized amounts as the related master recordings have not yet been delivered to us pursuant to such agreements. We periodically, but at least on an annual basis, review these assets for evidence of impairment on a catalog-by-catalog basis, by comparing the expected future cash flows to be generated from these assets to the carrying value of the assets and the future obligations. Future adverse changes in market conditions or poor demand for our music and video recording assets could result in losses or an inability to recover the carrying value of the individual catalogs of content, thereby possibly requiring an impairment charge in the future.

Share-Based Compensation

We elected early adoption of Statement of Financial Accounting Standards No 123 (revised 2004) of the Financial Accounting Standards Board, Share-Based Compensation. As a result, we recognize compensation expense in an amount equal to the estimated fair value of share-based awards and issuances, such as stock options and warrants granted to employees and non-employees. Such expense is recognized over the period during which the recipient is required to provide services in exchange for the award or issuance (usually the vesting period). The computation of share-based compensation cost involves numerous assumptions by management. We utilize the fair value method, whereby the compensatory element of each share-based grant or issuance is estimated on the date of grant. Prior to 2006, we utilized Black-Scholes, a standard option pricing model, to measure fair value. Assumptions used in this model include, among others, expected life (turnover), risk-free interest rate, dividend yield and volatility of the underlying equity security. Beginning in the first quarter of 2006, we determined that the Trinomial Lattice Model was the best available measure of the fair value because it utilized the assumptions used in the Black-Scholes model and also 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. We based our assumption of the expected volatility of our stock using the historical volatility for our peer group public companies because sufficient historical trading data does not yet exist for our stock. The use of different peer group companies and other assumptions by management in the Trinomial Lattice Model could produce substantially different results.

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Deferred income taxes result primarily from temporary differences between financial and tax reporting. Deferred tax assets and liabilities are determined based on the difference between the financial statement basis and tax basis of assets and liabilities using enacted tax rates. Future tax benefits are subject to a valuation allowance when management is unable to conclude that its deferred tax assets will more likely than not be realized from the results of operation. At each of the financial statement dates presented, we recorded a full valuation allowance against deferred income taxes due to our limited operating history and net losses recorded since inception. Our estimate for the valuation allowance for deferred tax assets requires us to make significant estimates and judgments about our projected future operating results. If actual results differ from these projections or if our expectations of future results change, it may be necessary to adjust the valuation allowance.

We have generated losses for federal and state income tax reporting since our inception in 2005. These tax losses are available for carryforward until their expiration, which begins in 2025 and 2015 for federal and state purposes, respectively. The federal and state unused net operating loss carryforward generated by DMI between its inception in 2004 and acquisition by us in 2006 will begin to expire in 2024 and 2014, respectively. In addition to potential expiration, there are other factors that could limit our ability to use these federal and state tax loss carryforwards. For example, under Section 382 of the Code (**Section 382**), as amended, use of prior net operating loss carryforwards can be limited after an ownership change. Our ability to fully utilize DMI's net operating loss carryforward will be subject to limitation under Section 382 as a result of our acquisition 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 our use. In addition, we must generate taxable income in the future, which may not happen, in order to use net operating loss carryforwards that have not expired.

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 FASB Statement 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. We do not believe that the adoption of FIN 48 will have a material impact on our consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (**SFAS 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 GAAP. As a result of SFAS 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 157 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of this statement on our consolidated financial statements.

Results of Operations

The following table sets forth items in our Consolidated Statements of Operations as a percentage of revenue, as well as certain operating data regarding tracks available for sale and paid downloads data for the periods indicated. The data for all periods prior to February 7, 2006 relates to Digital Musicworks International, Inc. (**DMI**), our wholly-owned subsidiary that was deemed to be the accounting acquiror for financial reporting purposes, with the historical shareholders' equity of DMI restated for all periods prior to February 7, 2006 to give retroactive effect to our acquisition of DMI on such date. Data for all periods beginning February 7, 2006

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includes the combined operations of DMGI, DMI and certain assets of Rio Bravo Entertainment LLC, which assets we acquired on February 7, 2006. Data for all periods beginning September 8, 2006 also includes the operations of Digital Rights Agency, LLC, which we acquired on such date.

	For the Six Months Ended June 30,				For the Years Ended December 31,				Period from February 26, 2004 (inception) to December 31, 2004	
	2007	% of Total	2006	% of Total	2006	% of Total	2005	% of Total	Amount	% of Total
	Amount		Amount		Amount		Amount		Amount	
Statement of Operations Data:										
Revenue	\$ 6,543,811	100.0%	\$ 1,560,187	100.0%	\$ 5,564,949	100.0%	\$ 679,975	100.0%	\$ 37,268	100.0%
Cost of revenue:										
Royalties and payments to content owners	4,593,191	70.2%	735,325	47.2%	3,329,698	59.8%	232,294	34.2%	10,703	28.7%
Amortization of digital rights and master recordings	394,451	6.0%	134,848	8.6%	422,489	7.6%	22,518	3.3%	3,041	8.2%
Write-down of non-productive assets							295,356	43.4%		
Gross profit	1,556,169	23.8%	690,014	44.2%	1,812,762	32.6%	129,807	19.1%	23,524	63.1%
Operating, general and administrative expenses	(3,482,509)	(53.2%)	(2,294,862)	(147.1%)	(5,655,161)	(101.6%)	(1,550,424)	(228.0%)	(666,831)	(1789.3%)
Merger-related expenses	(328,844)	(5.0%)								
Interest, taxes and other, net	409,349	6.3%	601,540	38.6%	1,219,965	21.9%	(136,997)	(20.1%)	(1,291)	(3.5%)
Net loss	\$ (1,845,835)	(28.2%)	\$ (1,003,308)	(64.3%)	\$ (2,622,434)	(47.1%)	\$ (1,557,614)	(229.1%)	\$ (644,598)	(1729.6%)
Key Revenue and Operating Data:										
Digital music revenue by source:										
Downloads	\$ 4,610,791	70.5%	\$ 1,473,060	94.4%	\$ 4,702,955	84.5%	\$ 660,638	97.2%	\$ 37,268	100.0%
Subscriptions	992,699	15.2%	75,464	4.8%	456,576	8.2%	15,156	2.2%		0.0%
Mobile services	762,244	11.6%			334,979	6.0%		0.0%		0.0%
Other	174,891	2.7%	11,663	0.7%	70,439	1.3%	4,181	0.6%		0.0%
Total digital music revenue	6,540,625	100%	1,560,187	100%	5,564,949	100%	679,975	100%	37,268	100%
Digital video and other revenue	3,186									
Total revenue	\$ 6,543,811	100.0%	\$ 1,560,187	100.0%	\$ 5,564,949	100.0%	\$ 679,975	100.0%	\$ 37,268	100.0%
Digital music revenue from:										
Owned and controlled music recordings										
Owned and controlled music recordings	\$ 1,974,467	30.2%	\$ 1,231,768	78.9%	\$ 2,887,008	51.9%	\$ 679,975	100.0%	\$ 37,268	100.0%
Music recordings under short-term distribution agreements	4,566,158	69.8%	328,419	21.1%	2,677,941	48.1%				
Total digital music revenue	6,540,625	100.0%	1,560,187	100.0%	5,564,949	100.0%	679,975	100.0%	37,268	100.0%

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Digital video and other revenue

3,186

Total revenue	\$ 6,543,811	100.0%	\$ 1,560,187	100.0%	\$ 5,564,949	100.0%	\$ 679,975	100.0%	\$ 37,268	100.0%
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Average number of music recordings available for sale during the year

241,400

55,600

107,000

9,000

N/A

Number of music recordings available for sale at the end of the year

261,600

73,000

219,800

30,600

700

Number of paid downloads(1)

6,369,700

2,015,800

6,390,000

973,300

59,800

(1) Does not include the number of times our music recordings were streamed or played on subscription-based digital music retailers or downloaded through mobile services.

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Revenue. Revenue increased to \$6,543,811 for the six months ended June 30, 2007, from \$1,560,187 for the six months ended June 30, 2006. Total paid downloads increased to 6,369,700 from 2,015,800 for the same periods, respectively. The increase in the number of paid downloads was driven by the increase in music recordings made available for sale, partially offset by a decline in the average monthly download rate to 6.1 times during the first six months of 2007 from 6.3 times during the first six months of 2006. The average number of music recordings available for sale was approximately 241,400 during the first six months of 2007 and 55,600 during the first six months of 2006. The increase in the average number of music recordings available reflects the increase in music recordings under contract which have been delivered to and processed by us and made available for sale by our digital entertainment service partners and the acquisition of DRA which added approximately 53,000 music recordings in September 2006. In addition, our revenue from subscription services and other sources such as physical rights licensing increased to \$1,167,590 in the first six months of 2007, from \$87,127 in the first six months of 2006. Revenue from mobile distribution was \$762,244 in the first six months of 2007 and \$0 in the first six months of 2006, primarily as a result of our acquisition of DRA. We commenced the digital distribution of our video content during 2007 on a limited and, in several cases, a test-marketing basis, and our revenue for the period from this source was \$3,186.

Cost of revenue. Our royalties and payments to content owners increased to \$4,593,191 for the six months ended June 30, 2007, compared to \$735,325 for the six months ended June 30, 2006. The increase is related to the overall increase in revenue and the acquisition of DRA. During the first six months of 2007, our royalties and payments to content owners amounted to 70.2% of our total revenue as compared to 47.2% of total revenue in the same period last year. During the first six months of 2006, 78.9% of our revenue was derived from music recordings either (i) owned by us which require no external payments to content owners or (ii) distributed by us under long-term distribution agreements which typically carry revenue sharing rates of 25% to 50% paid to the content owner. The acquisition of DRA in September 2006 had a significant effect on our revenue mix and gross profit margins, as revenue derived from digital music distributed under short-term agreements increased to 69.8% of our total revenue in the first six months of 2007 as compared to 21.1% in the first six months of 2006. DRA's short-term distribution agreements have revenue sharing arrangements that typically result in payments to content owners ranging from 80% to 85% of revenue. In addition, the amortization of digital rights and master recordings increased to \$394,451 in the first six months of 2007, compared to \$134,848 in the first six months of 2006. We have used a portion of the net proceeds from our initial public offering in February 2006 to acquire additional digital rights and master recordings. As of June 30, 2007, we are amortizing digital rights and master recordings with a cost basis of approximately \$6.5 million compared to approximately \$3.2 million at June 30, 2006. As a result of these factors, gross profit increased to \$1,556,169 in the first six months of 2007, as compared to \$690,014 in the first six months of 2006, but gross profit margins decreased to 23.8% of total revenue in the current period, compared to 44.2% in the first six months of 2006.

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Operating, general and administrative expenses. The following table sets forth the individual components of operating, general and administrative expenses for the six months ended June 30, 2007 and 2006:

	For the Six Months Ended June 30,			
	2007		2006	
	Amount	Percentage of Total	Amount	Percentage of Total
Personnel-related expenses	\$ 1,526,818	43.8%	\$ 1,087,511	47.5%
Professional fees	508,143	14.6%	321,382	14.0%
Corporate governance expenses	332,960	9.6%	269,548	11.7%
Share-based compensation	196,200	5.6%	159,884	7.0%
Depreciation and amortization	178,147	5.1%	47,183	2.1%
Rent	145,198	4.2%	71,787	3.1%
Travel expenses	130,298	3.7%	85,943	3.7%
Media and investor relations	111,558	3.2%	69,237	3.0%
Other	353,187	10.2%	182,387	7.9%
Total	\$ 3,482,509	100.0%	\$ 2,294,862	100.0%

Operating, general and administrative expenses increased to \$3,482,509 for the six months ended June 30, 2007 from \$2,294,862 for the six months ended June 30, 2006. Our operating, general and administrative expenses for the first six months of 2007 include the expenses of our DRA subsidiary which was acquired in September 2006. In addition, operating, general and administrative expenses increased after our initial public offering in February 2006 because of an increase in (i) employees and the resulting payroll costs and share-based compensation attributable to the granting of stock options and restricted stock incentives, partially offset by \$38,384 of share-based compensation recognized in the first six months of 2006 associated with the accelerated vesting of DMI stock options, (ii) professional fees, including assistance in the documentation and testing of internal controls as required by the Sarbanes-Oxley Act, (iii) corporate governance expenses which include board fees, director and officer insurance, stock transfer, printing and filing fees, (iv) media and investor relations which includes advertising costs for acquired content, (v) travel-related expenses, (vi) office rent, and (vii) other expenses as we acquired equipment and expanded our infrastructure to acquire rights to additional music and video recordings, to process an increasing number of music recordings, to develop competencies in digitally encoding video content, and to meet our obligations as a public company.

Merger related expenses. Through June 30, 2007, we had incurred \$328,844 of expenses related to the pending merger with Orchard, primarily professional fees. In this transaction, Orchard will be deemed the acquirer for financial reporting purposes and, as such, all of our merger related costs and expenses must be charged to expense as incurred.

Interest, taxes and other, net. Interest income was \$441,516 in the six months ended June 30, 2007, compared to \$608,006 for the six months ended June 30, 2006, due to the temporary investment of the net cash proceeds from our initial public offering. Our initial public offering closed on February 7, 2006 and we received net cash proceeds of \$33.2 million.

Comparison of Year Ended December 31, 2006 and 2005

Revenue. Revenue increased to \$5,564,949 for the year ended December 31, 2006, from \$679,975 for the year ended December 31, 2005. Total paid downloads increased to approximately 6,390,000 from 973,300 for the same periods, respectively. The increase in the number of paid downloads was driven by the increase in music recordings made available for sale, partially offset by a decline in the average monthly download rate per music recording to approximately 5.9 times during 2006 from approximately 9.0 times during 2005. The average number of music recordings available for sale totaled approximately 107,000 during 2006 and 9,000 during 2005. The increase in the average number of music recordings available reflects the increase in music recordings

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processed by us and made available by the digital music retailers, the acquisition of DRA which added approximately 53,000 music recordings on September 8, 2006, and the acquisition on February 7, 2006 of certain assets of Rio Bravo Entertainment LLC, representing approximately 6,000 music recordings. We experienced a decline in our average download rate in 2006 as compared to 2005 because the majority of the music recordings added during 2006 were of a nature and mix of genres that were not as commercially popular or had less than worldwide distribution rights compared to the music recordings available for sale in 2005. Partially offsetting these factors was the addition of the DRA music recordings on September 8, 2006. DRA's catalog features more titles by current recording artists and DRA's catalog downloaded at an average monthly rate of approximately 14.7 times during the period from the acquisition date through December 31, 2006. In addition, our revenue from subscription fees and other sources such as physical rights licensing increased to \$527,015 in 2006, from \$19,377 in 2005. Revenue from mobile distribution was \$0 in 2005 and increased to \$334,979 for 2006, which reflects the revenue from DRA's mobile services for the period from September 8, 2006 to December 31, 2006.

Cost of revenue. Our royalties and payments to content owners increased to \$3,329,698 for the year ended December 31, 2006, compared to \$232,294 for the year ended December 31, 2005. The increase is related to the increase in revenue and the acquisition of DRA. During the years ended December 31, 2006 and 2005, our royalties and payments to content owners amounted to 59.8% and 34.2% of revenue, respectively. During 2005, the majority of our content was owned by us or distributed under long-term distribution agreements which typically carry revenue sharing rates of 25% to 50% paid to the content owner. The acquisition of certain assets of Rio Bravo Entertainment LLC in February 2006 and DRA in September 2006 had a significant effect on the mix of our revenue and our gross profit margin, as the short-term distribution agreements of these acquired operations have revenue sharing arrangements that typically result in payments to content owners ranging from 80% to 85% of revenue. The amortization expense of master recordings and digital music rights increased to \$422,489 in 2006, compared to \$22,518 in 2005. This increase in amortization expense is due to the purchase of digital music rights and master recordings during the second half of 2005 and during 2006 and the acquisitions of certain assets of Rio Bravo Entertainment LLC and DRA. As of December 31, 2006, we were amortizing rights and recordings with a cost basis of approximately \$4.8 million compared to approximately \$1.2 million as of December 31, 2005. Our cost of revenue for 2005 also included a write-down of non-productive assets of \$295,356, relating to cash advances and the capitalized costs of producing master recordings under contracts with certain recording artists. During 2005, we cancelled certain of these contracts because we did not believe that future cash flows would be sufficient to recover the advances and costs that were capitalized under the remainder of the contracts. We are no longer seeking to sign additional artists to record new material as a means of furthering our digital music strategy.

Operating, general and administrative expenses. The following table sets forth the individual components of operating, general and administrative expenses for the years ended December 31, 2006 and 2005:

	For the Years Ended December 31,			
	2006		2005	
	Amount	Percentage of Total	Amount	Percentage of Total
Personnel-related expenses	\$ 2,759,628	48.8%	\$ 829,823	53.5%
Professional fees	651,682	11.5%	265,473	17.1%
Corporate governance expenses	567,391	10.0%		0.0%
Media and investor relations	280,613	5.0%	84,448	5.4%
Share-based compensation	326,495	5.8%	8,304	0.5%
Travel expenses	202,019	3.6%	117,957	7.6%
Rent	203,485	3.6%	68,842	4.4%
Other	663,848	11.7%	175,577	11.5%
Total	\$ 5,655,161	100.0%	\$ 1,550,424	100.0%

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Operating, general and administrative expenses increased to \$5,655,161 for the year ended December 31, 2006, from \$1,550,424 for the year ended December 31, 2005. Operating, general and administrative expenses increased after our initial public offering in February 2006 because of an increase in (i) employees and resulting payroll costs and share-based compensation attributable to the granting of stock options and restricted share incentives, (ii) professional fees, (iii) corporate governance expenses which include board fees, insurance, stock transfer, printing and filing fees, (iv) media and investor relations, (v) travel-related expenses, (vi) office rent, and (vii) other expenses as we began to expand our infrastructure to acquire rights to additional music and video recordings, to process an increasing number of music recordings, to develop competencies in digitally encoding video content, and to meet our obligations as a public company. In addition, during the third and fourth quarters of 2006, we recorded one-time charges of \$113,000 and \$76,000, respectively, related to severance costs. Our operating, general and administrative expenses for 2006 include expenses of our DRA subsidiary of \$360,354 for the period from September 8, 2006 to December 31, 2006.

