James T. Coffman
Luis R. Mejia
Melissa A. Robertson
Gregory T. Lawrence
Jeffrey B. Finnell
Christopher K. Agbe-Davies
Thomas D. Manganello
Andrew B. Stevens

Attorneys for Plaintiff
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549
(202) 942-4744 (Mejia)
MejiaL@sec.gov

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

SECURITIES AND EXCHANGE COMMISSION,
450 Fifth Street, N.W.
Washington, DC 20549
Plaintiff,

v.

TIME WARNER INC.,
One Time Warner Center
New York, New York 10019
Defendant.

C.A. No. 1:05CV00578-GK

COMPLAINT

Plaintiff Securities and Exchange Commission alleges as follows:

SUMMARY

1. This is a financial fraud case. America Online, Inc. ("AOL") and its successor corporation AOL Time Warner Inc. ("AOLTW" and collectively with AOL, the "Company") artificially inflated reported online advertising revenues and Internet

subscriber counts—two key measures by which investors and analysts evaluated the Company. The Company reported inflated online advertising revenue in periodic reports filed with the Commission and other public statements from October 2000 through February 2003 based on transactions entered into from June 2000 through December 2001. The Company also inflated its Internet subscriber counts in 2001. Subsequent to the events described below, AOLTW changed its name to Time Warner Inc.

2. The Company inflated its online advertising revenues by engaging in "round-trip" transactions with a host of companies with which it had commercial relationships. These transactions ranged in complexity and sophistication, but in substance, the Company provided its customers with funds to purchase online advertising from AOL. Simultaneously, the customer would enter into an agreement to "purchase" online advertising from AOL in an amount corresponding to the payment from the Company. AOL and AOLTW improperly recognized as online advertising revenue the amounts received pursuant to these purported advertising agreements and improperly accounted for the funds it provided to the customers.

3. Several of the customers were public companies with securities registered with the Commission. Some of these customers used the transactions to artificially inflate their own financial results. As a consequence, the Company also aided and abetted the frauds of three public companies that improperly recognized revenue in connection with the round-trip transactions.

4. The Company also inflated the number of AOL's Internet subscribers by including memberships provided in bulk to corporate customers in its published subscriber counts, even though most employees of those corporate customers never

became members. The Company also inflated AOL's subscriber counts by, among other means, funding its corporate customers' bulk subscription "purchases."

5. The Company's financial statements were further misstated by its failure to properly consolidate the losses and debt of one of its subsidiaries, AOL Europe, S.A. This resulted in material misstatements of the Company's 2000 and 2001 financial results, including overstatements of operating income, net income, and free cash flow, and understatements of net losses and total debt.

6. This conduct violated the federal securities laws as well as a cease-and-desist order against AOL issued by the Commission on May 15, 2000. The Commission issued the cease-and-desist order because of AOL's improper capitalization of certain advertising costs that should have been expensed as they were incurred. As a result of this improper accounting treatment, AOL reported profits for six of eight quarters in fiscal years 1995 and 1996, rather than the losses it would have reported had it properly expensed the advertising costs. Within several weeks of consenting to that order, AOL began violating it by engaging in the new acts alleged in this Complaint.

7. On October 23, 2002, months after the Commission commenced its investigation of this matter, the Company announced that it would restate its financial results for each of the quarters ended September 30, 2000 through June 30, 2002, and for the years ended December 31, 2000 and 2001 (the "2002 Restatement"). The 2002 Restatement reversed some, but not all, of the improper round-trip transactions and resulted in a reduction of $190 million in principally online advertising revenue. The 2002 Restatement was materially deficient.

JURISDICTION AND VENUE

8. This Court has jurisdiction over this action under Section 22(a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. § 77v(a)], and Sections 21(d), 21(e), and 27 of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78u(d) and (e) and 78aa]. Defendant, directly or indirectly, made use of the means or instrumentalities of interstate commerce, of the mails, or of the facilities of a national securities exchange in connection with the transactions, acts, practices, and courses of business alleged in this Complaint.

9. Venue is appropriate in this Court under Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)] and Section 27 of the Exchange Act [15 U.S.C. § 78aa] because the defendant does business in this judicial district and certain acts or transactions constituting the violations occurred in this district.

DEFENDANT

10. Time Warner Inc. is the corporate parent of AOL and is a media and entertainment company incorporated in Delaware and headquartered in New York, New York. Time Warner Inc.'s common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the New York Stock Exchange. Time Warner Inc. files annual, quarterly, and current reports with the Commission on Forms 10-K, 10-Q, and 8-K. Time Warner Inc. registered securities offerings from January 2001 through January 2003 by filing with the Commission Forms S-3 and S-8.

