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Time Warner Settles AOL Fraud Charges

The media giant agrees to pay $510 million to resolve accusations of revenue inflation.

December 16, 2004 | Sallie Hofmeister and Jube Shiver Jr. | Times Staff Writers

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Media giant Time Warner Inc. agreed Wednesday to pay $510 million to settle government charges of accounting fraud at its troubled America Online unit, freeing the company to use its stock for acquisitions.

A settlement would remove the uncertainty clouding the future of the world's largest entertainment company, accused by regulators of inflating the advertising revenue of its Internet service provider.

Wall Street had been expecting a deal, because Time Warner set aside $500 million last month to resolve problems with the government. Time Warner stock has climbed more than 15% since.

The two-pronged agreement would be with both the Justice Department and the Securities and Exchange Commission. It must be approved by SEC commissioners.

Wall Street analysts had been prepared a year ago for the accounting debacle to cost Time Warner as much as $4 billion in penalties and litigation. But Chief Executive Richard Parsons took a hard stance with regulators, refusing to admit guilt even though that might have more quickly resolved the investigations.

Now, with the probes nearly behind him, Parsons is expected to turn his attention to such potential acquisition targets as the ailing cable giant Adelphia Communications Corp., which is attempting to emerge from Chapter 11 bankruptcy proceedings.

"This gets the monkey off Time Warner's back," said Richard Greenfield, an analyst with Fulcrum Global Partners. "It proves that taking a strong arm with regulators paid off. The settlement was far better than many of us feared."

Under the settlement with the Justice Department, Time Warner agreed to pay $210 million and accept responsibility for the conduct of certain AOL executives who allegedly aided in securities fraud with some of the online unit's Internet partners. The practices led to the improper inflation of revenues for both AOL and its partners.

Of the $210 million, $60 million will be paid to the government in criminal penalties, while the remaining $150 million will be put into a settlement fund for investors who bring successful shareholder lawsuits and other claims against Time Warner.

AOL isn't in the clear just yet. The Justice Department said it would file a criminal complaint against the Internet unit, although it would defer prosecution for two years while it continued to investigate whether

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certain AOL executives illegally helped small online partners inflate revenues. Those deals occurred before the ill-fated $100-billion merger between AOL and Time Warner in 2001.

As part of the settlement with the Justice Department, Time Warner agreed to cooperate with the criminal investigation. If Time Warner executives fail to do so, Deputy U.S. Atty. Gen. James Comey said, "the deal is off and they are in a world of trouble."

The Justice Department said in documents filed Wednesday in U.S. District Court in Alexandria, Va., that AOL and a partner called Purchasepro.com, which is now defunct, had improperly inflated their ad revenues through a series of complex transactions.

On the SEC front, Time Warner would pay $300 million to settle a probe into AOL's accounting of a $400-million payment received from Germany's Bertelsmann, the online giant's partner in Europe. The SEC believes that the payment was improperly booked as advertising revenue when it should have been recorded as a reduction in the price the company paid to buy back Bertelsmann's stake in AOL Europe.

Time Warner also agreed to restate its earnings to properly account for the Bertlesmann transaction and to name an independent examiner who will review the company's accounting for certain other transactions between 1999 and 2002.

In addition, Chief Financial Office Wayne Pace and two other financial executives would be allowed to keep their jobs and face no penalties by promising to comply in the future with all regulations.

Sources said the deal could take a couple of months to finalize.

Analyst Jeffrey Logsdon of Harris Nesbitt in Boston said Time Warner could now be poised to make a comeback. "You've now moved from obstacles to opportunities," he said.

Logsdon said the dual settlements would set the stage for a long-awaited simplification in Time Warner's financial structure. One of Parsons' top priorities, analysts say, is to unwind a partnership with cable leader Comcast Corp., which owns a 21.5% stake in Time Warner Cable, the nation's second-ranked cable provider.

The Comcast stake is the last vestige of a much-maligned partnership that dates to 1992, when Time Warner raised cash by selling off an ownership interest in its HBO, Warner Bros. Studios and cable operations. The partnership made Time Warner's financial structure cumbersome.

Comcast would like to trade its stake for a million or so cable subscribers. To pay off Comcast without impairing its cable reach, Time Warner has been expected to bid for some or all of ailing cable TV provider Adelphia. Suitors have been asked to submit offers by late January.

Time Warner had been considering a joint bid with Comcast, although analysts said the new settlements would allow the company to go it alone. Time Warner has been unable to issue new stock or debt while its financial statements were under review by the SEC, restricting its ability to bid for Adelphia.

Analysts said Time Warner executives also could now focus full time on the revival of AOL, its weakest division. AOL has been hurt as Internet users moved from the dial-up connections it dominates to faster broadband services. A new management team has retooled AOL's content and is accelerating its push into high-speed access.

"AOL is not a dead business, as many had predicted," said Fulcrum's Greenfield. "We're very encouraged by its early moves."

Time Warner stock was unchanged, closing at $19.38 on the New York Stock Exchange.

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