Interest, taxes and other, net. Interest income increased to \$1,251,396 for the year ended December 31, 2006, from \$5,568 for the year ended December 31, 2005, due to the temporary investment of the net cash proceeds from our initial public offering of common stock, which closed on February 7, 2006. Interest, taxes and other expense is comprised primarily of interest expense on operating leases in 2006 and a charge to interest expense in 2005 related to the conversion of certain debt to equity by DMI, our accounting acquiror.

Comparison of Year Ended December 31, 2005 and Period from February 26, 2004 (Inception) to December 31, 2004

Revenue. Revenue grew from \$37,268 for the period from February 26, 2004 (Inception) to December 31, 2004, to \$679,975 for the year ended December 31, 2005. From inception to December 31, 2004, our revenue was insignificant because we were beginning our operations and focused on acquiring our initial digital rights to music recordings, establishing relationships with digital music retailers and identifying artists to sign to our record label. We had only approximately 700 music recordings available for purchase as of December 31, 2004, compared to 30,600 available for purchase at digital music retailers as of December 31, 2005. The increase in music recordings available for purchase and corresponding number of downloads were the driving factor behind the increase in revenues.

Cost of revenue. Cost of revenue increased from \$13,744, or 36.9% of revenue, for the period from February 26, 2004 (Inception) to December 31, 2004, to \$550,168, or 80.9% of revenue, for the year ended December 31, 2005. The cost of revenue for the year ended December 31, 2005 was negatively impacted by the write-down of non-productive assets of \$295,356, relating to cash advances and the capitalized costs of producing master recordings under contracts with certain recording artists. During 2005, we cancelled certain of these contracts because we did not believe that future cash flows would be sufficient to recover the advances and costs that were capitalized under the remainder of the contracts. We are no longer seeking to sign additional artists to record new material as a means of furthering our digital music strategy.

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Operating, general and administrative expenses. The following table sets forth the individual components of selling, general and administrative expenses for the year ended December 31, 2005 and for the period from February 26, 2004 (Inception) to December 31, 2004:

	For the Year Ended, December 31, 2005		Period from February 26, 2004 (Inception) to December 31, 2004	
	Amount	Percent of Total	Amount	Percent of Total
Personnel-related expenses	\$ 829,823	53.5%	\$ 320,533	48.1%
Professional fees	265,473	17.1%	180,405	27.1%
Media and investor relations	84,448	5.4%	27,886	4.2%
Share-based compensation	8,304	0.5%	1,281	0.0%
Travel expenses	117,957	7.6%	56,758	8.5%
Rent	68,842	4.4%	8,360	1.3%
Other	175,577	11.5%	71,608	10.8%
	\$ 1,550,424	100.0%	\$ 666,831	100.0%

Operating, general and administrative expenses increased from \$666,831 for the period from February 26, 2004 (Inception) to December 31, 2004, to \$1,550,424 for the year ended December 31, 2005. Operating, general and administrative expenses increased in 2005 because of a substantial increase in employees and resulting payroll costs, professional fees, travel related costs and other expenses as we began to more aggressively identify and acquire rights to music recordings and process an increasing number of music recordings for sale.

Interest, taxes and other, net. Interest, taxes and other expense increased from \$3,593 for the period from February 26, 2004 (inception) to December 31, 2004, to \$142,565 for the year ended December 31, 2005. The increase in 2005 relates primarily to a non-cash interest charge of \$125,034 related to the conversion of certain debt to equity by DMI, our accounting acquiror.

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The following table sets forth unaudited quarterly data for the years ended December 31, 2005 and 2006, and for the first half of 2007:

	For the Quarters Ended (unaudited)									
	3/31/2005	6/30/2005	9/30/2005	12/31/2005	3/31/2006	6/30/2006	9/30/2006	12/31/2006	3/31/2007	6/30/2007
Statement of Operations Data:										
Revenue	\$ 41,480	\$ 53,560	\$ 130,495	\$ 454,440	\$ 720,648	\$ 839,539	\$ 1,214,209	\$ 2,790,553	\$ 3,392,547	\$ 3,151,264
Cost of revenue:										
Royalties and payments to content owners	14,411	18,485	36,078	163,320	348,526	386,799	667,154	1,927,219	2,450,838	2,142,353
Amortization of digital rights	3,923	5,065	6,061	7,469	52,035	82,813	136,251	151,390	178,517	215,934
Write-down of non-productive assets		73,442		221,914						
Gross profit (loss)	23,146	(43,432)	88,356	61,737	320,087	369,927	410,804	711,944	763,192	792,977
Operating, general and administrative expenses	(537,745)	(333,782)	(257,050)	(421,847)	(950,664)	(1,344,198)	(1,616,393)	(1,743,906)	(1,725,081)	(2,086,273)
Interest, taxes and other, net	1,495	(7,056)	(128,418)	(3,018)	216,635	384,906	356,792	261,633	225,541	183,808
Net loss	\$ (513,104)	\$ (384,270)	\$ (297,112)	\$ (363,128)	\$ (413,943)	\$ (589,365)	\$ (848,797)	\$ (770,329)	\$ (736,348)	\$ (1,109,488)
Net loss per share basic and diluted	\$ (.23)	\$ (.17)	\$ (.13)	\$ (.16)	\$ (.07)	\$ (.07)	\$ (.10)	\$ (.09)	\$ (.08)	\$ (.12)
As a percentage of revenue:										
Cost of revenue	44.2%	181.1%	32.3%	86.4%	55.6%	55.9%	66.2%	74.5%	77.5%	74.8%
Gross profit margin(1)	55.8%	(81.1%)	67.7%	13.6%	44.4%	44.1%	33.8%	25.5%	22.5%	25.2%
Operating data:										
Average number of music recordings for sale during the quarter	1,900	5,100	9,400	19,500	42,500	69,700	109,900	196,200	232,300	249,900
Number of music recordings for sale at end of quarter	2,300	8,000	12,200	30,600	65,000	73,000	184,000	219,800	243,100	261,600
Number of paid downloads during	56,400	75,100	191,400	650,400	952,400	1,063,400	1,363,200	3,011,000	3,650,100	2,719,700

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quarter(2)

- (1) Gross profit in the quarters ended June 30, 2005 and December 31, 2005 was adversely impacted by write-downs of non-productive assets of \$73,442 and \$221,914, respectively, related to cash advances and the capitalized costs of producing master recordings under contracts with certain recording artists. Without these charges, gross profit margin in these quarters would have been 56.0% and 62.4% of revenue, respectively.
- (2) Does not include the number of times our music recordings were streamed or played on subscription-based digital music retailers or downloaded through mobile services.

Our quarterly revenue is subject to numerous factors as previously noted, including the number of recordings available for sale, download rates, the number of and fee rates received from digital entertainment services offering our recordings for sale, and seasonality. Quarterly revenue increases during 2006 reflect the acquisition of certain assets of Rio Bravo on February 7, 2006, and the acquisition of DRA on September 8, 2006.

Our gross profit margin varies depending on the mix of revenue received from individual music recordings and other sources and the manner in which we have obtained digital distribution rights. Higher margins are achieved from

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revenue generated from owned content and under perpetual and long-term license agreements and lower margins are achieved through short-term distribution agreements, like those added during the first and third quarters of 2006 in connection with the acquisitions of Rio Bravo and DRA, respectively. In addition, gross profit in the quarters ended June 30, 2005 and December 31, 2005 was adversely impacted by write-downs of non-productive assets as described in note (1) above.

Operating, general and administrative expenses declined in the second and third quarters of 2005, as a result of a reduction in the personnel associated with the management and promotion of artists signed to DMI's record label. These expenses increased on a sequential quarter-over-quarter basis during 2006 beginning with our initial public offering in February 2006 as we expanded our infrastructure and work force to accommodate future growth, as we began to incur the costs of being a public company and as a result of our acquisition of DRA on September 8, 2006. During the last three sequential quarters, operating, general and administrative expenses have amounted to approximately \$1.74 million, \$1.73 million and \$1.76 million, respectively. In addition, net loss for the quarter ended June 30, 2007 includes \$328,844 of merger-related expenses.

Liquidity and Capital Resources***Cash Flows for the Six Months Ended June 30, 2007***

Our operating activities resulted in a net cash outflow of \$636,227 during the six months ended June 30, 2007. The primary components of the reconciliation of net loss of \$1,845,835 to net cash used by operations included non-cash charges relating to the recoupment of royalty advances of \$590,033, share-based compensation of \$196,200, depreciation of furniture and equipment of \$176,219 and the amortization of digital rights and master recordings of \$394,451. In addition, changes in working capital components used \$158,151 in operating cash flow as receivables and prepaid expenses increased by a greater amount than royalties, and accounts payable and accruals.

Our investing activities resulted in net cash outflows of \$5,876,842 during the six months ended June 30, 2007, which was principally comprised of \$406,713 for the purchase of furniture and equipment, \$1,252,968 for the purchase of digital rights and master recordings, and \$4,222,699 for cash advances to acquire digital license rights to music and video recordings.

Our financing activities during the six months ended June 30, 2007 resulted in a net use of cash of \$23,722 primarily for payments on capital lease obligations.

As of June 30, 2007, we had cash and cash equivalents of approximately \$14.0 million and a working capital surplus of approximately \$14.8 million. At June 30, 2007, we were contractually obligated to pay approximately \$3.8 million in additional advance royalties and digital rights and master recordings purchase consideration, due under various digital rights agreements generally as music and video recordings and related metadata and artwork are received from the content owners for processing by us. We are 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 and \$736,000 in monthly installments on capital and operating leases through October 2010.

Our principal sources of liquidity are our cash and cash equivalents. We believe that our existing cash reserves will be sufficient to fund our operations, working capital requirements, capital expenditure requirements, contractual obligations and content acquisition objectives during 2007. However, we may seek to raise additional capital through a future debt or equity financing to provide for greater flexibility to fund any such acquisitions and licensing activities.

Cash Flows for the Year Ended December 31, 2006

Net cash used in operations for the year ended December 31, 2006 was \$1,607,000. The primary components of the reconciliation of net loss of \$2,622,000 to net cash used in operations for the year ended December 31, 2006 included non-cash charges for share based compensation of \$326,000, recoupment of royalty

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advances of \$1,001,000, depreciation of furniture and equipment of \$157,000 and digital rights and master recording amortization of \$422,000. These non-cash charges were partially offset by increased working capital requirements of \$943,000 as the business and scope of operations grew in 2006.

Our investing activities resulted in a net cash outflow of \$11,551,000 for the year ended December 31, 2006, which was principally comprised of \$2,769,000 for the purchase of DRA, net of cash received, \$2,728,000 and \$5,406,000 to acquire digital rights and pay cash advances, respectively, for license rights to music and video recordings, and \$621,000 for the purchase of furniture and equipment.

Cash provided from financing activities for the year ended December 31, 2006 was \$33,196,000. Our initial public offering generated approximately \$33,233,000 in net cash proceeds. In addition, stock and warrant exercises of DMI prior to our initial public offering provided an additional \$43,000 in proceeds. This was partially offset by capital lease principal payments of approximately \$81,000.

As of December 31, 2006, we had cash and cash equivalents of approximately \$20,506,000 and a working capital surplus of \$21,192,000.

Cash Flows for the Year Ended December 31, 2005

Net cash used in operations for the year ended December 31, 2006 was \$1,123,000. The primary components of the reconciliation of net loss of \$1,558,000 to net cash used in operations for the year ended December 31, 2005 included non-cash charges for the write-down of non-productive assets of \$295,000, interest expense related to the conversion of subordinated notes payable of \$127,000, recoupment of royalty advances of \$100,000, depreciation of furniture and equipment of \$39,000 and digital rights amortization of \$23,000. These non-cash charges were partially offset by increased working capital requirements of \$157,000.

Our investing activities resulted in a net cash outflow of \$1,897,000 for the year ended December 31, 2005, which was comprised of \$890,000 and \$953,000 to acquire digital rights and to pay royalty advances for long-term license rights to music recordings, respectively, and \$54,000 to purchase of furniture and equipment.

Cash provided from financing activities for the year ended December 31, 2005 was \$2,753,000, which was comprised of net cash proceeds from DMI's issuance of Series B convertible preferred stock and subordinated notes payable of \$2,568,000 and \$230,000, respectively, and was partially offset by capital lease payments of \$44,000.

Contractual Obligations

The following table summarizes our contractual obligations as of June 30, 2007 and the effect such obligations are expected to have on our liquidity and cash flow in future periods:

Contractual Obligations	Total	Payments Due by Period			
		Less than 1 year	1-3 years	3-5 years	After 5 years
Capital lease obligations	\$ 38,000	\$ 36,000	\$ 2,000	\$	\$
Operating lease obligations	698,000	295,000	403,000		
Music and video content acquisition and royalty advance obligations	3,781,000	3,477,000	135,000	135,000	34,000
Total	\$ 4,517,000	\$ 3,808,000	\$ 540,000	\$ 135,000	\$ 34,000

In addition to the long-term obligations in the table above, we were obligated in connection with the acquisition of DRA to pay additional consideration if certain financial targets were achieved through December 31, 2007. This earn-out obligation was settled in full with the former owners of DRA through the payment in July 2007 of approximately \$705,000 in cash and the issuance of 56,998 shares of DMGI common stock.

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Off-Balance Sheet Arrangements

As of June 30, 2007, we had no off-balance sheet arrangements.

Factors Affecting Future Results

We have incurred losses since inception and our ability to achieve profitability in the near term is primarily dependent on increasing our revenue while controlling and limiting our expenses at current levels. The factors we expect will affect our future results are discussed below.

Digital music industry conditions. The digital music industry is still evolving and subject to rapid change. The previously strong quarter-over-quarter growth in digital music sales reported industry-wide has slowed recently, which is natural as an industry matures and the base on which percentage growth is measured becomes larger. There was an industry-wide decline in sales of physical product (pre-recorded music CDs) experienced during the first six months of 2007 which was larger than the increase in digital music sales for the same period. The early-stage nature of the digital transition presently occurring in the music industry and our limited operating history have not allowed us to definitively identify specific consumer trends or factors in our business that may affect the timing and extent of digital downloading as a replacement for purchases of music CDs and the resulting impact on our revenue.

Because of the lengthy interval between the time we acquire digital rights or enter into license or distribution agreements for music recordings and the time that such recordings are received, processed, delivered to digital entertainment services and ultimately processed and approved for sale by the services, only a relatively small amount of the music content we have acquired since the IPO was available for sale at June 30, 2007. We are working to reduce the time it takes to get our recordings to market and to deliver more of our music recordings to other digital music retailers and especially to mobile distribution services in order to improve our download rates and revenue per music recording.

We have observed a continued increase in the competitive environment for the acquisition of digital rights to music recordings owned by active independent record labels from our competitors engaged in the short-term distribution of digital music and from subsidiaries of the four major record label groups. In particular, major record label groups, which have always aggressively competed to provide physical distribution for independent labels, have become increasingly active in the digital market segment. During the first half of 2007, we were notified by three independent record labels digitally distributing their music through our DRA subsidiary that they intend to shift distribution of their catalogs from us to a subsidiary of a major record label. In addition, our direct competitors, which have typically engaged in the digital distribution of music with no upfront advance cash payments, have begun making cash royalty advances or reduced their gross profit margins to attract or retain high-quality music catalogs. While we do not expect the decrease in revenue and gross profit from the three labels we have lost to subsidiaries of the major record label groups to be material, the aggressive competition from our direct competitors, as well as from major record label groups and other independent physical distributors with the ability to offer reduced physical distribution fees in order to gain the digital distribution rights from independent labels and content owners, may cause us to experience a higher rate of non-renewal than we have experienced in the past and may adversely impact our ability to enter into new agreements.

Apple iTunes and EMI Music recently announced an agreement to sell a broad selection of EMI music recordings without digital rights management, or DRM. Such recordings would be made available in a higher quality format and at a higher price to the consumer than music recordings currently offered on Apple iTunes. During the third quarter of 2007, we expect Apple iTunes will make this distribution option available to us and we will likely make certain of our content available without DRM, in a higher-quality format and at a higher price. We believe that the availability of non-DRM music downloads may lead to accelerated growth in the digital music industry.

Revenue from video content. As of June 30, 2007, we had more than 4,000 hours of music, television and film video content under contract. As of that date, we had processed and delivered over 3,500

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episodes of video content to 18 online and mobile video retailers. Because most of our distribution partners are still in the process of launching and establishing their digital entertainment services for video or are in the testing phase for advertising-supported business models, the revenue we have received from video sales-to-date has been negligible. We have been participating in the testing phase of a number of our partners' services. Based on the preliminary results of these tests and on the stated plans of certain of our partners to launch their advertising-supported models during the third quarter of 2007, we believe our revenue from video content will continue to increase from current levels, although we are unlikely to realize any meaningful revenue from digital video distribution until, at the earliest, the fourth quarter of 2007.

Business development. As of June 30, 2007, we had cash and cash equivalents of \$14 million, the majority of which is earmarked for content acquisitions, including approximately \$3.8 million we are contractually obligated to pay under content acquisitions and long-term license arrangements. In addition, we paid approximately \$705,000 in June 2007 as additional DRA purchase consideration in order to cancel the earn-out obligation which was a part of the acquisition agreement. Negotiating and consummating digital rights agreements for entertainment content is a complex and time consuming process, and we cannot predict how quickly we will be able to deploy our capital and add to the music and video content we have available to consumers. We are seeking to acquire additional digital rights and to enter into additional long-term license agreements for both music and video content. We also are seeking to enter into additional short-term distribution agreements for both music and video content as they provide a method for achieving revenue growth without investing our capital in the form of cash royalty advances or purchase price. However, depending on competitive market conditions, we may offer cash advances to certain substantial content owners under existing short-term distribution agreements as an inducement to extend their agreements with us.

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The Orchard Enterprises Inc.

Overview

The Orchard Enterprises Inc, or Orchard, is a leading global digital distributor and marketer of music. As of June 30, 2007, Orchard had over 600,000 individual music recordings, or tracks, for sale. Additionally, Orchard estimates it currently has under license, but has not yet made available, a substantial number of additional tracks. Orchard currently has agents or employees in over 25 countries and controls a catalog sourced from over 75 countries, covering thousands of labels and a broad and deep array of music genres and eras. Orchard supplies music and video to the leading digital music stores and mobile operators throughout the world, and executes global marketing and promotion programs locally, with experts in major music territories managing initiatives tailored to each country's unique dynamic situation.