11. AOL Time Warner Inc. was formed by the merger of AOL and Time Warner on January 11, 2001. It changed its name to Time Warner Inc. on October 16, 2003.

12. AOL is an Internet service provider located in Dulles, Virginia. AOL provides its members with access to the Internet, e-mail accounts, and content.

13. Certain conduct alleged in this Complaint occurred at AOL before it merged with Time Warner. AOL's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exhange. It filed annual, quarterly, and current reports with the Commission on Forms 10-K, 10-Q, and 8-K. AOLTW registered a securities offering on December 28, 2000 by filing with the Commission a Form S-4.

FACTS

I.
AOL and Time Warner Propose a Merger.

14. In the fall of 1999, AOL entered into merger discussions with Time Warner, and the two companies announced a proposed merger in January 2000. The implied market value of the merged company was approximately $200 billion, making it the then-largest merger in U.S. history.

II.
AOL Settles an Action with the Commission Based on AOL's Improper Accounting Practices.

15. On May 15, 2000, the Commission issued a cease-and-desist order against AOL in connection with AOL's accounting for advertising costs in 1995 and 1996. The Commission found that AOL violated the reporting and the books and records provisions of the federal securities laws by capitalizing costs of acquiring new subscribers and reporting the costs as an asset on its balance sheet, instead of expensing them as incurred. AOL had capitalized aggregate advertising costs of approximately $385 million by September 30, 1996, when it wrote them off in their entirety. AOL consented to the

issuance of the cease-and-desist order without admitting or denying the Commission's allegations.

16. In connection with the cease-and-desist order, the Commission filed a related civil action against AOL in the United States District Court for the District of Columbia seeking a civil penalty. AOL settled the matter by consenting to a court order requiring it to pay a $3.5 million penalty.

III.

AOL and AOLTW Violate the Commission's Cease-and-Desist Order and Engage in Fraud to Artificially Boost Online Advertising Revenue.

17. Beginning in mid-2000, while the AOL/Time Warner merger was pending, stock prices of Internet-related businesses declined precipitously as, among other things, sales of online advertising declined and the rate of growth of new online subscriptions started to flatten. During this period, AOL employed round-trip transactions that boosted its online advertising revenue and masked the fact that it also was beginning to experience a business slow-down.

18. AOL's round-trip transactions took several forms, including: (i) vendor transactions, in which AOL agreed to pay inflated prices for, or forego discounts on, goods and services it purchased in exchange for the vendors' purchases of online advertising in the same amount as the markup or foregone discount; (ii) converting settlements of legal claims into online advertising revenue; (iii) business acquisitions, in which AOL increased the purchase price in exchange for the sellers' purchase of online advertising in the same amount as the increase in the purchase price; and (iv) referral transactions, in which AOL and its counterparties falsely created and reported revenues.

19. By each of these means, AOL effectively funded its own online advertising revenue by giving the counterparties the means to pay for advertising that they would not otherwise have purchased. To conceal the true nature of the transactions, the Company typically structured and documented round-trip transactions as if they were two or more separate, bona fide transactions, conducted at arm's length and reflecting each party's independent business purpose.

20. AOL's recognition of online advertising revenue in connection with these transactions departed from generally accepted accounting principles ("GAAP"). GAAP requires accounting to reflect the substance of a transaction over its legal form. For example, revenue should not be recorded in a round-trip transaction in which the essence of the transaction is merely a circular flow of cash and the customer does not want or need the goods or services provided, would not normally purchase the goods or services at that time, or purchases quantities in excess of its needs. AOL's recognition of revenue on these round-trip transactions departed from GAAP by elevating form over substance.

21. In connection with these round-trip transactions, AOL often delivered untargeted, less desirable, remnant advertising. Often, the round-trip advertisers had little or no ability to control the quantity, quality, and sometimes even the content of the online advertising they received. Because the round-trip customers effectively were paying for the online advertising with AOL's funds, they seldom, if ever, complained.

A. **The Vendor Round-Trip Transactions**

22. As described above, AOL agreed to pay inflated prices for, or forego discounts on, goods and services it purchased in exchange for the vendors' purchases of online advertising in amounts equivalent to the markup paid or discount foregone. The essence of these transactions was a circular flow of money by which AOL used its own cash to create the false appearance of receipt of advertising revenue, enabling the Company to meet internal revenue targets and analysts' expectations. Examples of these transactions include the following:

Computer Hardware Transactions

23. In June 2000, AOL transformed a commitment to purchase computer hardware into a transaction that generated $37.5 million in online advertising revenue for AOL in the second half of 2000.

24. The hardware supplier is a California-based company that manufactures the network equipment AOL uses to support its online service. In November 1998, AOL entered into an agreement to purchase at least $300 million of network equipment over three years.