Orchard believes that it has changed traditional notions of distribution by pioneering a broad suite of client services in addition to its primary music distribution and marketing business. These services range from placing a music recording for use in film, TV and advertising programming (referred to as synchronization), to co-marketing initiatives with leading consumer brands (for example, creating a digital music promotion that is redeemable by consumers who purchase an electronics item), to global publishing administration (whereby Orchard researches and administers the publishing copyright royalties on behalf of master recording owners). Orchard believes that it is often first to market in making independent music available in new digital music retail services (whereby independent refers to master recordings not controlled or owned by the four major music companies, which are Sony/BMG, Universal Music Group, EMI Recorded Music and Warner Music Group). For example, Orchard was the launch partner for Verizon's VCAST music service and represented the only independent music in the service when it became available to consumers. Further, Orchard was among the first independent music providers to license the 3 mobile service in the United Kingdom directly, without licensing the master recordings to an intermediary mobile technology company. Orchard believes that, with an ability to coordinate global programs within local markets, it has pioneered new forms of entertainment marketing for the digital media era.

Orchard considers as a competitive differentiator the degree to which the company works as a close business partner with its independent label clients to provide a broad array of ancillary services. Orchard provides retail sales and marketing, an extensive suite of online promotional programs, synchronization placement, global royalty collection and global publishing administration. Orchard also provides strategic media services to digital retailers and leading consumer brands, ranging from publishing research, licensing and administration through comprehensive online and offline branding programs.

Orchard's proprietary content delivery platform (V.E.C.T.O.R), launched in 2007, efficiently supplies hundreds of digital retail and mastertone storefronts (i.e., all retail locations whereby consumers can purchase short segments of music called mastertones for use as ringtones and the like in their mobile telephone or other mobile device) and gives Orchard proprietary in-house control over all receipt and processing of a music catalog, delivery of music to retail storefronts, and storage/management of music assets. This capability encompasses both full-track downloads and mastertone music. Further, the V.E.C.T.O.R. solution is designed to also manage all aspects of video processing, delivery and storage/management, which Orchard intends to make available over the course of 2007.

Market Overview

In all material respects, Orchard views the current state of the recorded music and digital music and video markets similarly to the perspective articulated by DMGI. Further, Orchard believes that the current trends in both recorded music and digital music and video markets will place a premium on effective global distribution. Over time, as artist managers work directly with distribution partners and other non-traditional partners to create new models for funding the creation and marketing of music recordings and their distribution and sales, the role of the traditional label will continue to be diminished. Orchard believes this presents growth opportunities and that Orchard is well-positioned to take advantage of these macro market trends.

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With respect to digital distribution, Orchard believes that the market for short-term distribution of music recordings is bifurcating between value-added service partners (those that maintain relatively high (over 25%) distribution fees for services provided, and commoditized providers (those that compete primarily on price, but also on operational effectiveness and accounting accuracy and flexibility). Orchard believes that creating long-term sustainable business value rests in maintaining and cultivating Orchard's strong value-added brand reputation, continuing to innovate in providing new products and services to its label, video, retail and other clients. Orchard also believes that the commoditized segment of the digital distribution market will consolidate, as businesses are forced to combine to achieve sufficient scale to cover their cost of operations.

Orchard believes that changes occurring at the advertiser/brand level, and the role that branded digital entertainment properties increasingly play in providing non-traditional sources of revenue for content owners, offer new and innovative ways to increase consumer audiences and sell more digital music and video. This is manifest in Orchard's focus on cultivating its array of music service products such as placement of master recordings for use in film, television and commercial programming; partnering with consumer packaged goods companies, technology companies and other brands to integrate digital entertainment properties into their own customer value propositions; and the like.

Competitive Strengths

Like DMGI, Orchard increases the selection of music and video content available to consumers by making it available in digital formats, provides a means for content owners to access the digital entertainment marketplace with minimal effort on their behalf, serves as a trusted content provider to digital entertainment services, and offers competitive differentiators to non-traditional users of digital entertainment properties. Orchard addresses the needs of consumers, content owners, and digital entertainment services similarly to DMGI, but additionally:

Consumers. Orchard also creates innovative product packages and compilations to facilitate customers' discovery of new developing artists, providing access to music catalogs, and exposure to music from different regions and cultures.

Content Owners. Orchard also offers a wide array of value-added service to help content owners realize more value from their assets and also increase audiences allowing content owners additional ways to monetize their assets. For additional information regarding these value-added services, see THE COMPANIES The Orchard Enterprises Inc. Distribution and Marketing and Other Services below.

Digital Entertainment Services. Orchard also has a focus on serving digital entertainment services with merchandising and marketing expertise. In addition, Orchard offers select digital entertainment service partners the option for Orchard to research, license and/or administer publishing royalties on behalf of the service.

Non-Traditional Partners. Orchard also serves non-traditional clients as a business partner, integrating digital entertainment with their products. For example, Orchard offers programs to help consumer packaged goods companies and electronics manufacturers to bundle music with their products. This bundling is intended to increase the number of units a retailer agrees to stock in its stores, and improve retail merchandising placement, while at the same time generating new sources of revenue and audience exposure for Orchard's label clients. A recent example of this is a mastertone promotion with Procter & Gamble for their Pringles potato chip product.

In addition to addressing the needs of the digital entertainment marketplace through content licensing and short-term distribution, Orchard may also seek to maintain long-term control and outright ownership over some music content. Although this has not been an integral part of Orchard's growth strategy to date because of the significant capital required, in select cases, Orchard has acquired ownership of master recordings or digital rights or sought to enter into long-term license arrangements. In this regard, Orchard owns three record labels outright: Xanadu, a jazz label currently comprising approximately 120 albums and 760 individual recordings; Music of the World, a world music label currently comprising approximately 80 albums and 780 individual recordings; and

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Re:Live , a large library of live music recordings recorded during the period 2002 to 2006 in small to medium sized venues in the United States, comprising approximately 1,200 albums and 11,900 individual recordings.

Growth Strategy

Like DMGI, Orchard seeks to own or control through either long-term license or short-term distribution agreements the digital rights to as much music and video content as possible, on terms that Orchard deems commercially reasonable, subject to Orchard's financial resources. Once acquired, Orchard makes its content available to consumers by placing it on leading and selected specialty digital entertainment services. Orchard pursues these objectives with strategies similar to those articulated by DMGI and also acquires content in much the same manner. Unlike DMGI, Orchard also pursues strategies related to its value-added product and service offerings and seeks to position itself with its digital retail sales partners as a provider of merchandising, marketing and publishing administration services.

For the six months ended June 30, 2007 and the year ended December 31, 2006, Orchard generated approximately 17% and 19%, respectively, of its revenues from music content to which it has long-term licenses (meaning a license with a duration of 5 years or more), and approximately 70% and 68%, respectively, of its revenues from music content for which it has short-term distribution rights. Those categories of music represent, respectively, 26% and 74% of the total number of tracks for sale by Orchard as of June 30, 2007. Orchard did not generate any revenue from music content for which it owned the digital rights or master recordings during these periods.

Orchard's Content

As of June 30, 2007, Orchard had approximately 600,000 individual music recordings available for sale through its network of digital entertainment services. In addition to these 600,000 recordings, Orchard estimates it has access to substantial additional music recordings from its content owners currently under contract. These additional music recordings represent content that Orchard has not yet opted to request for distribution and sale, keeping in line with its strategy of endeavoring to optimize the long-term value of its content providers' catalogs, or has not yet been provided by the content owners. For large catalogs of music recordings and particularly with respect to non-Western repertoire, rather than delivering immediately, Orchard sometimes selectively rolls out tracks under license under a schedule over time. Also, tracks under license may not yet be offered for sale by the online stores for other reasons, e.g., they are still being processed internally for inclusion in Orchard's systems, or the online stores may not yet have completed their review, processing, or, as applicable, encryption of, the tracks that Orchard has delivered. In addition, more so than DMGI, many of the content owners for which Orchard provides digital distribution are independent record labels with active artists who are periodically releasing new albums for digital distribution through Orchard.

In addition to music, Orchard has licensed some video content for distribution and intends to implement a video acquisition and distribution strategy and begin widespread distribution of video content in the fourth quarter of 2007. To date, Orchard's licensed video content includes, for example, material from The Three Stooges, Simply Red and Brian Setzer. Genres include comedy and music videos (rock, metal, pop, Latin and electronic). Like DMGI, Orchard believes there is significant revenue potential in digitally distributing video entertainment. To date, Orchard has only delivered a small number of videos to iTunes for priority promotional campaigns. Many of the content owners for which Orchard currently provides digital music distribution have access to a material amount of incremental video product, particularly music videos, which Orchard believes will be made available to it to distribute through digital video retailers.

Like DMGI, the digital rights that Orchard acquires are contractual and based upon the rights granted to Orchard by the content owner who may not be the original rights owner. Orchard's contractual arrangements typically provide for assurances regarding proper title and ownership to the digital rights acquired (typically through representations, warranties and indemnities as to ownership). Orchard also performs what it believes to be a reasonable amount of diligence on the ownership of music and video recordings by the record labels, artists

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and video catalog owners from whom Orchard acquires digital rights. Given the contractual nature of Orchard's rights and its acquisition of older music recordings, from time-to-time Orchard receives a claim from a third party challenging its rights. In such cases, Orchard typically ceases selling the recording until the dispute is investigated and resolved. Depending on the outcome of the rights dispute, Orchard will resume selling the recording and/or seek remedy from the content owner under the representations, warranties and indemnities provided in Orchard's contractual arrangements.

Like DMGI, Orchard's music content is from various genres and time periods and includes back catalog, out-of-print recordings, past hits, world music, classical music performances, previously unreleased music recordings, and live performances. Orchard's content also includes multi-platinum artists across a diverse set of music territories, current recordings by contemporary independent labels and artists, as well as other music that may no longer be readily available from traditional music retailers. In addition, Orchard may acquire music and audio or audio/video from live performances not previously commercially available, radio and television performances, and other sources as they are identified by Orchard.

When Orchard acquires or licenses digital rights or enters into short-term distribution arrangements, its preference is to obtain the broadest territorial distribution rights as possible. From time to time, however, Orchard enters into digital rights agreements with less than world-wide distribution rights, which it factors into the contractual terms with the content owner.

Orchard makes its music content available at leading digital music retailers and mobile services that currently collectively offer digital music for sale in more than 30 countries. For the six months ended June 30, 2007 and the year ended December 31, 2006, approximately 76% and 77%, respectively, of Orchard's revenue was generated in the United States, with the remaining 24% and 23%, respectively, coming from digital music retailers serving customers outside the United States.

Content Processing and Operations

Orchard distributes its music content through similar digital music retailers at similar terms as DMGI. Currently, no customer accounts for more than 10% of Orchard's revenues other than Apple iTunes and eMusic (an affiliated company under common ownership with Orchard), which accounted for 51% and 12% in 2006, 45% and 14% in 2005, 45% and 4% in 2004 and 53% and 11% in the six months ended June 30, 2007, respectively, of Orchard's total revenue for such periods.

Orchard has developed a proprietary system to receive and process, store, manage and deliver content to digital music retailers and other digital entertainment services. This infrastructure is called V.E.C.T.O.R. (Very Efficient Conduit To Our Retailers), which is used for content delivery to both Internet-based and mobile-based retailers. As of July 31, 2007, V.E.C.T.O.R. was integrated directly with content management systems of 43 Internet retailers and 34 mobile (i.e., cellular telephone) retailers and Orchard intends to continue to add digital entertainment services over time. Even taking into account the full integration of all of DMGI's music, audio and video assets into Orchard's production systems, Orchard does not currently anticipate any constraints with respect to ingestion, storage or delivery in the next two years. Further, because many of the Internet-based retailers use their content management systems to support multiple digital music retail storefronts, Orchard can automatically deliver to over 175 such storefronts.

Of Orchard's 43 Internet retailers currently supplied by V.E.C.T.O.R., 28 operate in the United States, 14 in Europe, and one in China. For the 34 mobile retailers, 15 operate in the United States, two in Canada, two in Asia and the remaining 15 operate in the European Union. From February through June 2007, Orchard provided a total of 15.6 million deliveries via V.E.C.T.O.R., and V.E.C.T.O.R. supported an average of over 260,000 daily deliveries during June 2007.

In July 2007, Orchard added an automated mobile retail delivery component to V.E.C.T.O.R.. This addition not only reduced the labor cost associated with mastertone and full track delivery to mobile retailers, but

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also reduced time-to-market. Orchard believes that its proprietary V.E.C.T.O.R. delivery system has had a positive impact on label relations with its content owners and the digital entertainment services it supplies by reducing time to market considerably, which has enabled Orchard to ensure that new releases from labels become available on the Internet in conjunction with the physical product release. Orchard believes that meeting this deadline (typically referred to as a music recording's release date) has a positive impact on sales of those recordings.

Orchard intends to launch a proprietary video delivery component of V.E.C.T.O.R. by the end of the fourth quarter of 2007, with the goal of managing all video deliveries internally without reliance on third-party technology providers, unlike most of its competitors. Orchard believes that this should provide DMGI with a comparative advantage with respect to its larger current video catalog.

Artist/Label Client Management

Orchard works closely with its independent record label clients to manage the scheduling, production, delivery and marketing of music recordings. Orchard believes it provides a high level of personalized service and attention to its label clients and views services as a priority and as a strategic advantage. Orchard considers that its focus on service is a key factor behind its ability to achieve and maintain licensing terms that it believes to be more attractive than the industry average.

Orchard seeks to maximize sales by meeting its record label clients' product release dates with wide availability and visibility across its global network of digital and mobile entertainment service partners. Orchard accomplishes this through frequent communication with its label clients to obtain regular updates on release schedules, marketing plans for priority products, digital-only and/or bonus content, overall expectations regarding sales, and expectations regarding promotional and programming opportunities.

Orchard maintains a company-wide product release schedule that is reviewed internally each week to identify new priorities and targets. This includes, for a given release, levels and types of placements expected across digital music stores by region, top online press outlets to solicit for reviews and features, potential for SMS codes and ringtones, opportunities for master recording placement in film, TV and commercial programs, and the like. The schedule is also used to review the progress of previously identified priorities and targets (for example, SoundScan data regarding total album/track sales and the ratio of physical to digital sales, digital music service provider placements and promotions achieved, online press coverage secured, and the like) and to make timely adjustments where needed.

In order to adequately manage time, resources and expectations with regard to the sales and performance of a given product, both internally and externally, Orchard engages with its independent record label contacts to review factors such as an artist's previous sales history, the initial outlay of a release (i.e., the amount of physical product delivered into retailers) and the distribution of physical units by market, significant past press achieved, the label's marketing budget, and whether any third parties have been hired to handle press, public relations, or radio promotion. After taking all of these factors into account, and subject to the relevant label's approval, Orchard devises and manages an overall digital marketing plan. Achievements in the form of digital music service merchandising placements or promotions, which Orchard captures in the form of screenshots that are available to its label clients online via the client's online account interface, are typically relayed to clients the same day they originate on digital music service retailers. Achievements in the form of online press, reviews, blog entries, stream and/or MP3 postings are typically relayed to record label clients in the form of bi-weekly or monthly reports, although major wins are relayed on the same day they occur.

Orchard also serves to advise its independent record label clients on new digital and mobile outlets that come online within Orchard's distribution network, to monitor delivery and availability status of catalog (i.e., compliance checks), and to assist its labels in analyzing sales data. The majority of this information is also available to its label clients in the client's online account interface.

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Orchard provides a wide array of hands-on support functions and value-added services related to retail digital sales for its artist and label clients, including:

Label Set-up/Account Management. From the inception of a new label's contractual relationship with Orchard, Orchard initiates a detailed checklist of new label set-up and orientation services, to ensure that the label has an assigned representative, that all basic administrative and royalty information is correctly configured in its systems, and that the label receives a formal welcome email detailing instructions for the initial shipment of product.

Release Management. Once Orchard receives a delivery of master recordings or video—whether new releases or catalog—Orchard institutes a thorough metadata diagnostic and, subsequently, accurate metadata is built and uploaded into Orchard's system to ensure track information is in the order and format as required at each digital entertainment service. Orchard works with the content owner to produce solicitation materials and marketing plans to maximize the retail merchandising for each release and to drive sales. When Orchard signs a large, historically significant catalog of releases, Orchard builds custom compilations, catalog onesheets, and other marketing tools to reintroduce the catalog to digital music service providers.

Label Communication. Orchard's goal is to provide fast and reliable written, email and phone support 10 hours a day, 5 days a week with a target of responding to all correspondence within 24 hours met at a greater than 95% success rate. Managing music catalogs from across the globe, Orchard customer service representatives have, as a group, fluency in numerous languages. Orchard also produces a bi-monthly client newsletter, updating its record label clients on new digital entertainment service signings, promotional opportunities and new business opportunities.

Prospective Label & Non-client Communication. Orchard receives hundreds of items of general correspondence each week, ranging from prospective new labels to inquiries about releases it distributes. Orchard filters all new label submissions via a proprietary online tool, evaluates the viability of each request for distribution services, and interacts with prospective content owners through the contract review and pre-signing period, answering questions, and providing information about Orchard's services and value proposition.

Custom Compilations. Orchard assembles both promotional and commercial compilations highlighting developing artists and artists performing at vital industry music festivals (such as the South by Southwest Music Festival held annually in Austin, Texas). Compilations are a valuable tool to drive album sales and awareness for emerging artists, catalog titles, music from other countries, and the like.

Orchard Live Club Nights. Orchard coordinates, produces and records live a monthly club night to feature developing artists and artists with priority new releases. These events raise awareness about the acts within the industry at large, and help connect bands, press, radio and live music specialists with Orchard to maximize the awareness a particular artist has generated and further it with music industry gatekeepers.

Art Production. Orchard creates, converts and performs creative layout for a variety of marketing tools, marketing collateral, album artwork, social networking sites and both traditional and digital Point of Purchase items.

Label Relations Technology. Orchard has developed a variety of proprietary label relations technologies. Orchard intends to launch the next product generation of its existing business-to-business website, entitled Artist Label Workstation (ALW) during the second half of 2007. The ALW, available to all Orchard distributed clients, is expected to house all administrative aspects of release and account management, new tools for efficient and interactive engagement between record label and Orchard staff, and a streamlined and

flexible new royalty monitoring system with a suite of marketing analysis tools.