25. AOL's equipment needs outpaced expectations, and by June 2000 AOL had already purchased $300 million of equipment.

26. In June 2000, the supplier asked AOL to enter into a new purchase commitment. During the negotiations that followed, AOL secured an additional 15% discount in exchange for committing to purchase $250 million of additional equipment.

27. To inflate its online advertising revenues, AOL proposed to pay the supplier $37.5 million—by foregoing the 15% discount and paying the full $250 million

for the equipment—in exchange for the supplier's agreement to purchase $37.5 million of online advertising. The hardware supplier agreed, and AOL structured the transaction to conceal the fact that it paid an additional $37.5 million for the network equipment in exchange for the supplier's agreement to purchase $37.5 million of online advertising.

28. The advertising contract provided AOL with complete discretion over where and when to run this online advertising, subject only to a $25 million cap on advertising within a single quarter.

29. Faced with a shortfall in online advertising revenues in the third quarter of 2000, AOL obtained oral approval to run the full $37.5 million in advertising in that quarter. AOL also charged a 175% premium to its list price for the $37.5 million ad purchase.

30. In its 2002 Restatement, AOLTW reversed the $37.5 million and accounted for it as a reduction in the purchase price for the network equipment.

31. Following the model described above, AOL converted a $12 million discount from another hardware vendor into $12 million of advertising revenue in the fourth quarter of 2000. In its 2002 Restatement, AOLTW reversed the $12 million of online advertising revenue recognized in connection with this transaction.

Software License Transactions

32. In September 2000, AOL engineered a round-trip transaction with a California-based software company that creates and licenses data storage software. The software company's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and is quoted on the Nasdaq National Market ("Nasdaq").

33. During the summer of 2000, AOL began negotiating to purchase a software license from the company. By mid-September 2000, the parties agreed on a $30 million purchase price for the license and associated services.

34. During the final month of the license negotiations, AOL proposed that the software company purchase online advertising from AOL. The software company rejected AOL's proposal.

35. Hours before the parties were set to execute the license agreement, AOL offered to pay an additional $20 million for the license in return for the software company's agreement to purchase $20 million of AOL online advertising. The parties did not change the terms of the license as a result of the price increase nor did they engage in any substantive negotiations regarding the online advertising contract. By oral side agreement, the parties further agreed to simultaneously wire payments of the amounts due under the contracts.

36. AOL and the software company documented the license transaction to conceal the fact that AOL agreed to pay an additional $20 million for the license in exchange for the software company's agreement to purchase $20 million in online advertising. The Company improperly recognized the $20 million as advertising revenue, and the software company improperly recognized most of the additional $20 million as license and service revenue. In its 2002 Restatement, AOLTW reversed the $20 million of improperly recognized revenue.

37. In January 2001, AOL returned to the software company's independent auditors a materially misleading confirmation of the purported terms of the license, further aiding and abetting the software company's fraud.

38. Another example involves a $4.5 million round-trip. In July 2000, AOL began negotiations with another software maker and licensor to purchase a license. By mid-November 2000, AOL and the licensor agreed on a $33 million price for this software.

39. During the negotiations, AOLTW pressed the licensor to purchase online advertising. The licensor, which had no need or budget for the advertising, repeatedly rejected AOLTW's proposal. After agreeing to the $33 million purchase price, but before the deal was signed, AOLTW then proposed to pay the licensor an additional $4.5 million for its license in exchange for an agreement by the licensor to buy $4.5 million of online advertising from AOLTW. The licensor agreed.

40. AOLTW documented the transactions as two independent agreements: AOLTW's purchase of a software license from the licensor for $37.5 million and the licensor's purchase of $4.5 million of online advertising from AOLTW. AOLTW recognized $4.5 million as advertising revenue in the first quarter of 2001. The Company did not restate its financial results to reverse this $4.5 million of advertising revenue in the 2002 Restatement.

B. <u>The Business Acquisition Transactions</u>

The Bertelsmann Online Advertising Contracts

41. In 2001 and 2002, AOLTW improperly recognized $400 million in online advertising revenue as a result of transactions with Bertelsmann AG ("BAG"). In substance, BAG paid $400 million to AOLTW as consideration for amendments to a multi-billion-dollar contract governing AOLTW's purchase of BAG's interest in AOL Europe. The contract amendments had substantial value and BAG offered to compensate

AOLTW for the amendments. Rather than accept cash in exchange for the two amendments, however, AOLTW requested BAG to purchase online advertising in the aggregate amount of $400 million. AOLTW inflated its online advertising revenues by recognizing the $400 million as advertising revenue rather than as consideration received for amending the AOL Europe purchase agreement.

Purchase of BAG's Interest in AOL Europe

42. AOL and BAG formed a joint venture in 1995 that created AOL Europe, which owns and operates European Internet services (including AOL UK and AOL Germany). In March 2000, AOL and BAG entered into a contingent purchase agreement concerning AOL's acquisition of BAG's interest in AOL Europe. The agreement was structured as a put/call option (the "Put/Call"). Under the Put/Call, BAG could exercise an option to "put" its AOL Europe shares to AOL by selling those shares for $6.75 billion; if BAG did not exercise its option, AOL could exercise an option to "call" BAG's AOL Europe shares by purchasing BAG's shares for $8.25 billion. BAG's Put rights under the Put/Call had two settlement dates: January 2002 for 80% of BAG's AOL Europe shares, and July 2002 for the remaining 20% of BAG's AOL Europe shares. The Put/Call provided AOL the option to pay in cash or stock. AOL retained the further option to settle in cash or stock for 12 days after the price of AOL stock was fixed for settlement (the "free-look period"). If AOL's stock price at the end of the free-look period was below the price fixed for settlement under the Put/Call, AOL could deliver stock worth less than the Put/Call price.

43. At the same time in March 2000, BAG and AOL executed an online advertising agreement committing BAG to purchase $150 million in online ads from

AOL over four years (the "Premier Ad Deal"). The Premier Ad Deal provided BAG "premier status," entitling it to extensive ad placement and exclusivity rights, and "preferred pricing," under which the parties agreed by December 2000 to provide BAG with a 40% discount to AOL's list price. Under the Premier Ad Deal, BAG negotiated the content, placement, and timing of the online advertising. After the January 2001 merger of AOL and Time Warner, AOLTW became AOL's successor in interest under the BAG agreements.

$125 Million Put/Call Amendment Deal

44. Shortly after entering into the Put/Call agreement, BAG attempted to realize some or all of the $6.75 billion it was due upon exercise of its Put rights, which according to the contract could not be settled until 2002. In the fall of 2000, BAG tried to sell its interest in the Put/Call agreement to an investment banking firm. However, the investment bankers were unwilling to purchase BAG's interest in the Put/Call because of the uncertainty inherent in its terms. Specifically, the free-look period put BAG at risk of receiving AOL stock worth substantially less than $6.75 billion, and AOL's option to pay with stock, rather than cash, created material, and potentially costly, obstacles to realizing value from BAG's rights prior to the settlement of the Put/Call. As a result of this uncertainty, BAG could not monetize, or realize value from, its rights under the Put/Call agreement prior to settlement. The most effective way to reduce the uncertainty, thereby enabling BAG to realize value by borrowing against the Put/Call agreement, was to obtain AOLTW's agreement to pay the Put price in cash rather than stock.

45. In January 2001, BAG proposed to amend the Put/Call to require AOLTW to pay some or all of the $6.75 billion price in cash to enable BAG to monetize its

interest. BAG offered to compensate AOLTW for the amendment with cash, a reduction in the Put/Call price, or other means. AOLTW proposed that the consideration take the form of an agreement by BAG to purchase online advertising from AOLTW.

46. From January through March 2001, AOLTW and BAG negotiated the terms of the Put/Call amendment. Almost all of the negotiations focused on the value and structure of various Put/Call amendments. There were few, if any, negotiations concerning terms of the online advertising deal, other than the overall price, which was determined by the negotiated value of the Put/Call amendment. During the negotiations, AOLTW and BAG consulted with finance experts and investment bankers concerning the value of the Put/Call amendment, which included the value of the free-look period and the value of avoiding a block sale discount for large blocks of stock. Values asserted by AOLTW during negotiations with BAG ranged from $200 million to $412 million.

47. On March 30, 2001, AOLTW and BAG amended the Put/Call to require AOLTW to pay at least $2.5 billion in cash if BAG exercised its $6.75 billion Put (the "First Put/Call Amendment"). As consideration for the First Put/Call Amendment, BAG agreed to pay AOLTW $125 million in the form of an online advertising purchase (the "March '01 Deal").

48. BAG had no need for additional online advertising. The March '01 Deal provided online advertising that was qualitatively different from the online advertising provided under the Premier Ad Deal. Among other things, the March '01 Deal stripped BAG of the preferred pricing and special rights that it enjoyed under the Premier Ad Deal, and it essentially eliminated BAG's ability to control the content, placement, and frequency of the advertising delivered pursuant to the March '01 Deal.