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Distribution and Marketing

Like DMGI, Orchard distributes its music content to leading digital entertainment services worldwide. Orchard believes it has strong business relationships with Apple iTunes and other digital entertainment services to which it provides content. Historically, certain of Orchard's distributed content has received premium placement on digital entertainment services, and Orchard intends to continue to work closely with its distribution partners to achieve optimum placement and drive sales.

The flexibility of the digital format allows Orchard to market its music content in creative ways by mixing-and-matching its individual recordings to create new digital music albums. With this flexibility, Orchard is able to offer a variety of its music content in new compilation albums to attract consumers of a particular lifestyle or age group or related to an event type, holiday or live music concert, by way of example.

Orchard markets and distributes audio and video content across a range of digital entertainment outlets, which in turn sell and promote content to consumers. Many of these retail partners operate across multiple business models and as the market develops, the business models, in turn, evolve. The business models of Orchard's digital entertainment service partners include (but are not limited to):

A-la-carte download services on the Internet. These digital entertainment services offer consumers the ability to download individual recordings or albums for permanent use for a fixed price. Example services include iTunes, Urge, Zune, Virgin, and Musicload. In such models, Orchard typically receives either a fixed wholesale price per track or album downloaded, or a percentage of the consumer retail price.

Subscription download services on the Internet. These services offer consumers the ability to download up to a certain number of recordings each month for a fixed subscription fee. Example services include eMusic, an affiliate of Orchard. In such models, Orchard typically receives a percentage of the total revenue pool generated by the service, after costs and deductions, based on Orchard's share of total downloads in the service during the billing period.

Subscription streaming services on the Internet. These services offer consumers the ability to stream unlimited content on their computers for a fixed monthly fee. Example services include Napster, Rhapsody and Yahoo! Unlimited. In such models, Orchard typically receives a percentage of the total revenue pool generated by the service, after costs and deductions, based on Orchard's share of total streams in the service during the billing period.

To-go subscription services on Internet. These services offer consumers the ability to carry unlimited quantities of content on portable devices for a fixed monthly fee. On termination of the subscription, the files on the portable devices expire and the consumer no longer has access to that content. Example services include Napster and Rhapsody. In such models, Orchard typically receives a percentage of the total revenue pool generated by the service, after costs and deductions, based on Orchard's share of total tracks played by consumers on their devices during the billing period.

A-la-carte full track download on mobile. These services offer consumers the ability to download individual music recordings or albums over wireless networks onto mobile devices for permanent use for a fixed price. Some services allow consumers to download the tracks purchased on their mobile device to computers. Example services include Verizon, Sprint, 3 and Orange. In such models, Orchard typically receives either a fixed wholesale price per track or album downloaded, or a percentage of the consumer retail price.

Full track subscription on mobile. These services offer consumers the ability to download unlimited music content on their mobile devices for a fixed monthly fee. The content remains live on their devices for the period their subscription is active. Example services include Jamba, Napster and eMusic. In such models, Orchard typically receives a percentage of the total revenue pool generated by the service, after costs and deductions, based on Orchard's share of total plays in the service during the billing period.

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A-la-carte mastertones on mobile. These services offer consumers the ability to download unlimited mastertone content to their mobile device. Example services include Verizon, Sprint and 9 Squared. In such models, Orchard typically receives either a fixed wholesale price per mastertone downloaded, or a percentage of the consumer retail price.

A-la-carte ringback tones on mobile. These services offer the consumer the ability to rent the mastertones that callers hear for a fixed price. The music is streamed over the mobile provider's network. Example services include Verizon, AT&T and T Mobile. In such models, Orchard typically receives either a fixed wholesale price per mastertone downloaded, or a percentage of the consumer retail price.

Direct-to-consumer mastertone via SMS. These services offer consumers the ability to purchase mastertone downloads by texting a keyword to a pre-defined SMS shortcode. Consumers are then billed on an a-la-carte basis. Example services include 9 Squared. In such models, Orchard typically receives either a fixed wholesale price per mastertone downloaded, or a percentage of the consumer retail price.

A-la-carte mastertone via Internet. These services offer consumers the ability to purchase mastertones from Internet websites from which consumer can then have the mastertone delivered directly to the consumers' mobile device. Example services include 9 Squared and Thumplay. In such models, Orchard typically receives either a fixed wholesale price per mastertone downloaded, or a percentage of the consumer retail price.

Streaming radio to mobile devices. These services offer consumer the ability to stream programmed radio stations directly to their mobile device. Example services include Mobzilla. In such models, Orchard typically receives a percentage of the total revenue pool generated by the service, after costs and deductions, based on Orchard's share of total plays in the service during the billing period.

Advertising supported models. These services offer consumers the ability to stream content without cost, in exchange for consumers being exposed to advertising. Example services include Qtrax and Spiral Frog. In such models, Orchard typically receives a percentage of the total advertising revenue pool generated by the service, after costs and deductions, based on Orchard's share of total plays in the service during the billing period.

Orchard seeks to maximize revenue across its digital entertainment service partner network by endeavoring to increase the availability and visibility of its distributed content across these various business models. Other objectives include creating and executing retail marketing plans for key labels, artists and releases and providing feedback for the same, analyzing retail promotions and trends to create a better understanding of what drives sales at digital retail, and selecting the right niche services specialized in a particular geography or genre (e.g., a reggae service).

Orchard promotes to its global network of digital entertainment services by maintaining relationships at a local level. Orchard manages marketing staff or representatives based in major music markets like the United States, the United Kingdom, France, Germany, Italy, Spain, Argentina and Australia, and promotes a combination of both local and global priorities in each market to ensure a global marketing solution for its independent record label clients. Orchard employs a wide array of tools in the process of marketing to its global network of digital entertainment services that include:

Securing exclusives, pre-orders, bonus content and the like to ensure that Orchard's digital entertainment service partners have appropriate incentives to promote specific releases or tracks;

Managing weekly newsletters customized for individual digital music stores highlighting priority releases to feature, and offering monthly release schedules to assist such stores in planning longer-term promotions;

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Developing theme-, event- and concept-based playlists to integrate into radio stations, playlists and larger retail features, and celebrity playlists that utilize celebrities to promote Orchard content at retail platforms;

Creating listening packages to make it easier for programming decision-makers to listen to Orchard content;

Offering programmers access to live shows and facilitating at-location listening sessions for key programmers and editors; and

Conducting regular in-person meetings with key programming decision makers at most major digital entertainment service partners. Orchard also works closely with certain content owners to market their music and video content directly to consumers, who will then be encouraged to purchase this content at digital entertainment services. Orchard also experiments with new ways to market its music catalog directly to consumers. For example, Orchard controls the SMS short-code **INDIE** for the U.S. market and is using this short-code to deliver content directly to consumers via mobile devices. In addition, Orchard intends to continue to market its services to content owners through strategic advertising and media releases, attendance at trade shows, event sponsorships and the like.

For a select group of high priority releases, Orchard further coordinates online publicity and new media marketing and promotions to engage and capture consumers for its record label clients. Orchard proactively markets its music to online so-called **tastemakers** and **trendsetters** to increase exposure for its releases outside of digital retail, and believes strategically that a **push** approach (engaging these influencers proactively) is considerably more effective than the **pull** approach employed by many competitors. While Orchard's goal is to boost digital sales by generating awareness for the digital music recordings it is marketing, Orchard believes that all exposure for the artist benefits sales. Therefore, in certain cases, Orchard expands its marketing efforts to include tour marketing. As a result, artists and record labels distributing digital music through Orchard can often benefit from additional sales across concert tickets and physical recordings (compact discs). Orchard can serve as the equivalent of a record label hiring an outside online marketing agency, but rather than charge its label clients an additional fee Orchard provides its marketing services as added value that is covered within its higher-than-average distribution fee (premium service for a premium price).

At the beginning of each marketing campaign, Orchard holds an internal meeting to evaluate the potential success of a release so as to allocate the appropriate resources. Then, Orchard creates a marketing campaign outline that includes what Orchard will do for the record label, as well as what Orchard requires from the label to conduct an effective campaign. After Orchard reviews the outline with the label, it launches the campaign with a general press release about the project. Following this, Orchard solicits coverage on websites, carries out contests with lifestyle and media partners, schedules interviews with the artist, and adds tracks to podcasts and online radio, among other things. Orchard sends comprehensive reports (pitched, confirmed, coverage, screenshots) to its record label clients on a regular basis to keep them apprised of progress. The nature of Orchard's programs includes:

Online Publicity. Orchard pitches online media outlets for coverage such as editorial features, album reviews and interviews. The outlets include major music portals (e.g., AOL Music, Yahoo! Launch), niche blogs (e.g., Stereogum, Brooklyn Vegan), online counterparts of magazines (e.g., Spin.com, Blender.com) and social networking sites (e.g., MySpace and imeem).

Communication Tools. Orchard offers a range of communication products to generate interest about upcoming releases and catalog programs in order to secure album reviews, interviews, editorial features, news stories, in-studio sessions, live performance recordings and on-site video interviews, market-specific concert previews and reviews, and single track streams/downloads included in media sections, among other things. These products include, by way of example:

- (i) **Flashlight**[®]. Orchard's bi-weekly, editorially-driven tipsheet that is sent to over 850 editors and writers and features sections such as albums of the week, upcoming events, tracks of the week, **bubbling up** and a release schedule;

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- (ii) Blog Blitzes . Press releases emailed to targeted media upon launch of a marketing campaign, prior to the release date, on the day of release as well as for any notable news items moving forward (e.g., an album charting, a feature in a high-profile trade magazine and/or impressive TV appearances);
- (iii) Targeted pitches to individual sites. Most coverage comes from customized pitches to one site at a time; and
- (iv) Single track streams/downloads. Each campaign has a track available for free stream or download.

New Media Marketing & Promotions. Orchard offers additional marketing and promotion services to activate the existing fan base and build new audiences. These include, by way of example:

- (i) Full album streams. Orchard secures streams on high profile sites with mass appeal to expose the artist to a large group of music consumers;
- (ii) Download cards. Orchard coordinates printing download cards for its independent record labels, so that they can have a tangible way to promote their music to consumers. Download cards are custom designed, credit card-like products that have redemption codes on them to securely download music and video, and are sometimes executed in partnership with a targeted digital music service partner;
- (iii) Social networking promotions. Orchard provides interactive tools to put on the artist/release page to encourage sales. These range from embedded storefronts that users can place within their social networking pages (for example, a SNOCAP MyStore), to a banner that links to the artist or album page on a digital retailer selected by Orchard, from a variety of so-called widgets (i.e., a third party item that can be embedded into a web page) and other interactive tools to post on the page. The interactive tools provided by Orchard can also include an event demand widget, where fans vote on where they want the artist to play, or could include a text messaging digital chalkboard, where fans text in a message that immediately shows up in an area on the page;
- (iv) Contests and promotional giveaways. Orchard uses ticket giveaways for tour press, and third party promotional materials (such as T- shirts and MP3 players) to create awareness-generating events, such as contests with media partners;
- (v) Video premiers. Orchard secures exclusive, limited time video features with key websites that reach the artist s target demographic;
- (vi) Podcasts. Orchard uses podcasts to increase awareness and sales. For example, Orchard publishes a weekly Flashlight®-branded podcast, assists its label clients in creating artist or label-specific podcasts, and uploads tracks to the PodShow network (where podcast creators go to find tracks to use in their podcasts), among other things; and
- (vii) Online radio servicing. Orchard provides albums to a limited number of major online radio broadcasters (including AOL, Pandora, Yahoo! LAUNCHcast, Last.fm).

Other Services

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Orchard provides a full array of non-retail services to its label clients as well as its digital entertainment service partners. Orchard believes that these non-retail services not only maximize revenue through non-traditional models, but also provide key marketing exposure to artists and labels, simplify labels' administrative tasks, increase the value of Orchard to its clients and partners, and diversify revenue streams. Orchard's non-retail services include:

Master Placement for Synchronization Use. Orchard proactively markets its labels' content for use in film, television, advertising, video games, and a variety of other interactive and audiovisual uses (so-called "synchronization"). In the past year, Orchard has secured hundreds of placements, including

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commercials for Jaguar, Target and British Airways; films such as John Tucker Must Die, Grindhouse, and Flushed Away; and TV shows such as CSI: Miami, Dexter, and Sleeper Cell. Orchard currently engages daily with major film and television studios and top advertising agencies. Fees are wide ranging, from \$1,000 for a short film to \$150,000 and above for a major advertisement. Of this fee, Orchard generally retains 30-50%. Orchard believes that it is uniquely positioned in the market due to its deep catalog, wide genre variety, and large amount of international music. Orchard represents content that is in demand and yet has been traditionally difficult for film, TV, and advertising producers to license. Orchard has positioned itself as a clearinghouse of independent and international rights, and is currently expanding its synchronization operations locally across the United Kingdom, Spain, Portugal, France, Switzerland, Germany, Greece, Israel, Argentina and Australia.

Mechanical Administration. Since 2005, Orchard has offered comprehensive mechanical licensing services to its independent record label clients and its licensing department helps these content owners to resolve complex domestic and international publishing issues. In order to sell content through downloads or mobile use in the United States, labels must obtain explicit clearance (often called a mechanical license) from the owner or administrator of the composition (often called the publisher), and must pay a mechanical royalty for every sale. These royalties for music recordings are a statutory rate in the United States of America, which was \$0.085 per music recording sold during 2005, and increased to \$0.091 in January 2006. Mechanical licensing can be complicated in the United States because there is no one consolidated body that administrates these licenses for all publishers, as there is in most other developed countries. Moreover, there is no one consolidated source of publisher ownership and administration data, which means that this information must be manually researched by a skilled publishing expert. Because of its expertise and knowledge in obtaining the required mechanical licenses, Orchard offers this service to its label clients. As licensing agent, Orchard obtains and administers mechanical licenses on behalf of its clients, permitting them to reduce costs and facilitate getting more content available for sale. Orchard believes this non-retail service is especially useful for labels based outside the United States, where copyright laws are different and often do not mandate song-by-song licensing. Orchard typically charges an administrative fee of 15% of the royalties paid to publishers on the artists or record labels behalf.

Royalty Collection. Another non-retail service Orchard offers its independent record label clients is the worldwide collection of neighboring rights. Neighboring rights are royalties generated whenever a recording is broadcast through radio, TV, or the Internet (though in the United States they are limited to digital mediums such as satellite radio). These royalties are owed to the owner of the sound recording as well as the artists who performed on the recording. In each territory, broadcasters pay a royalty to a local collecting body. Orchard offers a consolidated source to accumulate these royalties from the collecting bodies around the world. Based on IFPI data, global performance rights collections accounted for over \$728 million of record labels income in 2006, with the majority of the income generated outside of the United States. For this service, Orchard typically charges an administrative fee of between 15-20% of royalties collected.

Publishing Administration. Orchard has begun to acquire music publishing rights, comprised of exclusive rights of administration, and in some cases ownership, of musical compositions. For its publishing catalogs, Orchard will administer all licenses and collect all royalties (such as mechanical, including from sales of physical CDs, public performance and synchronization royalties), and endeavor to grow the value of the catalog, particularly through synchronization exploitation. Orchard benefits doubly from synchronization licenses, first from the synchronization license fee, and second from the collection of related performance royalties generated from TV broadcasts of the licensed programs. Orchard believes that it is uniquely positioned to locate and acquire rights to catalogs of up-and-coming artists and identify potential hits in their infancy. This is a new activity for Orchard, but it anticipates charging a fee of 15% for administering the licenses and collecting royalties, and between 30-50% for synchronization licenses.

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Licensing and Publishing Services. Orchard offer its licensing and publishing expertise to its digital entertainment service partners as well as its independent record label clients. The rapidly evolving digital music industry fosters many retail innovations that often outpace standard licensing practices and create complex rights issues. Orchard offers its services to act as an agent and negotiate and administer licenses on behalf of a digital entertainment service. Many rights issues arise between the United States and the other territories because of very different copyright laws. Orchard believes that its hands-on expertise in this area and international presence place it in a favorable position to assist clients in resolving these issues. As there is no one consolidated source of publishing and songwriter information, the data that Orchard has collected on its distributed catalog is valuable and can be sold to any retail service which has licensed Orchard's catalog and is obligated to obtain publishing clearances of any kind. As of August 2007, Orchard had developed a publishing database of almost 350,000 unique music recordings. Orchard utilizes its position, as a rights clearinghouse and network to over 10,000 record labels and 40,000 artists, to fulfill special bulk licensing needs, including providing pre-negotiated/pre-cleared content for synchronization uses (uses that otherwise must be negotiated individually on a song-by-song basis). Orchard charges for this service based on the scope of the project or amount of data to be delivered.

Special Products. Orchard provides turnkey direct-to-consumer mobile and Internet delivery services and solutions to brands and advertising agencies, enabling them to incorporate digital music into their marketing and promotional initiatives. Orchard believes that this allows its clients to increase retail sell-in and improve merchandise positioning, entice consumers with a call to action, catalyze deep brand engagement at the point of sale, program placement of music recordings and mastertones on the digital retail storefronts that reside on mobile handsets, and collect consumer information for future sale, among other benefits. Orchard has a wide array of premium digital content applicable to different customer demographics and it has structured direct-to-consumer content delivery relationships to allow over-the-air mobile delivery, Bluetooth location based delivery and Internet download redemption technology, among other types of product offerings.

Global Operations

Orchard has developed a global organization of employees, consultants and companies that not only source local repertoire within their local territories for distribution by Orchard, but also expand and service Orchard's network of digital entertainment service partners and provide ancillary Orchard services and products with their local territories. Orchard currently has agents or employees in over 25 countries worldwide.

Competition

Orchard competes along two lines; first, with respect to content owners choosing, in the first instance, to use a third party for distribution and marketing services with respect to digital sale of their content (as opposed to striking direct deals with digital entertainment outlets); and second, with other third-party providers of similar types of distribution services. Numerous companies compete to acquire digital rights to music and video content, including, among others, DMGI, Independent Online Distribution Alliance (IODA), ONEDigital/InGrooves, IRIS, Vital/PIAS, Believe, Zebralution, edelNet and the independent label distribution subsidiaries of the four major record label groups (i.e., Red-Sony/BMG, Fontana-Universal Music Group, Caroline-EMI Recorded Music and ADA-Warner Music Group). Orchard also competes with these entities when its existing distribution agreements expire and are subject to renewal. Orchard competes for distribution rights on the basis of payment terms, processing services, marketing ability, reporting services and other products and services it offers to content owners. Orchard is unable to anticipate which other companies are, or are likely to be, seeking to secure digital distribution rights to the same music recordings Orchard may seek to license.

There are currently over five million music recordings available at Apple iTunes. Orchard competes at Apple iTunes and other digital music services for consumers' attention and their download and subscription expenditures with the four major labels, which major catalogs together represent, as of the end of 2006,

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approximately 72% of the current U.S. recorded music market (as per The American Association of Independent Music) In addition, Orchard competes for consumers' expenditures with the independent content owners that place their music recordings in digital music services either directly or through third-party aggregators. The music recordings for which Orchard has digital distribution rights in the U.S. and European markets are generally not current mainstream and popular hits in those markets, like those held by the major labels and certain independent labels. The four major record label groups and select independent labels have superior brand recognition, longer operating histories and greater financial, marketing and other resources than Orchard, and may be able to enter into strategic or commercial relationships with the digital music retailers and mobile services that are competitively beneficial to them. The major label groups particularly, by the sheer size and popularity of their catalogs, often demand and may receive preferential terms. Likewise, Orchard secures digital rights to video content from independent owners and may be competing against content made available from large studios. These companies often have content with better brand recognition and greater ability to enter into favorable strategic and commercial relationships with digital entertainment services.

The market for digital music and video content is currently a small but growing percentage of total revenue from the sale of such content. The compact disc and digital video disc remain the predominant media for music and video distribution, although like DMGI, Orchard believes both the recorded music and video industries are transitioning from physical formats to digital formats. Orchard believe that the market share attributable to digital distribution will increase and digital formats will ultimately become the preferred way consumers experience music and video.

New technological requirements are evolving for the digital distribution of video content and existing technologies for digital music distribution continue to be refined and expanded. Other companies may have better, more efficient and cost effective processing capabilities that may also increase competitive pressures on us in the future. The established physical distributors may be able to leverage their physical distribution offering (which is still important to content owners, as physical formats still predominate) to force content owners to also grant digital distribution rights to them and may be tying their primary owned label business with their independent distribution businesses to secure more favorable rates for their independent distribution business.

Intellectual Property

Orchard relies on a combination of trade secret, copyright and trademark laws in the United States and other jurisdictions, as well as confidentiality provisions and contractual restrictions, to protect its proprietary rights, including its know-how.

The Orchard, Flashlight and The Orchard logo design are registered as Service Marks on the Principal Register of the U.S. Patent & Trademark Office. The Orchard is also a registered mark in Benelux. In addition, Orchard uses the following trademarks, which Orchard has not yet attempted to register nor researched registrability: SoundBrands, Digital Vinyl, Trackdown, V.E.C.T.O.R., Re:Live, OPP (Orchard Promo Program), Blog Blitzes and Selector Series.

Employees

As of July 17, 2007, Orchard had 68 full time employees. Among these employees, four were senior management, 26 were in marketing and business development, 22 were in administration and 16 were in engineering and operations.

Properties

Orchard occupies approximately 13,600 square feet of office space at 100 Park Avenue in New York, New York, under a lease agreement that expires on January 30, 2009. In addition, Orchard maintains a small suite of offices at 25 Floral Street, Covent Garden, London pursuant to a license having an automatic renewal every two months.

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Legal Proceedings

Orchard is involved in legal proceedings from time to time in the ordinary course of its business. Management of Orchard does not believe that any of these claims and proceedings against Orchard is likely to have, individually or in the aggregate, a material adverse effect on its consolidated financial condition or results of operations.

Other Information

Orchard's principal executive offices are located at 100 Park Avenue, 2nd Floor, New York, NY 10017 and its telephone number at that location is (212) 201-9280. Orchard's website is located at www.theorchard.com. The contents of Orchard's website are not incorporated by reference in this proxy statement.

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The following table sets forth selected historical consolidated financial information of Orchard for the periods presented. The selected financial information as of December 31, 2004, 2005 and 2006, and for each of the years then ended, has been derived from Orchard's audited consolidated financial statements. The selected financial information as of December 31, 2003 and for the year then ended is unaudited. The selected financial information as of June 30, 2007 and 2006 and for the six months then ended has been derived from Orchard's unaudited condensed consolidated financial statements, which include, in the opinion of Orchard's management, all adjustments, consisting of normal recurring adjustments, necessary to present fairly the results of operations and financial position of Orchard for the periods and dates presented. The results of operations for an interim period are not necessarily indicative of results for the full year or any other interim period. This financial information and other data should be read in conjunction with the respective audited and unaudited financial statements of Orchard, including the notes thereto, and THE COMPANIES The Orchard Enterprises Inc. Management's Discussion and Analysis of Financial Condition and Results of Operations beginning on page 101 of this proxy statement and Orchard's audited consolidated financial statements for the years ended December 31, 2006, 2005 and 2004 and Orchard's unaudited condensed consolidated financial statements for the six months ended June 30, 2007 and 2006, which are included elsewhere in this proxy statement.

Applicable SEC rules require that we provide selected financial data relative to Orchard for each of the last five fiscal years. However, Orchard has been unable to compile such data for the year ended December 31, 2002, which was prior to the controlling investment in Orchard by Dimensional, because reliable supporting documentation is not available and could not be located for this time period or recreated without unreasonable effort and expense. As the legitimate digital music industry did not emerge until 2003, DMGI and Orchard believe that the four and one-half years of financial data presented adequately highlight the significant trends in Orchard's historical financial condition and results of operations and the omission of selected financial data for Orchard for the year ended December 31, 2002 does not have a material impact on the understanding of Orchard's financial results and condition and related trends.

	For the Six Months Ended		For the Year Ended December 31,			
	June 30,		2006	2005	2004	2003
	2007	2006	Amount	Amount	Amount	Amount
Statement of Operations Data:						
Revenues	\$ 11,987,265	\$ 6,382,405	\$ 14,918,135	\$ 6,820,378	\$ 1,981,883	\$ 402,399
Costs of revenues	8,613,787	4,881,882	10,717,017	5,277,958	1,497,430	489,262
Gross profit (loss)	3,373,478	1,500,523	4,201,118	1,542,420	484,453	(86,863)
Operating expenses	5,158,866	4,300,991	9,782,737	5,367,147	3,828,453	1,564,372
Loss from operations	(1,785,388)	(2,800,468)	(5,581,619)	(3,824,727)	(3,344,000)	(1,651,235)
Other expense, net	406,873	182,918	387,341	473,942	272,551	65,007
Net loss	\$ (2,192,261)	\$ (2,983,386)	\$ (5,968,960)	\$ (4,298,669)	\$ (3,616,551)	\$ (1,716,242)

	June 30,	2006	December 31,	2004	2003
	2007		2005		
Other Data:					
Cash and cash equivalents	\$ 3,127,145	\$ 1,675,889	\$ 21,866	\$ 239	\$
Working capital deficit	(11,953,688)	(9,456,271)	(10,768,269)	(6,375,082)	(2,651,587)
Total assets	10,358,667	6,541,778	2,325,049	580,648	138,599
Convertible debt payable to a related party	10,700,000	6,600,000	7,931,000	5,066,000	2,110,000
Accumulated deficit	(18,683,155)	(16,490,894)	(10,521,934)	(6,223,265)	(2,606,714)
Stockholders' deficiency	(10,683,891)	(8,485,235)	(10,520,120)	(6,222,568)	(2,606,714)

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Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of Orchard's financial condition and results of operations should be read in conjunction with Orchard's consolidated financial statements and related notes appearing elsewhere in this proxy statement. This discussion contains forward-looking statements, the accuracy of which involves risks and uncertainties, see FORWARD-LOOKING STATEMENTS beginning on page 23. Orchard's actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by Orchard described in RISK FACTORS beginning on page 8.

Overview

Background and Basis of Presentation

The Orchard Enterprises Inc., or Orchard, was incorporated in New York in September 2000 and is a leading global digital distributor and marketer of music. As of June 30, 2007, Orchard had over 600,000 individual music recordings, or tracks, for sale. Additionally, Orchard estimates it currently has under license, but has not yet made available, a substantial number of additional tracks. Orchard currently has agents and employees in over 25 countries and controls a catalog sourced from over 75 countries, covering thousands of independent record labels, and a broad and deep array of music genres and eras. Orchard supplies music and video to the leading digital music stores and mobile operators throughout the world, and executes global marketing and promotion programs locally, with experts in major music territories managing initiatives tailored to each country's unique dynamic situation. Orchard believes that it has changed traditional notions of distribution by pioneering a broad suite of client services in addition to its primary music distribution and marketing business and considers as a competitive differentiator the degree to which the company works as a close business partner with its content owners.

On April 28, 2003, Dimensional Associates, LLC, or Dimensional, an entity formed by a group of private investors, invested in and acquired operating control of Orchard through the purchase of a convertible debt instrument followed by subsequent periodic funding events under the same terms and conditions as the original convertible debt instrument. These debt instruments are described below in Liquidity and Capital Resources Description of Indebtedness and in Note 9 to Orchard's audited consolidated financial statements appearing elsewhere in this proxy statement. Orchard's consolidated financial statements include its accounts, and those of its wholly-owned subsidiaries, Orchard Management, Inc. and Orchard EU, Limited.

Significant Customers

Since inception through June 30, 2007, Orchard's revenue has been derived primarily from the distribution of digital music content. Two customers, iTunes and eMusic, account for a significant portion of Orchard's total revenue and its accounts receivable. Orchard and eMusic are both owned by Dimensional. Revenue from iTunes represented 53%, 51%, 45% and 45% of total revenue and revenue from eMusic represented 11%, 12%, 14% and 4% of total revenue for six months ended June 30, 2007 and for the years ended December 31, 2006, 2005 and 2004, respectively. Accounts receivable from iTunes were 28%, 35%, 31% and 31% of total accounts receivable at June 30, 2007, and at December 31, 2006, 2005 and 2004, respectively. Accounts receivable from eMusic were 15%, 15%, 20% and 12% of total accounts receivable at June 30, 2007, and at December 31, 2006, 2005 and 2004, respectively.

Sources of Revenues

Orchard's digital music revenue is derived from the following sources:

Permanent downloads. In aggregate terms, Orchard's permanent download revenue is driven by the number of music recordings it has available for downloading at digital music retailers, multiplied by the average number of times its music recordings are downloaded, multiplied by the fee paid to Orchard by each retailer. The download rates for Orchard's music recordings are driven primarily by the overall size

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and growth of the digital music market, the popularity and demand for the recordings it makes available, the number and nature of the digital music services through which it makes the recordings available to consumers, and Orchard's territorial distribution rights. Orchard negotiates the fee it receives per download in advance at the time it enters into an agreement with a digital music retailer. Under Orchard's agreements with Apple iTunes, it currently receives \$.70 per download for distribution in the United States and up to approximately \$.98 (at current exchange rates) per download for distribution outside the United States. The overall average download rate paid to Orchard by all digital music retailers was approximately \$0.74, \$0.73, \$0.70 and \$0.65 for the six months ended June 30, 2007, and for the years ended December 31, 2006, 2005 and 2004, respectively.

Subscription download services on the Internet. Orchard also generates revenues from services that offer consumers the ability to download up to a certain number of recordings each month for a fixed subscription fee. Example services include eMusic, an affiliate of Orchard. In such models, Orchard typically receives a percentage of the total revenue pool generated by the service, after costs and deductions, based on Orchard's share of total downloads in the service during the billing period.

Subscription streaming fees. Certain digital music retailers distribute Orchard's music recordings on a subscription basis. Orchard's subscription revenue is a percentage of each retailer's total subscription revenue based on the number of times Orchard's music recordings are listened to by subscribers as compared to the total for all music recordings listened to during the relevant time period, although the exact formulations by which Orchard's revenue is derived varies somewhat between services. Following the termination of their subscription, consumers are not able to play Orchard's music recordings.

Combined revenue from digital downloads and subscription fees comprised approximately 77.3%, 77.9%, 79.1% and 72.5% of Orchard's total revenue for the six months ended June 30, 2007, and for the years ended December 31, 2006, 2005 and 2004, respectively.

Mobile services. Approximately 8.2%, 5.0% and 1.4% of Orchard's revenue for the six months ended June 30, 2007, and for the years ended December 31, 2006 and 2005, respectively, was derived from mobile services. Orchard expects the sale of its music recordings through mobile services to become a more significant portion of its revenue in the future. Orchard's revenue from mobile services is derived primarily from downloads of full-length music recordings and ringtones/mastertones. Orchard received an average of \$0.92 and \$0.94 per full-length download and \$0.94 and \$0.91 per ringtone/mastertone, from its mobile service partners for the six months ended June 30, 2007 and for the year ended December 31, 2006, respectively. Most mobile services generally make available to consumers a limited selection of ringtones due to the limited space on mobile handset screens and higher per track processing costs related to the many formats that are required for various mobile handset makes and models.

Other. Orchard's other revenue is comprised mainly from licensing fees also referred to as music services, administrative and consulting fees and other sources such as technology-related servicing fees charged to certain digital music retailers.

Costs of Revenues

Orchard's cost of digital revenue consists of:

royalties to artists, record labels and other content owners; and

costs of outsourced encoding of digital files and digital delivery costs.

Orchard's costs of revenues and corresponding gross profit is determined by the revenue earned on its available music content. In Orchard's digital distribution agreements with content owners, which usually have terms of two to five years, Orchard receives revenue directly from the digital entertainment services and a negotiated revenue sharing percentage, which averages about 75%, is paid as a royalty to the content owner.

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Orchard is typically not responsible for any third party royalties (such as artists and publishers) and generally makes no upfront or fixed payments to the content owner at the time it enters into the agreement, although in certain instances, as an inducement to enter into a longer-term license agreement, Orchard may make a royalty advance against the content owner's share of future royalties. All such advance royalties are capitalized as a prepaid asset that is amortized as cost of revenue as the related revenue is earned and the cash advances are recouped. Orchard includes depreciation and amortization associated with equipment and computer software utilized by Orchard to digitally encode music files in costs of revenues. Orchard utilizes third parties from time-to-time to digitally encode music files into the specific formats required by digital entertainment services, and these costs are also included in costs of revenues. Also, any other third party costs directly associated with earning other revenue (such as delivery costs associated with receiving a digital delivery fee and royalties and commissions paid to secure synchronization placements) are charged to costs of revenues.

Operating expenses include all costs associated with general and administrative expenses, sales and marketing and product development in order to operate the business.

Seasonality

The early-stage nature of the entire digital distribution industry and Orchard's limited operating history have resulted in Orchard not being able definitively to identify seasonality in its business, although it suspects that the first and fourth quarters of the calendar year may have seasonally higher sales, just as this is the peak time for sales of music recordings in physical format (generally ascribed to increased consumer spending due to the holidays).

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures in the consolidated financial statements. Critical accounting estimates and assumptions are those that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance. Orchard bases its estimates and judgments on its experience and on various other factors that it believes to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. Orchard believes the following critical accounting policies used in the preparation of its consolidated financial statements require significant judgments and estimates. For additional information relating to these and Orchard's accounting policies, see Note 3 to its consolidated financial statements included elsewhere in this proxy statement.

Revenue Recognition and Assessing the Collectibility of Accounts Receivable

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

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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.

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 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.

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

Because Orchard receives payment at approximately the same time as it receives the detailed revenue reports, its accounts receivable therefore generally consists of approximately one month's revenue for digital entertainment services that report on a monthly basis and one quarter's revenue for digital entertainment services that report on a quarterly basis. In making estimates regarding the collectibility of its accounts receivable, Orchard's management considers the credit profile of its retailers, current economic trends, contractual terms and conditions, historic payment experience and known or expected events that may impact the retailer's ability to pay its obligations. Historically, Orchard has incurred minimal losses for bad debts, although this may not be the case in the future, and has recorded a bad debt allowance of \$75,387 at June 30, 2007 and \$70,000 at December 31, 2006.

Recoverability of Royalty Advances

Orchard pays advance royalties to certain record labels and artists and accounts for these advance royalty payments pursuant to the provisions of Statement of Financial Accounting Standards (*SFAS*) No. 50, *Financial Reporting in the Record and Music Industry* (*SFAS 50*). Pursuant to SFAS 50, certain advance royalty payments that are believed to be recoverable from future royalties to be earned by the content owner or its distributor are capitalized as assets. The decision to capitalize an advance to a content owner or its distributor as an asset requires significant judgment as to the recoverability of these advances. Orchard assesses the recoverability of these assets upon initial commitment of the advance based upon its 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 are assessed for recoverability periodically and, at minimum, on a quarterly basis.

Accounting for Income Taxes

Deferred income taxes result primarily from temporary differences between financial and tax reporting. Deferred tax assets and liabilities are determined based on the difference between the financial statement basis

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and tax basis of assets and liabilities using enacted tax rates. Future tax benefits are subject to a valuation allowance when management is unable to conclude that its deferred tax assets will more likely than not be realized from the results of operation. At each of the financial statement dates presented, Orchard recorded a full valuation allowance against deferred income taxes due to its limited operating history and net losses recorded since inception. Orchard's estimate for the valuation allowance for deferred tax assets requires Orchard's management to make significant estimates and judgments about its projected future operating results. If actual results differ from these projections or if Orchard's management's expectations of future results change, it may be necessary to adjust the valuation allowance.

Orchard has generated losses for federal and state income tax reporting since its inception in 2000. These tax losses are available for carryforward until their expiration in the years 2020 through 2027. In addition to potential expiration, there are other factors that could limit Orchard's ability to use its federal and state tax loss carryforwards. For example use of prior net operating loss carryforwards can be limited after an ownership change. Accordingly, it is not certain how much of Orchard's existing net operating loss carryforwards will be available for use by the combined company. In addition, Orchard (or the combined company) must generate taxable income in the future in order to use net operating loss carryforwards that have not expired.

Effective January 1, 2007, Orchard began to measure and record uncertain tax positions in accordance with FIN 48 *Accounting for Uncertainty in Income Taxes* (FIN 48) an Interpretation of FASB Statement No. 109. FIN 48 prescribes a threshold for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Only tax positions meeting the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of this Interpretation. FIN 48 also provides guidance on accounting for derecognition, interest and penalties, and classification and disclosure of matters related to uncertainty in income taxes. Accounting for uncertainties in income tax positions under FIN 48 involves significant judgments by management.