49. AOLTW decided each quarter how much online advertising to run under the March ’01 Deal by determining the amount of online ad revenues it needed during the period to reach its targets. Often, the advertising for BAG ran late in the reporting period, after AOLTW had determined the amounts by which it could not otherwise attain its revenue goals. BAG generally signed the advertising purchase orders after AOLTW had already run the advertising. Negotiations, to the extent they occurred, concerned mostly the allocation of the ads among BAG’s various subsidiaries and not the placement or frequency of the ads. An AOLTW internal summary of the March ’01 Deal described the online advertising as “pure gravy” and a “freebie,” explaining that “these plans are not to be negotiated.” A later AOLTW internal memorandum described the March ’01 Deal as an “aggressive revenue recognition plan” under which “AOL policy has been focused on maximum revenue recognition without regard to the quality of the carriage or input from the BAG Brands on either participation or carriage.” Internal BAG memoranda and e-mails likewise referred to the agreement in pejorative terms, including describing the advertising as valueless and “rubbish.”

50. AOLTW ignored the substance of the transaction and improperly recognized online advertising revenue in 2001 as a result of the March ’01 Deal as follows: $16.3 million in the first quarter, $65.5 million in the second quarter, and $39.8 million in the third quarter. The Company did not restate this transaction in the 2002 Restatement.

$275 Million Put/Call Amendment Deal

51. In September 2001, BAG asked AOLTW to commit to pay cash for the remaining $4.25 billion due when BAG exercised its Put right. Again, AOLTW proposed to structure the consideration received for the amendment as a payment for on-

line advertising. Once again, AOLTW improperly accounted for the payment from BAG for a Put/Call amendment as if it were advertising revenue.

52. From late November through mid-December 2001, AOLTW and BAG negotiated over the second amendment to the Put/Call. As was the case in March, substantially all of the negotiations concerned the value and structure of the proposed Put/Call amendment. There were few, if any, negotiations concerning terms of the online advertising deal, other than the overall price, which was determined by the negotiated value of the Put/Call amendment. During the negotiations, AOLTW and BAG consulted with finance experts and investment bankers concerning the value of a second Put/Call amendment. The values asserted by AOLTW during the negotiations with BAG ranged from $250 million to $420 million.

53. On December 21, 2001, AOLTW and BAG amended the Put/Call to require AOLTW to pay the remaining $4.25 billion Put amount in cash (the "Second Put/Call Amendment"). As consideration for the Second Put/Call Amendment, BAG agreed to pay AOLTW $275 million in the form of an online advertising purchase (the "December '01 Deal").

54. BAG had no need for additional online advertising. Like the March '01 Deal, the December '01 Deal stripped BAG of the preferred pricing and special rights that it enjoyed under the Premier Ad Deal, and it essentially eliminated BAG's ability to control the content, placement, and frequency of the advertising delivered. AOLTW booked almost the entire $275 million in online advertising from the December '01 Deal in 2002. AOL administered the December '01 Deal substantially the same as it did the March '01 Deal.

55. AOLTW ignored the substance of the transaction and improperly recognized online advertising revenue on the December ’01 Deal in the following amounts in 2002: $80.3 million in the first quarter, $84.4 million in the second quarter, $51.6 million in the third quarter, and $58.0 million in the fourth quarter. The Company did not restate its financial results to reverse the revenue recognized in connection with this transaction in the 2002 Restatement.

56. GAAP requires that the accounting for a transaction reflect its economic substance. The economic substance of the exchanges of March and December 2001 was that BAG paid $400 million for amendments to the Put/Call. AOLTW concealed that fact and fraudulently recognized the $400 million paid for the amendments as if it were bona fide advertising revenue.

Other BAG Transactions

57. In addition to the $400 million in fraudulent revenue from the March and December ’01 Deals, AOLTW and BAG entered into a round-trip agreement which resulted in $17.4 million of improperly recognized online advertising revenue in the fourth quarter of 2000. From the fourth quarter of 2000 through the fourth quarter of 2001, AOL and BAG also entered into a series of undisclosed side agreements resulting in the premature recognition of approximately $33.6 million in online advertising revenue.

Another Instance of Improper Revenue Recognition In Connection With an Acquisition

58. AOLTW entered into a “stock swap” with one of its joint venture partners in the first quarter of 2001. In the stock swap, among other things, AOLTW purchased the partner’s 55% interest in their joint venture. Similar to other round-trip transactions in

which AOLTW funded its revenue, AOLTW and the partner agreed on a purchase price of $700 million, with the understanding that the purchase price would be increased by $25 million in exchange for the partner's commitment to purchase $25 million of online advertising from AOLTW. AOLTW artificially inflated its online advertising revenue in each quarter of 2001 and the first quarter of 2002 by improperly recording $25 million in online advertising revenue. The Company did not restate its financial results to reverse the $25 million recognized as revenue for this transaction in the 2002 Restatement.

C. Legal Settlements Converted to Online Advertising Revenue

59. Shortly after AOL began trading discounts for online advertising revenue with its vendors, AOL also started converting settlements of disputes into online advertising revenue.

60. For example, in August and September 2000, two companies agreed to settle longstanding disputes with AOL by paying AOL $12.5 million and approximately $25 million, respectively. Under GAAP, these payments should not have been recorded as advertising revenue.

61. The two companies offered to pay these amounts to AOL without regard to any advertising purchases. AOL improperly converted these settlements into online advertising revenue and documented the settlement payments as advertising purchases, thereby improperly inflating its online advertising revenue by $12.5 million in the third quarter of 2000 and by $23.8 million in the third and fourth quarters of 2000.

62. Similarly, in two transactions with a major communications provider, AOLTW improperly converted settlements with the counterparty into purchases of online advertising and documented the settlement payments as advertising purchases, thereby

inflating its online advertising revenues by $34.2 million and $17 million in the second and fourth quarters of 2001.

63. Likewise, AOLTW converted a $4 million lease termination penalty into a $4 million ad revenue deal with a vendor on which it recognized revenue in the fourth quarter of 2001.

64. In its 2002 Restatement, AOLTW reversed online advertising revenue recognized in connection with these transactions.

D. <u>The Sham Referrals</u>

Improper Transactions with PurchasePro

65. PurchasePro.com, Inc. was a publicly-owned corporation with its corporate headquarters in Las Vegas, Nevada. PurchasePro's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and quoted on the Nasdaq. PurchasePro provided business-to-business electronic-commerce software licenses and services.

66. AOL and PurchasePro engaged in round-trip transactions to enable both companies to record and report false revenues.

67. In the third quarter of 2000, AOL paid PurchasePro $2 million for software licenses that it neither needed nor intended to use. In exchange, and by way of an undisclosed side agreement, PurchasePro amended a warrant agreement so that AOL would receive $3 worth of warrants for PurchasePro stock for every $1 in third-party revenue AOL referred to PurchasePro. In a false confirmation to PurchasePro's auditors, AOL failed to disclose, among other things, that it had received additional rights under the warrant agreement in exchange for making the $2 million purchase. PurchasePro

materially overstated its revenues by improperly recognizing the $2 million in revenue in the third quarter of 2000.

68. In the fourth quarter of 2000, AOL and PurchasePro manipulated their warrant agreement to artificially manufacture revenue for both companies. Under the agreement, AOL could earn warrants only when third parties it referred to PurchasePro entered into commercial arrangements that enabled PurchasePro to recognize revenue. The agreement did not permit AOL to earn warrants based on purchases it made from PurchasePro. Nevertheless, in the fourth quarter of 2000, AOL bought $10 million worth of products and services from PurchasePro, and PurchasePro deemed AOL to have "earned" $30 million worth of warrants. To circumvent PurchasePro's auditors' objections, AOL and PurchasePro falsified documents to create the appearance that AOL had actually referred $10 million of third-party purchases to PurchasePro. AOL thus improperly recognized advertising and electronic commerce revenue on the net $20 million difference between the value of the warrants and the $10 million it paid directly to PurchasePro. PurchasePro, for its part, improperly recognized revenue on AOL's $10 million purchase and thus overstated its fourth quarter and year-end revenues. In the 2002 Restatement, AOLTW did not restate its financial results to reverse the $20 million in improper revenue it recognized on this transaction.

The Homestore Transactions

69. Homestore, Inc. is a Delaware corporation headquartered in Westlake Village, California. Homestore provides Internet real estate listings to consumers and sells products and services to real estate brokers. Since June 2000, Homestore has provided content for the "House and Home" channel on AOL's online service.

Homestore's stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and is quoted on the Nasdaq.

70. During the third quarter of 2000 and the first quarter of 2001, the Company and Homestore entered into a series of purportedly unrelated transactions which resulted in both companies misstating their revenues. To conceal the true nature of these arrangements, AOL and Homestore entered into undisclosed side agreements and falsified documents to make it appear that third parties purchased online advertising. During the second and third quarters of 2001, AOLTW assisted in inflating Homestore's revenues through another series of transactions that effectively resulted in Homestore's buying its own revenues. AOL falsified documents to make it appear that third parties purchased Homestore online advertising.

71. In total, the Company improperly inflated its online advertising revenue based on the Homestore-related transactions by at least $1.5 million in the fourth quarter of 2000 and $7 million in the first quarter of 2001. In its 2002 Restatement, AOLTW restated its financial results to reverse these amounts. For its part, Homestore materially overstated its reported financial results for the third quarter of 2000 and the first through third quarters of 2001 based on improperly recognizing the following amounts of revenue on AOL-related transactions: $1.5 million in the third quarter of 2000, $15 million in the first quarter of 2001, $18.5 million in the second quarter of 2001, and $3.3 million in the third quarter of 2001. Homestore has restated its financial results to reverse the amounts for 2001.