Long-Lived Assets.

Orchard evaluates long-lived assets, including license rights, under the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed of. Management reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable. In connection with this review, Orchard reevaluates the periods of depreciation and amortization. Orchard recognizes an impairment loss when the sum of the future undiscounted net cash flows expected to be realized from the asset is less than its carrying amount. If an asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value, which is determined using the projected discounted future net cash flows. Orchard measures fair value by discounting estimated future net cash flows using an appropriate discount rate. Considerable judgment by Orchard is necessary to estimate the fair value of the assets and accordingly, actual results could vary significantly from such estimates. Orchard's most significant estimates and judgments relating to the long-lived asset impairments include the timing and amount of projected future cash flows and the discount rate selected to measure the risks inherent in future cash flows.

Share-Based Compensation.

Orchard determined the estimated fair value of shares of its common stock issued to employees in return for services during 2006 with the assistance of an independent valuation specialist who performed a contemporaneous valuation. Determining the fair value of Orchard's common stock requires making complex and subjective judgments and is subject to assumptions and uncertainties. Orchard believes that, with the assistance of the unrelated independent valuation specialist, it has used reasonable methodologies, approaches and assumptions consistent with the American Institute of Certified Public Accountants Practice Guide, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* to determine the fair value of its common stock.

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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.

Internal Controls over Financial Reporting

In connection with the audits for the years ended December 31, 2004, 2005 and 2006, Orchard's independent auditors identified significant deficiencies in Orchard's accounting for fixed assets, its tracking and accounting for hard drives and Orchard's lack of a formal period-end accrual process that together constituted a material weakness. To remedy this material weakness, Orchard is in the process of or plans to:

hire both a Chief Financial Officer and Controller;

implement a fixed assets tracking system and maintain appropriate supporting documentation for fixed asset transactions;

implement a direct digital delivery system, minimizing the impact of hard drives on the financial statements; and

formalize its period-end financial close and reporting process to ensure that its financial statements include all necessary accruals.

In addition, in connection with the audit for the year ended December 31, 2006, Orchard's independent auditors identified significant deficiencies with respect to Orchard's procedures for the re-issuance of royalty checks as well as its journal entry process. To remedy these significant deficiencies, Orchard is in the process of, or plans to, formalize its processes and procedures around reissuing royalty checks to ensure that the original check is properly voided prior to re-issuing a new check as well as formalizing its journal entry process and implementing formal policies regarding the preparation, approval and recording of manual journal entries.

Factors Affecting Future Results

Orchard has incurred losses since inception and its ability to achieve profitability in the near term is primarily dependent on increasing revenue while controlling and limiting expenses at current levels. Some of the current industry conditions and factors that Orchard expects could have a significant impact on its future results are discussed below:

Factors impacting revenue and download rates for music content. Achieving profitable growth will require continued growth in the overall market for digital retail sales of music, video and other forms of media, and Orchard's ability to maintain a competitive suite of digital distribution and service offerings that will be attractive to independent record labels and other owners of digital media content. Like DMGI, Orchard expects continued competition from entrenched music distribution companies moving more aggressively into the digital sector (e.g., the distribution companies owned by the four major music companies), other independent distributors, and new entrants to the market. Orchard believes that its revenue and download rates for music content might be affected by a number of macro-factors, including:

Overall growth of the retail consumer market for digital music;

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Amount of additional digital music and video recordings that are made available to consumers from all sources and the impact on average sales that results from having an increasing amount of music and video content available within the retail channels;

The speed and efficacy with which new digital entertainment services – either through traditional a la carte downloads or subscription models, or new forms of music retail such as advertising-based or P2P models – enter and grow the market; and

The speed and efficacy with which digital music retailers invest on one hand in product enhancements that allow them to more dynamically serve music to targeted subgroups (*e.g.*, ethnic nationals living abroad) and, on the other hand, particularly with respect to mobile operators, integrate their sophisticated marketing segmentation and direct marketing capabilities more closely with demographically-based music marketing.

Gross profit. Orchard's gross profit is directly affected by its ability to negotiate favorable digital distribution agreements with record labels and other content owners. The current and future marketplace will continue to evolve and shape Orchard's ability to enter into new distribution agreements with content owners seeking to access the digital marketplace and renew existing agreements as they begin to expire. As more competitors enter this market and seek to sign similar agreements with content owners, this could adversely impact Orchard's gross profit.

Operating expenses. Orchard's operating expenses include all costs associated with general and administrative expenses, sales and marketing and product development in order to operate the business. These expenses increased in each of the past three years as Orchard added additional personnel dedicated to expanding its operations and broadening its product and service offerings. Orchard expects these costs to increase, however at a more moderate pace, through the remainder of 2007.

Business development. Orchard plans to continue to build its core music and video businesses by investing in establishing digital distribution relationships with additional record labels and content owners, showcasing top-tier global artists, and expanding its marketing capabilities. Orchard also plans to continue to develop its broad services platform, including:

Placement of master recordings for synchronization use in advertising, film and television programs;

Marketing and technology programs to service brands, consumer packaged goods companies and other businesses integrating music with their marketing objectives;

Mechanical licensing and administration of music publishing for digital sales in the United States; and

Collection of sound performance recording royalties globally, among other offerings.

Table of Contents**Index to Financial Statements****Results of Operations**

The following table sets forth items in Orchard's consolidated statements of operations as a percentage of revenue, as well as certain additional revenue and operating data for the periods indicated.

	For the Six Months Ended June 30,				For the Year Ended December 31,					
	2007		2006		2006		2005		2004	
	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue
Statement of Operations Data:										
Revenues	\$ 11,987,265	100%	\$ 6,382,405	100%	\$ 14,918,135	100%	\$ 6,820,378	100%	\$ 1,981,883	100%
Costs of revenues	8,613,787	71.9%	4,881,882	76.5%	10,717,017	71.8%	5,277,958	77.4%	1,497,430	75.6%
Gross profit	3,373,478	28.1%	1,500,523	23.5%	4,201,118	28.2%	1,542,420	22.6%	484,453	24.4%
Operating expenses	5,158,866	43.0%	4,300,991	67.4%	9,782,737	65.6%	5,367,147	78.7%	3,828,453	193.2%
Other (income) expense	406,873	3.4%	182,918	2.9%	387,341	2.6%	473,942	6.9%	272,551	13.8%
Net loss	\$ (2,192,261)	(18.3%)	\$ (2,983,386)	(46.7%)	\$ (5,968,960)	(40.0%)	\$ (4,298,669)	(63.0%)	\$ (3,616,551)	(182.5%)

	For the Six Months Ended June 30,				For the Year Ended December 31,					
	2007		2006		2006		2005		2004	
	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue
Key Revenue and Operating Data:										
Revenue by source:										
Downloads	\$ 7,012,357	58.5%	\$ 3,740,713	58.6%	\$ 8,653,957	58.0%	\$ 3,752,127	55.0%	\$ 1,209,557	61.0%
Subscriptions ⁽¹⁾	2,249,067	18.8%	1,454,765	22.8%	2,964,087	19.9%	1,641,140	24.1%	227,749	11.5%
Mobile services	983,671	8.2%	147,586	2.3%	741,898	5.0%	92,849	1.4%		0.0%
Physical	172,873	1.4%	288,378	4.5%	580,346	3.9%	415,923	6.1%	311,948	15.7%
Other	1,569,297	13.1%	750,963	11.8%	1,977,847	13.3%	918,339	13.5%	232,629	11.7%
Total	\$ 11,987,265	100.0%	\$ 6,382,405	100.0%	\$ 14,918,135	100.0%	\$ 6,820,378	100.0%	\$ 1,981,883	100.0%

Average number of music recordings available for downloading during the period	590,000		346,000		404,000		211,000		120,000	
Number of music recordings available for downloading at the end of the period	624,000		397,000		523,000		274,000		146,000	
Number of paid downloads during the period	9,425,000		5,193,000		11,926,000		5,350,000		1,861,000	
Average price per download (download revenue divided by number of paid downloads)	0.74		0.72		0.73		0.70		0.65	

(1) Includes subscription download services on the Internet, including revenues from Orchard's affiliate eMusic of \$1,316,823 and \$922,769 for the six months ended June 30, 2007 and 2006, respectively, and of \$1,783,140, \$981,864 and \$73,313 for the years ended December 31, 2006, 2005 and 2004, respectively.

Table of Contents**Index to Financial Statements*****Comparison of Six Months Ended June 30, 2007 to 2006***

Revenues. Revenues increased to approximately \$12.0 million for the six months ended June 30, 2007 from approximately \$6.4 million for the six months ended June 30, 2006. Revenue from digital distribution (including permanent downloads and subscription services) increased to approximately \$9.3 million in the first half of 2007 from approximately \$5.2 million in the first half of 2006, as a result of adding additional digital entertainment services, a more efficient distribution process, an increase in available content and increased volume across the digital service partners' consumer usage base. Revenue from licensing and music services (including placement of master recordings for use in film, television and commercials), administrative and consulting fees and other sources such as technology service fees charged to digital music retailers, increased to approximately \$1.5 million in the first half of 2007 from approximately \$0.8 million in the first half of 2006. Revenue from mobile distribution increased to approximately \$1.0 million in the first half of 2007 from approximately \$0.1 million in the first half of 2006 as a result of adding additional mobile stores, increased available content for our mobile channel partners and overall favorable industry trends. Distribution revenue from physical sales of music recordings decreased to approximately \$0.2 million in the first half of 2007 from approximately \$0.3 million in the first half of 2006, as a result of the overall industry trend of shifting from physical sales to digital music recording sales.

Costs of revenues. Orchard's costs of revenues increased to approximately \$8.6 million for the six months ended June 30, 2007 from approximately \$4.9 million for the six months ended June 30, 2006. Royalty expense to artists, labels and other content owners increased to approximately \$7.9 million in the first half of 2007 from approximately \$4.1 million in the first half of 2006, primarily related to the increase in overall revenues. During the six months ended June 30, 2007 and 2006, Orchard's royalties to artists, labels and other content owners amounted to 66% and 67% of revenues, respectively. The increase in royalties as a percentage of revenues is primarily due to a more competitive landscape in the digital distribution market. Costs of revenues includes digital encoding costs (both internal and outsourced) and delivery fees and other expenses, which remained relatively constant at approximately \$0.7 million in the first half of 2007 as compared to approximately \$0.8 million in the first half of 2006. Gross profit margin improved to 28% of revenues in the first half of 2007 from 24% of revenues in the first half of 2006, primarily because the increase in revenue from technology service fees and a decrease in the corresponding costs of revenues associated with technology service fees, attributable to Orchard performing digital encoding services in-house rather than outsourcing.

Operating expenses. The following table sets forth the individual components of operating expenses for the six months ended June 30, 2007 and 2006:

	For the Six Months Ended June 30,			
	2007	Percentage of Total	2006	Percentage of Total
	Amount		Amount	
General and administrative	\$ 3,072,880	59.6%	\$ 2,597,232	60.0%
Sales and marketing	1,979,020	38.4%	1,630,922	38.3%
Product development	106,966	2.0%	72,837	1.7%
Total	\$ 5,158,866	100%	\$ 4,300,991	100%

General and administrative expenses increased to approximately \$3.1 million for the six months ended June 30, 2007 from approximately \$2.6 million for the six months ended June 30, 2006, as a result of an increase of approximately \$0.8 million related to increased headcount and headcount-related costs, including approximately \$0.1 million related to increased headcount from our European office and other additions attributable to the continued expansion of our infrastructure to improve our overall distribution processes and systems and service additional content owners and digital entertainment services, partially offset by a decrease of approximately \$0.3 million in other expenses, primarily consulting-related expenses. Sales and marketing expenses increased to approximately \$2.0 million for the six months ended June 30, 2007 from approximately

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\$1.6 million for the six months ended June 30, 2006, as a result of approximately \$0.5 million related to increased headcount and headcount-related charges, partially offset by a decrease of approximately \$0.1 million related to lower marketing and promotions spending as a result of performing more of those functions in-house. Costs classified as product development expenses were approximately \$0.1 million for each of the six month periods ended June 30, 2007 and 2006.

Other (income) expense. Interest expense increased to approximately \$0.4 million for the six months ended June 30, 2007 from approximately \$0.3 million for the six months ended June 30, 2006, due to the issuance of additional convertible debt instruments to Dimensional. Orchard had no interest income in the first half of 2007 compared to nominal interest income in the first half of 2006. Orchard also generated approximately \$0.1 million of other income in the first half of 2006 as a result of the write-off of a disputed note payable and related interest.

Comparison of Years Ended December 31, 2006 and 2005

Revenues. Revenues increased to approximately \$14.9 million for the year ended December 31, 2006 from approximately \$6.8 million for the year ended December 31, 2005. Revenue from digital distribution (including permanent downloads and subscription services) increased to approximately \$11.6 million in 2006 from approximately \$5.4 million in 2005, as a result of adding additional digital entertainment services, a more efficient distribution process, an increase in available content and increased volume across the digital service partners' consumer usage base. Revenue from licensing and music services (including placement of master recordings for use in film, television and commercials), administrative and consulting fees and other sources such as technology service fees charged to digital music retailers, increased to approximately \$2.0 million in 2006 from approximately \$0.9 million in 2005. Revenue from mobile distribution increased to approximately \$0.7 million in 2006 from approximately \$0.1 million in 2005 as a result of adding additional mobile stores, increased available content for our mobile providers and overall favorable industry trends. Distribution revenue from physical sales of music recordings increased to approximately \$0.6 million in 2006 from approximately \$0.4 million in 2005, as Orchard licensed-in additional music content in 2006. However, the overall industry trend of shifting from physical sales to digital music recording sales continues and therefore Orchard expects distribution revenue from physical sales to continue to decrease as a percentage of its total revenue.

Costs of revenues. Orchard's costs of revenues increased to approximately \$10.7 million for the year ended December 31, 2006 from approximately \$5.3 million for the year ended December 31, 2005. Royalty expense to artists, labels and other content owners increased to approximately \$9.9 million in 2006 from approximately \$4.6 million in 2005, primarily related to the increase in overall revenue. During the years ended December 31, 2006 and 2005, Orchard's royalties to artists, labels and other content owners amounted to 66.2% and 67.5% of revenue, respectively. Other costs of revenues include outsourced digital encoding costs and delivery fees and other expenses, which increased to approximately \$0.8 million in 2006 from approximately \$0.7 million in 2005. Gross profit margin improved to 28.2% of revenue in 2006 from 22.6% of revenue in 2005, primarily because of the increase in revenue from technology service fees and a decrease in the corresponding cost of revenue associated with technology service fees. The lower cost of revenue associated with the technology service fees was attributable to lower negotiated rates due to a change in our service provider and a one-time fee concession of \$0.4 million from a digital encoding service provider.

Operating expenses. The following table sets forth the individual components of operating expenses for the years ended December 31, 2006 and 2005:

	For the Years Ended December 31,			
	2006		2005	
	Amount	Percentage of Total	Amount	Percentage of Total
General and administrative	\$ 6,537,087	66.8%	\$ 3,727,066	69.4%
Sales and marketing	3,126,707	32.0%	1,468,261	27.4%
Product development	118,943	1.2%	171,820	3.2%
Total	\$ 9,782,737	100.0%	\$ 5,367,147	100.0%

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General and administrative expenses increased to approximately \$6.5 million for the year ended December 31, 2006, from approximately \$3.7 million for the year ended December 31, 2005, as a result of an increase of approximately \$1.0 million related to increased headcount and headcount-related costs, approximately \$1.2 million related to professional fees and approximately \$0.6 million in other expenses, primarily consulting-related expenses. These increases were attributable to the continued expansion of our infrastructure to improve our overall distribution processes and systems and service additional content owners and digital entertainment services. Sales and marketing expenses increased to approximately \$3.1 million for the year ended December 31, 2006 from approximately \$1.5 million for the year ended December 31, 2005, as a result of approximately \$1.0 million related to increased headcount and headcount-related charges, approximately \$0.3 million related to marketing and promotions spending, and approximately \$0.3 million related to other expenses, primarily consulting and temporary employees and increased travel-related expenses. Product development expenses were approximately \$0.1 million and \$0.2 million for the years ended December 31, 2006 and 2005, respectively.

Other (income) expense. Interest expense was approximately \$0.5 million for both the year ended December 31, 2006 and 2005. Interest income was nominal for both periods presented. Other income was approximately \$0.1 million for the year ended December 31, 2006 from the writeoff of a disputed note payable and related interest for which the statute of limitations for the enforcement of the debt by the lender expired.

Comparison of Years Ended December 31, 2005 and 2004

Revenues. Revenues increased to approximately \$6.8 million for the year ended December 31, 2005 from approximately \$2.0 million for the year ended December 31, 2004. Revenue from digital distribution (including permanent downloads and subscription services) increased to approximately \$5.4 million in 2005 from approximately \$1.4 million in 2004, as a result of adding additional digital entertainment services, an increase in available content and increased volume across the digital service partners' customer usage base. Revenue from licensing and music services, administrative and consulting fees and other sources, primarily technology service fees charged to digital music retailers, as well as placement of master recordings for use in film, television and commercials, increased to approximately \$0.9 million in 2005 from approximately \$0.2 million in 2004. Orchard generated revenue of approximately \$0.1 million from mobile distribution in 2005, its initial year of providing this service. Orchard expects this trend to continue as mobile distribution revenue continues to grow in line with the overall industry. Distribution revenue from physical sales of music recordings increased to approximately \$0.4 million in 2005 from approximately \$0.3 million in 2004, as Orchard licensed-in additional music content in 2005. However, the overall industry trend of shifting from physical sales to digital music recording sales continues and therefore we expect distribution revenue from physical sales to continue to decrease as a percentage of our total revenues.

Costs of revenues. Orchard's cost of revenue increased to approximately \$5.3 million for the year ended December 31, 2005 from approximately \$1.5 million for the year ended December 31, 2004. Royalty expense to artists, labels and other content owners increased to approximately \$4.6 million in 2005 from approximately \$1.1 million in 2004, primarily related to the increase in overall revenue. During the years ended December 31, 2005 and 2004, Orchard's royalties to artists, labels and other content owners amounted to 67.5% and 57.2% of revenue, respectively. The increase royalties as a percentage of revenue is primarily due to a more competitive landscape in the digital distribution market. Other costs of revenues include outsourced digital encoding costs and delivery fees and other expenses, which increased to approximately \$0.7 million in 2005 from approximately \$0.4 million in 2004. This increase is due to the increased size of Orchard's catalogue as a result of an increase in number and size of labels distributed.

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Operating expenses. The following table sets forth the individual components of operating expenses for the years ended December 31, 2005 and 2004:

	For the Years Ended December 31,			
	2005	Percentage of Total	2004	Percentage of Total
	Amount		Amount	
General and administrative	\$ 3,727,066	69.4%	\$ 2,544,953	66.5%
Sales and marketing	1,468,261	27.4%	1,114,390	29.1%
Product development	171,820	3.2%	169,110	4.4%
Total	\$ 5,367,147	100.0%	\$ 3,828,453	100.0%

General and administrative expenses increased to approximately \$3.7 million for the year ended December 31, 2005 from approximately \$2.5 million for the year ended December 31, 2004, as a result of an increase of approximately \$0.7 million related to increased headcount and headcount-related costs, approximately \$0.3 million related to management fees and approximately \$0.2 million in other expenses, primarily consulting-related expenses and increased facilities-related charges. These increases were attributable to the continued expansion of our infrastructure to improve our overall distribution processes and systems and service additional content owners and digital entertainment services. Sales and marketing expenses increased to approximately \$1.5 million for the year ended December 31, 2005 from approximately \$1.1 million for the year ended December 31, 2004, as a result of approximately \$0.2 million related to increased headcount and headcount-related charges, approximately \$0.2 million related other expenses, primarily consulting and temporary employees and increases in travel-related expenses. Costs classified as product development expenses were approximately \$0.2 million for each of the years ended December 31, 2005 and 2004.

Other (income) expense. Interest expense increased to approximately \$0.5 million for the year ended December 31, 2005 from approximately \$0.3 million for the year ended December 31, 2004, due to the increase in amounts outstanding under a convertible debt instrument. Interest and other income was nominal for both periods presented.

Liquidity and Capital Resources

Orchard has incurred losses and negative cash flow from operations since inception. As of June 30, 2007, Orchard had cash and cash equivalents of \$3.1 million and a working capital deficit of approximately \$12.0 million. The working capital deficit arises primarily because of the classification of Orchard's convertible debt as a current liability. Orchard's ability to continue operating as a going concern is substantially dependent on its ability to generate operating cash flows through the successful execution of its business plan or to secure funding sufficient to cover the net losses generated by 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 and through the issuance of debt and preferred or common stock. Orchard's principal sources of liquidity have been its issuance of convertible debt to Dimensional. Orchard's investor group has committed to fund Orchard's operations through at least October 1, 2008, subject to the merger with DMGI. However, Orchard may seek to raise additional capital through future debt or equity financing to provide for greater flexibility to fund expanded operations.

Cash Flows for the Six Months Ended June 30, 2007 compared to Six Months Ended June 30, 2006

Net cash used in operations for the six months ended June 30, 2007 was approximately \$2.3 million. The reconciliation of net loss of approximately \$2.2 million to net cash used in operations for the six months ended June 30, 2007 included non-cash charges for depreciation and amortization of approximately \$0.1 million. These net non-cash charges were partially offset by increased working capital requirements of approximately \$0.2 million.

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Net cash used in operations for the six months ended June 30, 2006 was approximately \$2.3 million. The reconciliation of net loss of approximately \$3.0 million to net cash used in operations of approximately \$2.3 million for the six months ended June 30, 2006 included a non-cash charge for depreciation and amortization of approximately \$0.1 million, and approximately \$0.1 million of stock-based compensation awarded in May 2006 as part of Orchard's plan of recapitalization, offset by non-cash income of approximately \$0.1 million in connection with the write-off of a disputed note payable and related interest. These non-cash charges were further offset by reduced working capital requirements of approximately \$0.6 million, primarily because accrued expenses, accrued royalties and accounts payable increased by a greater amount than accounts receivable, prepaid and other assets.

Orchard's investing activities resulted in a net cash outflow of approximately \$0.4 million for the six months ended June 30, 2007 in connection with the purchase of property and equipment. In the first half of 2006, investing activities resulted in a net cash outflow of approximately \$0.6 million to purchase property and equipment, which was partially offset by \$11,836 of proceeds from the sale of certain fixed assets. The property and equipment additions for both the six months ended June 30 2007 and 2006 were primarily driven by the increase in headcount as Orchard's business continued to grow, and for purchasing a direct digital delivery system during the six months ended June 30, 2007.

Cash provided from financing activities for the six months ended June 30, 2007 and 2006 was approximately \$4.1 million and approximately \$3.1 million, respectively, as a result of the proceeds from the issuance of additional convertible debt to Dimensional.

As of June 30, 2007, Orchard had cash and cash equivalents of approximately \$3.1 million and a working capital deficit of approximately \$12.0 million, compared to cash and cash equivalents of approximately \$1.7 million and a working capital deficit of approximately \$9.5 million at December 31, 2006.

Cash Flows for the Year Ended December 31, 2006 compared to Year Ended December 31, 2005

Net cash used in operations for the year ended December 31, 2006 was approximately \$4.3 million. The reconciliation of net loss of approximately \$6.0 million to net cash used in operations for the year ended December 31, 2006 included non-cash charges for depreciation and amortization of approximately \$0.2 million, bad debt expense of approximately \$0.1 million and stock-based compensation of approximately \$0.1 million. Non-cash income includes income from debt forgiveness of approximately \$0.1 million. These net non-cash charges were offset by reduced working capital requirements of approximately \$1.4 million, primarily because royalties payable increased at a faster rate than accounts receivable as Orchard's business continued to expand in 2006. Net cash used in operations for the year ended December 31, 2005 was approximately \$2.7 million. The reconciliation of net loss of approximately \$4.3 million to net cash used in operations for the year ended December 31, 2005 included a non-cash charge for depreciation and amortization of approximately \$0.1 million. This non-cash charge was offset by reduced working capital requirements of approximately \$1.6 million, primarily because royalties and accounts payable increased at a faster rate than accounts receivable as the business expanded in 2005.

Orchard's investing activities resulted in a net cash outflow of approximately \$0.6 million for the year ended December 31, 2006, which was for the purchase of property and equipment offset by approximately \$0.1 million of the proceeds from the sale of fixed assets. In 2005, investing activities resulted in a net cash outflow of approximately \$0.1 million, which was also for the purchase of property and equipment.

Cash provided from financing activities for the year ended December 31, 2006 was approximately \$6.6 million as a result of the proceeds from the issuance of convertible debt to Dimensional. In 2005, cash provided from financing activities was approximately \$2.9 million as a result of the proceeds from the issuance of convertible debt payable to Dimensional.

As of December 31, 2006, Orchard had cash and cash equivalents of approximately \$1.7 million and a working capital deficit of approximately \$9.5 million, compared to cash and cash equivalents of \$21,866 and a working capital deficit of approximately \$10.8 million at December 31, 2005.

Table of Contents**Index to Financial Statements*****Description of Indebtedness******Convertible Debt Instruments***

Since April 2003, Dimensional has extended various loans to Orchard, which debt is convertible into that number of shares of Orchard's Series A Convertible Preferred Stock, or the 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 Series A Preferred Stock pursuant to a stock purchase agreement between Orchard and Dimensional.

At December 31, 2005, the outstanding principal balance of the Dimensional convertible debt was approximately \$7.9 million and the outstanding balance of the accrued interest was approximately \$0.7 million. Interest expense on the convertible debt was approximately \$0.5 million for the year ending December 31, 2005. In May 2006, Orchard issued 7,931,000 shares of Series A Preferred Stock and 7,931,000 shares of Series B Convertible Preferred Stock, or the Series B Preferred Stock, to Dimensional in exchange for the conversion and cancellation of convertible debt with a principal balance of approximately \$7.9 million (the outstanding convertible debt principal balance at December 31, 2005). Accrued interest relating to this debt was not cancelled at this time. At December 31, 2006, the outstanding principal balance of the Dimensional convertible debt was approximately \$6.6 million and the outstanding balance of the accrued interest was approximately \$1.2 million (which includes interest on the approximately \$7.9 million debt cancelled in May 2006). Interest expense on the convertible debt was approximately \$0.5 million, for the year ending December 31, 2006.

In July 2007, Orchard converted and cancelled approximately \$10.7 million of outstanding principal convertible debt owed to Dimensional (the then outstanding principal balance) simultaneous with the authorization for a recapitalization of Orchard, and Dimensional forgave all interest owed and outstanding. Orchard's July 2007 recapitalization included amending and restating Orchard's certificate of incorporation and authorizing the issuance of (i) 10,700,000 shares of Orchard's Series A Preferred Stock and (ii) 9,675,295 shares of Orchard's Series B Preferred Stock and (iii) 2,377,778 shares of Orchard's common stock (which was issued to the original common shareholders).

As of August 31, 2007, the outstanding principal balance of convertible debt issued to Dimensional was approximately \$0.8 million and accrued interest on such debt was \$4,803.

For additional information relating to the convertible debt issued to Dimensional and the May 2006 and July 2007 recapitalizations, see Notes 8, 9 and 15 to Orchard's consolidated financial statements included elsewhere in this proxy statement.

Contractual Obligations

The following table summarizes our contractual obligations as of June 30, 2007 and the effect such obligations are expected to have on our liquidity and cash flow in future periods:

Contractual obligations	Total	Payments due by period			More than 5 years
		Less than 1 year	1-3 years	3-5 years	
Operating lease obligations	\$ 510,665	\$ 354,451	\$ 156,214	\$	\$
Purchase commitments	1,102,973	722,973	380,000		
Total	\$ 1,613,638	\$ 1,077,424	\$ 536,214	\$	\$

As of August 2007, Orchard leases space for its principal corporate offices under a lease agreement which expires in Jan 2009. Prior to August 2007, Orchard utilized and paid for certain office space subleased by an affiliated entity, with no formal sublease agreement in place. Orchard paid the lessee directly for the space it utilized. In 2006, Orchard incurred rental expense of approximately \$0.3 million under this arrangement. See Note 14 to Orchard's consolidated financial statements included elsewhere in this Proxy Statement for additional information regarding this lease arrangement.

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Off-Balance Sheet Arrangements

As of June 30, 2007, Orchard had no off-balance sheet arrangements.

Quantitative and Qualitative Disclosures about Market Risk

Foreign Exchange

Orchard receives payment from its customers in U.S. dollars for all sales to consumers in the United States. For those customers which sell Orchard's music to consumers in foreign countries, sales and payments to Orchard are based in local currency, which is converted to U.S. dollars at the market-based foreign exchange rates at the time of the receipt. Approximately 18% of Orchard's revenues for the six months ended June 30, 2007 and 17% for the year ended December 31, 2006, were derived on this basis from consumers outside the U.S. As a result, Orchard has foreign currency exposure to fluctuations in foreign currency exchange rates with respect to a portion of Orchard's revenue. Orchard's net foreign currency loss was approximately \$12,000 and \$2,000 for the six months ended June 30, 2007 and for the year ended December 31, 2006, respectively.

Interest Rate Risk

Orchard does not utilize derivative financial instruments, derivative commodity instruments or other market risk sensitive instruments, positions or transactions.

Related Party Transactions

From time to time, Orchard has amounts due to and receivables from companies under common ownership with the Investor Group. These amounts are billed and paid on a regular basis in the ordinary course of Orchard's business. Orchard had a net receivable from affiliates of \$5,339 at June 30, 2007 and net payables to affiliates of \$46,286 and \$23,183 at December 31, 2006 and 2005, respectively.

Orchard's relationships with these related parties include the following:

Management Agreement with Dimensional Associates, Inc. Through December 31, 2006, Dimensional Associates, Inc., which is under common ownership with Orchard, provided ongoing consulting and management advisory services to Orchard for a monthly management fee based on a predetermined allocation percentage, which fee was reviewed periodically by Investor Group management. Since 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 \$657,000 of management fees under this arrangement for the year ended December 31, 2006.

Operating Lease with Affiliate. Orchard leased its office space under a formal sublease from an affiliate of the Investor Group through April 2006, at which time the sublease expired, and Orchard began paying the lessee directly for the office space. Orchard also acquired furniture and leasehold arrangements from the affiliated entity in connection with the sublease of the premises. In August 2007, the sublease of the affiliated entity was formally assigned to Orchard. Orchard incurred approximately \$68,429 of expense for the year ended December 31, 2006 related to the direct sublease arrangement with its affiliate and \$169,225 and approximately \$266,000 of expense under the direct arrangement with the lessee for the six months ended June 30, 2007 and the year ended December 31, 2006, respectively.

Legal Costs. One firm engaged by Orchard to represent its general business interests 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 firm were \$2,263 for the six months ended June 30, 2007 and \$158,432 for the year ended December 31, 2006.

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Distribution Services with eMusic. eMusic, which is under common ownership with Orchard, provides digital music distribution services to Orchard. eMusic accounted for 11% and 12% of Orchard's revenues for the six months ended June 30, 2007 and the year ended December 31, 2006, respectively,

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and 15% of Orchard's accounts receivables for each of the six months ended June 30, 2007 and the year ended December 31, 2006, respectively.

Dimensional Music Publishing, LLC. During 2006, Orchard sold fixed assets to Dimensional Music Publishing, LLC, an entity under common ownership by the Investor Group, realizing a loss of \$1,448. In the past, Dimensional Music Publishing, LLC has also provided consulting services to Orchard, although no such consulting services were provided in 2006 or during the six months ended June 30, 2007.

Revenue Sharing Agreement with CGH Ventures, Inc. Since 2003, Orchard's subsidiary Orchard Management, Inc. has been obligated to pay CGH Ventures, Inc. 80% of the net revenues it earns pursuant to a revenue sharing agreement. CGH Ventures, Inc. is owned by two stockholders of Orchard. Orchard recorded \$15,978 and \$68,797 as commission expense for CGH Ventures, Inc.'s share of the net revenue for the six months ended June 30, 2007 and the year ended December 31, 2006, respectively.

For more information relating to Orchard's related party transactions, see Note 13 to its consolidated financial statements appearing elsewhere in this proxy statement.

Table of Contents**Index to Financial Statements****DMGI MARKET PRICE AND DIVIDEND DATA**

DMGI common stock trades on the Nasdaq Global Market System under the symbol DMGI. On _____, 2007, the closing sales price for DMGI common stock was \$ _____ per share. Set forth below are the high and low bid information for DMGI common stock as quoted on the Nasdaq Global Market, and its predecessor, the Nasdaq National Market, for the periods indicated.

	Common Shares	
	High	Low
2006		
First Quarter	\$ 10.09	\$ 9.01
Second Quarter	\$ 9.75	\$ 4.64
Third Quarter	\$ 6.25	\$ 3.97
Fourth Quarter	\$ 6.75	\$ 4.40
2007		
First Quarter	\$ 5.20	\$ 3.75
Second Quarter	\$ 5.04	\$ 3.80
Third Quarter (through August 31, 2007)	\$ 4.75	\$ 3.54

Dividends.

DMGI has never declared or paid any cash dividends on its common stock. DMGI currently intends to retain its future earnings, if any, for future growth and development of its business and does not anticipate paying any cash dividends in the foreseeable future. Any determination to pay dividends will be at the discretion of DMGI's board of directors and will depend on its results of operations, financial conditions and legal restrictions and other factors the board deems relevant.

Holder of Record.

As of _____, 2007, the last reported sales price of DMGI's common stock on the Nasdaq Global Market was \$ _____ per share, and the number of holders of record was _____. Because many of DMGI's shares of common stock are held by brokers and other institutions on behalf of stockholders, DMGI is unable to estimate the total number of stockholders represented by these record holders.

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SUBMISSION OF FUTURE DMGI STOCKHOLDER APPROVALS

Management of DMGI knows of no other matters which may be brought before the special stockholders meeting. If any matter other than the proposed merger or related matters should properly come before the special meeting, however, the persons named in the enclosed proxies will vote proxies in accordance with their judgment on those matters.

Under Delaware law, only business stated in the notice of special meeting may be transacted at either of the special meetings.

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WHERE YOU CAN FIND MORE INFORMATION

DMGI is subject to the informational requirements of the Securities Exchange Act of 1934, as amended, and we are required to file reports, any proxy statements and other information with the SEC. You can read any reports, statements or other information that DMGI files with the SEC over the Internet at the SEC web site at <http://www.sec.gov>. You may also read and copy any documents DMGI files with the SEC at its public reference facility at 450 Fifth Street, N.W., Washington, D.C. 20549. You may also obtain copies of the documents at prescribed rates by writing to the Public Reference Section of the SEC at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference facilities.

DMGI has not authorized anyone to provide you with information that differs from that contained in this proxy statement. This proxy statement is dated _____, 2007. You should not assume that the information contained in this proxy statement is accurate as on any date other than that date, and neither the mailing of this proxy statement to DMGI stockholders nor the issuance of shares of DMGI common stock in the merger shall create any implication to the contrary. This proxy statement does not constitute an offer to sell, or a solicitation of an offer to buy, any securities, or the solicitation of a proxy, in any jurisdiction to or from any person to whom it is not lawful to make any such offer or solicitation in such jurisdiction. Neither the delivery of this proxy statement nor any distribution of securities made hereunder may, under any circumstances, create an implication that there has been no change in the affairs of DMGI since the date hereof or that the information herein is correct as of any time subsequent to its date.

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DIGITAL MUSIC GROUP, INC.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors

Digital Music Group, Inc.