E. **Improper Subscriber Counts**

72. In addition to AOL's online advertising revenue, the market evaluated AOL (both before and after its merger with Time Warner) based on, among other factors, the number of subscribers using AOL's Internet service as well as the growth of that subscriber base. Senior Company executives set internal subscriber growth targets each quarter and pressured lower level executives and employees to meet the targets.

73. In 2000, AOL began selling Internet account memberships in bulk at substantial discounts to corporations with which it had commercial relationships. AOL counted these memberships as subscribers under the assumption that its corporate customers would offer these memberships to their employees and the employees would activate the memberships.

74. In 2001, AOLTW used the bulk subscription program to inflate its AOL membership numbers by counting members AOLTW knew did not actually exist. Specifically, AOLTW used bulk deals to "close the gap" between its actual AOL subscriber numbers and its targets. The "attach rates"—the percentage of persons or entities that actually became AOL members—were exceptionally low for bulk deals. Notwithstanding the low attach rates, which AOLTW tracked closely, AOLTW counted most of these bulk AOL subscription memberships in 2001 to meet its subscriber targets.

75. Some businesses resisted AOLTW's pressure to buy bulk AOL subscriptions because they did not want to incur the cost. These businesses only agreed to enter into contracts to "purchase" AOL subscriptions as an accommodation to AOLTW and upon AOLTW's agreement to fully fund these purchases.

76. For example, in the second quarter of 2001, internal reports indicated that AOLTW would fall short of its AOL subscriber growth target for the quarter by approximately 250,000 members. To meet its target, AOLTW pressed a major retail business to purchase 250,000 AOL subscriptions. The retailer declined. AOLTW then offered to reimburse the retailer for the cost of the subscriptions by increasing payments made to the retailer pursuant to another contractual arrangement. The retailer again declined. AOLTW finally prevailed upon the retailer to "purchase" the subscriptions by agreeing to inflate the payments under the other arrangement in such a way that, based upon historical experience, the retailer would receive more than 100% of the money it paid for the subscriptions.

77. As the quarter drew to a close, the gap in AOL's subscriber numbers had increased to approximately 350,000 as other marketing efforts had underperformed. To close the gap, AOLTW increased the number of AOL subscriptions in the bulk deal with the retailer from 250,000 to 350,000. Because the transaction was economically neutral (or beneficial) to the retailer, AOLTW knew it would not object. As a result, AOLTW met its AOL subscriber count goal that quarter.

78. In four instances, AOLTW should not have counted AOL bulk subscribers in certain quarters because it failed to complete the transactions within the quarters. Specifically, AOLTW failed to deliver by the end of the relevant quarter membership kits that met the specifications set forth in the respective contracts. AOLTW shipped non-conforming membership kits prior to quarter end with the understanding that it would replace these materials in the following quarter with materials that conformed to the

contracts. AOLTW improperly included in its subscription counts the memberships in each bulk deal at the time of the initial shipment of non-conforming kits.

79. AOLTW improperly counted these bulk subscription memberships to meet subscriber targets in the second, third, and fourth quarters of 2001 so it could report to the investment community that it had met its targets.

F. Failure to Consolidate AOL Europe

80. In addition to improperly recognizing as online advertising revenue payments it received from BAG for amendments to the Put/Call, AOL and AOLTW failed to properly consolidate the financial results of AOL Europe in their financial statements between March 2000 and January 2002. This resulted in material misstatements of AOL's and AOLTW's financial results, including overstatements of operating income and free cash flow in 2000 and 2001, overstatements of net income in 2000, understatements of net losses in 2001, and understatements of total debt in 2000 and 2001.

81. Provisions of the Put/Call agreement specified that AOL would continue to hold no more than 50% of AOL Europe's voting securities, but BAG agreed it would have no contractual veto, consent, approval, voting, or similar rights with respect to AOL Europe and agreed to cause its own designated directors, steering committee members, or members of any similar governing body of AOL Europe to act in accordance with AOL's directions. By virtue of these provisions, AOL obtained broad and direct powers enabling it to control the operations and assets of AOL Europe. Also, AOL informed the European Commission (in the context of satisfying EC merger regulations) that BAG

relinquished essentially all control regarding the operations or management of AOL Europe.

82. AOL's failure to properly report AOL Europe as a consolidated subsidiary commencing with the execution of the Put/Call agreement departed from GAAP. GAAP requires consolidation when one entity has a controlling financial interest in another entity.