Sacramento, California

We have audited the consolidated balance sheet of Digital Music Group, Inc. and subsidiary (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2006 and for the period from February 26, 2004 (Inception) to December 31, 2004. 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Digital Music Group, Inc. and subsidiary as of December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2006 and for the period from February 26, 2004 (Inception) to December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

/s/ Perry-Smith LLP

Sacramento, California

March 29, 2007

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	December 31,	
	2006	2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 20,505,674	\$ 468,490
Accounts receivable	1,687,492	244,278
Current portion of royalty advances	1,326,379	292,438
Prepaid expenses and other current assets	492,799	152,139
Total current assets	24,012,344	1,157,345
Furniture and equipment, net	803,203	162,153
Digital rights, net	3,033,239	1,196,047
Master recordings, net	1,777,480	
Royalty advances, less current portion	4,230,403	490,000
Goodwill	4,429,782	
Other assets	39,289	12,074
Total assets	\$ 38,325,740	\$ 3,017,619
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 273,037	\$ 63,753
Accrued liabilities	496,833	315,027
Royalties payable	1,883,773	138,608
Accrued compensation and benefits	115,817	38,435
Current portion of capital lease obligations	50,496	44,540
Total current liabilities	2,819,956	600,363
Capital lease obligations, less current portion	9,335	
Other long-term liabilities	92,461	
Total liabilities	2,921,752	600,363
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: 9,034,941 and 2,249,941 shares issued and outstanding at December 31, 2006 and 2005	90,350	22,500
Additional paid-in capital	40,138,284	4,640,291
Subscriptions receivable		(43,323)
Accumulated deficit	(4,824,646)	(2,202,212)
Total stockholders' equity	35,403,988	2,417,256
Total liabilities and stockholders' equity	\$ 38,325,740	\$ 3,017,619

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

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DIGITAL MUSIC GROUP, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		Period from February 26, 2004 (Inception) to
	2006	2005	December 31, 2004
Revenue	\$ 5,564,949	\$ 679,975	\$ 37,268
Cost of revenue:			
Royalties and payments to content owners	3,329,698	232,294	10,703
Amortization of digital rights and master recordings	422,489	22,518	3,041
Write-down of non-productive assets		295,356	
Gross profit	1,812,762	129,807	23,524
Operating, general and administrative expenses	5,655,161	1,550,424	666,831
Loss from operations	(3,842,399)	(1,420,617)	(643,307)
Interest income	1,251,396	5,568	2,302
Interest expense	(13,649)	(141,765)	(2,793)
Other income (expense), net	(16,982)		
Loss before income taxes	(2,621,634)	(1,556,814)	(643,798)
Income taxes	(800)	(800)	(800)
Net loss	\$ (2,622,434)	\$ (1,557,614)	\$ (644,598)
Net loss per common share basic and diluted	\$ (0.32)	\$ (0.69)	\$ (0.29)
Weighted average common shares outstanding basic and diluted	8,071,393	2,249,941	2,249,941

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

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DIGITAL MUSIC GROUP, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

For the period from February 26, 2004 (Inception) to December 31, 2006

	Common Stock		Additional	Subscriptions	Accumulated	Total
	Shares	Amount	Paid-in Capital			
Shares owned by founders and investors in Digital Musicworks International, Inc. (inception on February 26, 2004)	2,249,941	\$ 22,500	\$ 4,630,706	\$ (4,650,006)	\$	\$ 3,200
Cash received upon issuance of equity securities by Digital Musicworks International, Inc.				1,670,546		1,670,546
Stock-based compensation related to stock options and warrants issued to employees and consultants			1,281			1,281
Digital rights received in exchange for equity securities of Digital Musicworks International, Inc.				3,229		3,229
Net loss for the period from February 26, 2004 (Inception) to December 31, 2004					(644,598)	(644,598)
Balances, December 31, 2004	2,249,941	22,500	4,631,987	(2,976,231)	(644,598)	1,033,658
Stock-based compensation related to stock options and warrants issued to employees and consultants			8,304			8,304
Cash received upon issuance of equity securities by Digital Musicworks International, Inc.				2,932,908		2,932,908
Net loss for the year ended December 31, 2005					(1,557,614)	(1,557,614)
Balances, December 31, 2005	2,249,941	22,500	4,640,291	(43,323)	(2,202,212)	2,417,256
Merger with Digital Music Group, Inc. by the accounting acquiror, Digital Musicworks International, Inc.	2,425,000	24,250	(97,555)			(73,305)
Issuance of common stock in connection with acquisition of Rio Bravo Entertainment LLC digital rights	25,000	250	243,500			243,750
Cash received upon issuance of equity securities by Digital Musicworks International, Inc.				43,323		43,323
Issuance of common stock in connection with initial public offering, net of cash offering costs of \$4,792,397	3,900,000	39,000	33,193,603			33,232,603
Issuance of common stock in connection with acquisition of Digital Rights Agency, LLC	420,000	4,200	1,831,950			1,836,150
Stock-based compensation related to stock options and restricted stock issued to employees	15,000	150	326,495			326,645
Net loss for the year ended December 31, 2006					(2,622,434)	(2,622,434)
Balances, December 31, 2006	9,034,941	\$ 90,350	\$ 40,138,284	\$	\$ (4,824,646)	\$ 35,403,988

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

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

	Year Ended December 31,		Period from
	2006	2005	February 26, 2004 (Inception) to December 31, 2004
Cash flows from operating activities:			
Net loss	\$ (2,622,434)	\$ (1,557,614)	\$ (644,598)
Adjustments to reconcile net loss to net cash used in operating activities:			
Non-cash charges to operations:			
Depreciation of furniture and equipment	156,839	38,595	3,137
Amortization of digital rights and master recordings	422,489	22,518	3,040
Recoupment of royalty advances	1,001,426	99,730	
Amortization of deferred rent	43,554		
Recognition of deferred revenue	(8,685)		
Loss on disposal of furniture and equipment	16,639		
Write-off of non-productive assets		295,356	
Share-based compensation related to stock options, warrants and restricted shares issued	326,495	8,304	1,281
Interest expense related to conversion of subordinated notes payable		127,239	
Changes in operating assets and liabilities:			
Accounts receivable	(496,839)	(231,893)	(12,385)
Prepaid expenses and other current assets	(410,980)	(136,159)	(15,980)
Accounts payable	162,986	4,901	23,979
Accrued liabilities	(322,059)	45,495	34,530
Royalties payable	46,185	130,172	8,436
Accrued compensation and benefits	77,382	30,112	8,323
Net cash used in operating activities	(1,607,002)	(1,123,244)	(590,237)
Cash flows from investing activities:			
Purchases of furniture and equipment	(620,939)	(53,635)	(27,981)
Purchases of digital rights and master recordings	(2,728,090)	(890,407)	(175,985)
Payments of advance royalties	(5,405,771)	(952,916)	(106,717)
Acquisition of Digital Rights Agency, LLC, net of cash received	(2,769,354)		
Increase in other assets	(27,215)		(12,074)
Net cash used in investing activities	(11,551,369)	(1,896,958)	(322,757)

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

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

	Years Ended December 31,		Period from
	2006	2005	February 26, 2004 (Inception) to December 31, 2004
Cash flows from financing activities:			
Proceeds from the sale of common and preferred stock of Digital Musicworks International, Inc. prior to recapitalization, net of offering costs	\$	\$ 2,575,669	\$ 1,673,746
Proceeds from the exercise of Digital Musicworks International, Inc. options and warrants prior to recapitalization	43,323		
Proceeds from initial public offering of common stock of Digital Music Group, Inc., net of offering costs	33,232,603		
Proceeds from issuance of restricted stock	150		
Collection on behalf of (payments to) DMI Publishing, Inc.		(8,801)	8,801
Proceeds from the issuance of subordinated notes payable		230,000	
Payments on capital lease obligations	(80,521)	(44,013)	(33,716)
Net cash provided by financing activities	33,195,555	2,752,855	1,648,831
Net increase (decrease) in cash and cash equivalents	20,037,184	(267,347)	735,837
Cash and cash equivalents, beginning of period	468,490	735,837	
Cash and cash equivalents, end of period	\$ 20,505,674	\$ 468,490	\$ 735,837
Supplemental cash flow information:			
Interest paid	\$ 13,649	\$ 15,394	\$ 1,925
Supplemental disclosure of non-cash investing and financing transactions:			
Issuance of common stock and warrants in connection with the acquisition of Digital Rights Agency, LLC	\$ 1,836,150	\$	\$
Issuance of warrant to underwriters	\$ 620,529	\$	\$
Reduction in contract for digital rights	\$ (115,320)	\$	\$
Purchase of furniture and equipment under capital lease obligations	\$ 77,791	\$	\$ 122,269
Holdback for purchase of master recordings	\$ 75,000	\$	\$
Merger between Digital Music Group, Inc. and Digital Music Works International, Inc.	\$ 73,305	\$	\$
Issuance of shares of common stock in connection with purchase of digital rights	\$	\$	\$ 3,229
Conversion of notes payable and accrued interest into shares of preferred stock of Digital Musicworks International, Inc. prior to recapitalization	\$	\$ 232,205	\$

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Future obligations under contracts to purchase digital rights	\$	\$ 269,875	\$
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The accompanying notes are an integral part of these consolidated financial statements.

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DIGITAL MUSIC GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND BASIS OF PRESENTATION

Digital Music Group, Inc. (DMGI) was incorporated in Delaware on April 11, 2005 and is engaged in the digital distribution of music and video content. On February 7, 2006, DMGI completed its initial public offering (the IPO). Concurrent with the closing of its 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. The financial statements of Digital Music Group, Inc. prior to February 7, 2006 are the financial statements of DMI, which has been designated as the acquiror for financial reporting purposes. The historical shareholders' equity of DMI has been restated for all period prior to February 7, 2006 to give retroactive effect to the acquisition by DMGI. The results of operations from the assets acquired from Rio Bravo Entertainment LLC and of DMGI are included in the financial statements beginning on February 7, 2006.

On September 8, 2006, DMGI acquired all the membership interest of 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 from the date of acquisition. All intercompany accounts and transactions have been eliminated.

Certain reclassifications have been made to the prior period's financial statements in order to conform to the current period's presentation.

2. ACCOUNTING POLICIES

Use of Estimates and Assumptions

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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 \$6,500,000 and \$432,000 in cash equivalents at December 31, 2006 and 2005, 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.

Significant Customers

One digital entertainment service accounted for approximately 77%, 87% and 93% of DMGI's revenue for the years ended December 31, 2006 and 2005 and for the period from February 26, 2004 (Inception) to

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DIGITAL MUSIC GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2004, respectively. At December 31, 2006 and 2005, this service accounted for approximately 51% and 83%, respectively, of DMGI's accounts receivable.

Allowance for Doubtful Accounts

DMGI establishes allowances for doubtful accounts based on credit profiles of its retailers, current economic trends, contractual terms and conditions and historical payment experience, as well as for known or expected events. DMGI has not experienced any bad debts since its inception. Accordingly, at December 31, 2006 and 2005, no allowance for doubtful accounts has been recorded.

Fair Value of Financial Instruments

The carrying value of cash, cash equivalents, accounts receivable, accounts payable and accrued liabilities and capital lease obligations, approximates their fair value due to the short-term nature of these instruments.

Furniture and Equipment

Furniture and equipment are stated at cost and depreciated over the estimated useful lives of the assets, ranging from three to eight years, using the straight-line method. Capital leases are recorded at the lower of fair market value or the present value of future minimum lease payments. Each of DMGI's capital leases has a bargain purchase option at the end of the initial non-cancelable lease term which DMGI intends to exercise. Accordingly, assets under capital lease obligations are being depreciated using the straight-line method over the useful life of the assets, which exceeds the lease terms.

Royalty Advances, Digital Rights and Master Recordings

DMGI capitalizes the cost of acquiring catalogs of digital rights and master recordings and payments of advance royalties. Capitalized costs include amounts paid to content owners and direct ancillary costs such as legal and finders fees. Digital rights and master recordings acquired by DMGI are amortized using the straight-line method over the shorter of the term of the related agreement or seven years for digital rights and ten years for master recordings, which management believes reasonably relates the amount of amortization to the revenue expected to be realized. Royalty advances will be recouped from DMGI's future royalty obligations resulting from the fees it receives from digital entertainment services. DMGI classifies royalty advances as short-term or long-term based on the expectations of when these advances will be recovered.

DMGI reviews the recoverability of its capitalized digital rights, master recordings and royalty advances annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The test of recoverability is performed by comparing the carrying value of individual catalogs or groups of catalogs of digital rights, master recordings and content subject to royalty advances to its undiscounted expected future cash flows. If such review indicates that the carrying amount of an asset exceeds the sum of its expected future cash flows, the asset's carrying amount is written down to its estimated fair value. Fair value is determined by an internally developed discounted projected cash flow analysis of the asset. As a result of performing these tests for potential impairment, DMGI determined that no impairment existed as of December 31, 2006. During the year ended December 31, 2005, DMGI recorded a write-down of \$295,356 relating to cash advances and the capitalized costs of producing and promoting master recordings 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

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

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.

Table of Contents**Index to Financial Statements****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.

Table of Contents**Index to Financial Statements****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

Table of Contents**Index to Financial Statements****DIGITAL MUSIC GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. DIGITAL RIGHTS**

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:

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

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:

	December 31,
	2006
Master recordings	\$ 1,853,161
Less accumulated amortization	(75,681)
	\$ 1,777,480

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

8. INCOME TAXES

Income taxes are comprised of the following:

	Years Ended December 31,		Period from February 26, 2004 (Inception) to
	2006	2005	

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December 31,

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Current:			
Federal	\$	\$	\$
State	800	800	800
Total current	800	800	800
Deferred:			
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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Table of ContentsIndex to Financial Statements**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.

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

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 (Inception) to 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)
Total capital lease obligations	59,831
Less current portion	(50,496)
Long-term capital lease obligations	\$ 9,335

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 Contents**Index 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 Shares	Common Stock Amount	Additional Paid-in 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

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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	Weighted	Weighted	Aggregate
	Shares	Price	Average	Average	Intrinsic
			Remaining	Contractual	Value
			Price	Term	
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.

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

Restricted stock activity is summarized as follows:

	Number of	Weighted-Average
	Shares	Grant Date
		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**

	June 30, 2007 (Unaudited)	December 31, 2006
Assets		
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
Total current assets	18,390,044	24,012,344
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
Total assets	\$ 37,684,097	\$ 38,325,740
Liabilities and Stockholders Equity		
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
Total current liabilities	3,607,598	2,819,956
Capital lease obligations, less current portion	1,719	9,335
Other long-term liabilities	89,285	92,461
Total liabilities	3,698,602	2,921,752
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)
Total stockholders equity	33,985,495	35,403,988
Total liabilities and stockholders equity	\$ 37,684,097	\$ 38,325,740

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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**

	For the Six Months	
	Ended June 30,	
	2007	2006
	(Unaudited)	
Cash flows from operating activities:		
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)
Cash flows from investing activities:		
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)
Cash flows from financing activities:		
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
Supplemental disclosure of non-cash investing and financing transactions:				
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
	\$ 8,033,133

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
	\$ 8,033,133

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:

	For the six months
	ended June 30, 2006
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:

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

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

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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, 2007	December 31, 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:

	2007	2006
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-	
			Average	
		Weighted-	Remaining	Aggregate
	Number of	Average	Contractual	Intrinsic
	Shares	Exercise 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 with The Orchard Enterprises Inc. (The Orchard), a leading global digital distributor and marketer of music, under which Orchard will become a wholly-owned subsidiary of DMGI following the merger, and DMGI will change its name to The Orchard Inc. 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 exchange for all outstanding shares of common and preferred stock

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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)

Table of Contents**Index to Financial Statements****THE ORCHARD ENTERPRISES INC.****CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2006	2005
ASSETS		
CURRENT ASSETS:		
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
LIABILITIES AND STOCKHOLDERS DEFICIENCY		
CURRENT LIABILITIES:		
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
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS DEFICIENCY:		
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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Table of Contents**Index to Financial Statements****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
GROSS PROFIT	4,201,118	1,542,420	484,453
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
LOSS FROM OPERATIONS	(5,581,619)	(3,824,727)	(3,344,000)
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
NET LOSS	\$ (5,968,960)	\$ (4,298,669)	\$ (3,616,551)

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	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.

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

	Year ended December 31,		
	2006	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:			
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)
CASH FLOWS FROM INVESTING ACTIVITIES:			
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)
CASH FLOWS FROM FINANCING ACTIVITIES:			
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
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
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.

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

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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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 Lives (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
Total cost		822,652	284,945
Less accumulated depreciation and amortization		(171,247)	(66,090)
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:

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

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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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 (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.

Table of Contents**Index to Financial Statements****THE ORCHARD ENTERPRISES INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)**

	June 30, 2007	December 31, 2006
ASSETS		
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
TOTAL	\$ 10,358,667	\$ 6,541,778
LIABILITIES AND STOCKHOLDERS DEFICIENCY		
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)
TOTAL	\$ 10,358,667	\$ 6,541,778

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)**

	Six months ended June 30,	
	2007	2006
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
GROSS PROFIT	3,373,478	1,500,523
OPERATING EXPENSES:		
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
LOSS FROM OPERATIONS	(1,785,388)	(2,800,468)
OTHER (INCOME) EXPENSE:		
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
NET LOSS	\$ (2,192,261)	\$ (2,983,386)

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)**

	Six months ended June 30,	
	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
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)
CASH FLOWS FROM INVESTING ACTIVITIES:		
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)
CASH FLOWS FROM FINANCING ACTIVITIES		
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)
INCREASE IN CASH AND CASH EQUIVALENTS	1,451,256	109,111
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:

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

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 66²/₃ 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:

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

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 (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.

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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 Music Group, Inc. Historical	The Orchard Enterprises Inc. Historical	Pro Forma Adjustments	Pro Forma Digital Music Group, Inc.
ASSETS				
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		9,571,940 (e)	14,927,884
Other assets	42,563	143,428	(42,563)(e)	143,428
Total assets	\$ 37,684,097	\$ 10,358,667	\$ 10,483,831	\$ 58,526,595
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)				
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
			\$ 1,774,329 (a)	
Merger-related liabilities			1,922,500 (e)	3,696,829
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	(8,637,981)	16,012,175
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	(8,637,981)	16,103,179
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 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 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	\$ 10,483,831	\$ 58,526,595

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.****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		13,204,654
Amortization	394,451	2,324	\$ (394,451)(f)	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, 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 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. 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 estimated fair value of DMGI stock options and warrants was determined using the Trinomial Lattice Model using the following assumptions: risk-free rate of return of %; expected volatility of %; dividend rate of 0%; and a weighted-average expected life of years.

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	14,927,884
Assumed liabilities	(3,698,602)
Integration and other merger related costs, including DMGI	(3,696,829)
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 \$847,000 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.

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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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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 SEPTEMBER 13, 2007

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