FIRST CLAIM FOR RELIEF

Violations of Commission Cease-and-Desist Order

83. Paragraphs 1 through 82 are re-alleged and incorporated by reference.

84. On May 15, 2000, the Commission ordered that AOL "cease and desist from causing any violations, and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder." *In the Matter of America Online, Inc.,* Exchange Act Rel. No. 34-42781 (May 15, 2000).

85. By reason of the foregoing, and as explained further in paragraphs 89 through 94, the Company committed violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 13a-1 and 13a-13. Accordingly, the Company has violated, and unless ordered to comply will violate, the Commission's May 15, 2000 order.

SECOND CLAIM FOR RELIEF

Fraud

Violations of Section 17(a) [15 U.S.C. § 77q(a)] of the Securities Act, Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)], and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5]

86. Paragraphs 1 through 4 and 6 through 79 are re-alleged and incorporated by

reference.

87. By reason of the foregoing, defendant directly or indirectly, acting intentionally, by use of the means or instrumentalities of interstate commerce or of the mails, in connection with the offer, sale, or purchase of securities: (a) employed devices, schemes, or artifices to defraud; (b) made untrue statements of material fact or omitted to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading; (c) obtained money or property by means of any untrue statement of a material fact or any omission of a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading; or (d) engaged in transactions, acts, practices, or courses of business which operated as a fraud or deceit upon other persons.

88. By reason of the foregoing, defendant violated, and unless restrained will violate, Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5.

THIRD CLAIM FOR RELIEF

Reporting

Violations of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13 [17 C.F.R. § 240.12b-20, § 240.13a-1, § 240.13a-11, and § 240.13a-13]

89. Paragraphs 1 through 82 are re-alleged and incorporated by reference.

90. The Exchange Act and Exchange Act rules require every issuer of registered securities to file reports with the Commission that accurately reflect the issuer's financial performance and provide other true and accurate information to the public.

91. By reason of the foregoing, defendant violated, and unless restrained will violate, Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13.

FOURTH CLAIM FOR RELIEF

Record Keeping

Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B)] and Exchange Act Rule 13b2-1 [17 C.F.R. § 240.13b2-1]

92. Paragraphs 1 through 82 are re-alleged and incorporated by reference.

93. The Exchange Act and Exchange Act rules promulgated thereunder require each issuer of registered securities to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the business of the issuer and to devise and maintain a system of internal controls sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit preparation of financial statements and to maintain the accountability of accounts.

94. By reason of the foregoing, defendant violated, and unless restrained will violate, Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Exchange Act Rule 13b2-1.

FIFTH CLAIM FOR RELIEF

Aiding and Abetting Fraud

Violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5]

95. Paragraphs 1 through 3, 6 through 22, 32 through 37, and 65 through 71 are re-alleged and incorporated by reference.

96. By reason of the foregoing, defendant knowingly and substantially assisted PurchasePro, Homestore, and the company referenced in paragraph 32 in directly or indirectly, by use of the means or instrumentalities of interstate commerce or of the mails, in connection with the purchase or sale of securities: (a) employing devices, schemes, or artifices to defraud; or (b) making untrue statements of material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading.

97. By reason of the foregoing, defendant aided and abetted violations of, and unless restrained will aid and abet violations of, Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.

REQUEST FOR RELIEF

The Commission respectfully requests that the Court enter an Order:

(i) Ordering defendant to comply with the Commission's May 15, 2000 order issued in *In the Matter of America Online, Inc.*;

(ii) Permanently restraining and enjoining defendant from violating Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Exchange Act Rules 10b-5, 12b-20, 13a-1, 13a-11, 13a-13, and 13b2-1;

(iii) Permanently restraining and enjoining defendant, its subsidiaries, officers, directors, agents, servants, employees, and attorneys-in-fact, and all persons in active concert or participation with them, from aiding and abetting violations of any of the above-listed securities laws;

(iv) Ordering defendant to disgorge ill-gotten gains, including pre-judgment and post-judgment interest, resulting from the violations alleged in this Complaint;

(v) Ordering defendant to retain an independent examiner, not unacceptable to the Commission's staff, to determine whether defendant's historical accounting treatment for certain transactions was in conformity with GAAP;

(vi) Ordering defendant to pay a civil penalty; and

(vii) Granting such other relief as the Court deems just and appropriate.

Dated: March 21, 2005

Respectfully submitted,

________/S/___________________

James T. Coffman
Luis R. Mejia (DC Bar No. 417043)
Melissa A. Robertson (DC Bar No. 396384)
Gregory T. Lawrence
Jeffrey B. Finnell (DC Bar No. 441525)
Christopher K. Agbe-Davies (DC Bar No. 473727)
Thomas D. Manganello (DC Bar No. 481335)
Andrew B. Stevens

Attorneys for Plaintiff
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0911
(202) 942-4744 (Mejia)
MejiaL@sec.gov