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SUPERIOR COURT OF THE STATE OF ALASKA

FIRST JUDICIAL DISTRICT

ALASKA STATE DEPARTMENT OF REVENUE, ALASKA STATE PENSION INVESTMENT BD., and ALASKA PERMANENT FUND CORPORATION, Plaintiffs, v. AMERICA ONLINE, INC., TIME WARNER, INC., HISTORIC TW INC., ERNST & YOUNG LLP, MORGAN STANLEY & CO. INC., STEPHEN M. CASE, ROBERT W. PITTMAN, J. MICHAEL KELLY, DAVID COLBURN, ERIC KELLER and DOES 1-100, inclusive, Defendants.	Case No. 1JU-04-503 COMPLAINT (1) VIOLATIONS OF ALASKA TRADE AND COMMERCE STATUTES SECTIONS 45.55.010 AND 45.55.930; (2) COMMON LAW MISREPRESENTATION; AND (3) PROFESSIONAL NEGLIGENCE/ MALPRACTICE DEMAND FOR JURY TRIAL

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INTRODUCTION

1. The Alaska State Department of Revenue, the Alaska State Pension Investment Board, and the Alaska Permanent Fund Corporation (collectively, the "Alaska Funds" or "plaintiffs") bring this action against America Online, Inc. ("AOL"), Time Warner, Inc. ("AOLTW"), Historic TW Inc. ("Time Warner") and others (collectively, "Defendants") arising out of Defendants' fraudulent and unlawful practice of significantly and materially overstating the publicly-reported advertising revenues and growth of AOL and AOLTW, and overstating AOL's subscriber numbers, all of which was intended to, and did artificially inflate the stock price of AOL and AOLTW, to the detriment of plaintiffs.

2. Over the course of nearly four years, AOL, and later AOLTW after AOL merged with Time Warner on January 11, 2001 (the "Merger"), devised numerous deals and transactions through which the company improperly claimed advertising revenues to bolster the company's financial reports. Through various means, AOL and AOLTW also improperly inflated AOL's subscriber numbers. Defendants then issued press releases and filed financial reports with the Securities and Exchange Commission ("SEC") which contained false information about AOL's and AOLTW's revenues and subscriber numbers.

3. The Alaska Funds have suffered many millions of dollars of losses as a result of Defendants' misrepresentations and omissions about AOL's and AOLTW's financial results and subscriber numbers, and the other misconduct as described herein. To date, AOLTW has restated (or indicated that it might have to restate after further investigation) at least $590 million in revenues, and continues to investigate its prior financial statements and dealings. On October 23, 2002, AOLTW reported the following restatements to the reported revenues in their financial reports:

Quarter Ending	Amount Restated
9/30/00	$66 million
12/31/00	$22 million
3/31/01	$13 million
6/30/01	$28 million

9/30/01	$16 million
12/31/01	$17 million
3/31/02	$6 million

4. AOLTW has publicly stated that its financial statements for 2000 and 2001 can no longer be relied upon.

5. AOLTW also wrote down nearly $100 billion in goodwill over two quarters in 2002, due to the declining value of the company.

6. On March 25, 2002, in its form 10-K for the fiscal year ending December 31, 2001, AOLTW reported a charge of approximately $270 million to reflect a reduced value in its Hughes investment. Additionally, on November 14, 2002, AOLTW reported in its Form 10-Q that the non-cash pretax charges for the three and nine month periods ending September 30, 2002, included charges related to a $505 million writedown related to the Hughes deal described in paragraph 51.

7. From a high of $56.60 in May 2001, through to when the false statements began to be revealed in July 2002 and beyond, AOLTW's stock price has dropped to less than $17.

8. Through this Complaint, the Alaska Funds seek redress for losses they have suffered in connection with the purchase of AOL, Time Warner and AOLTW securities during the period January 27, 1999 through March 28, 2003, as a result of Defendants' unlawful and fraudulent conduct, in violation of Alaska state law.

JURISDICTION AND VENUE

9. The violations of law complained of herein occurred in part in Alaska and in Alaska's First Judicial District, including the dissemination of materially false and misleading statements into this Judicial District. Each of the Defendants have minimum contacts with Alaska and/or conduct business here sufficient to permit the exercise of jurisdiction over them. This Court has personal jurisdiction over the corporate defendants pursuant to AS 09.05.015(a)(1)(D) in that they are engaged in substantial activities in Alaska. Moreover, this Court has personal jurisdiction over the individual defendants under AS 09.05.015(a)(4) in that this is an action

claiming injury to property in this state in the form of pecuniary loss by Alaska arising out of defendants' conduct as described herein, and it was foreseeable that defendants' misrepresentations would be disseminated to and received in Alaska and that AOL and AOLTW securities would be purchased and sold in Alaska.

10. The amount of damages sued for is in excess of the jurisdictional minimum of this court.

THE PARTIES

I. PLAINTIFFS

11. Plaintiffs Alaska Department of Revenue, Alaska State Pension Investment Board, and Alaska Permanent Fund Corporation, on behalf of various State of Alaska investment funds, including the Alaska Permanent Fund, the Alaska pension funds, and the Alaska Constitutional Budget Reserve, purchased, either directly or through authorized agents, the publicly-traded securities of AOL, Time Warner and AOLTW before, in connection with, and, in the case of AOLTW, after the Merger, and have been damaged thereby.

12. The Alaska Department of Revenue is an Alaska state agency that collects and invests funds for the public purposes of the State, including investing on behalf of the Constitutional Budget Reserve Fund, the Public School Trust Fund, the Power Cost Equalization Endowment Fund, the Exxon Valdez Oil Spill Investment Fund, the Retiree Health Insurance Fund – Major Medical, Retiree Health Insurance Fund – Longterm Care, the University of Alaska, Investment Trust Fund, and the Alaska Children's Trust Fund.

13. The Alaska State Pension Investment Board ("ASPIB"), an entity of the State of Alaska, was established pursuant to AS 37.10.210 on July 1, 1992. The purpose of the board is to provide prudent and productive management and investment of state pension funds. The systems and plans for which the ASPIB manages and invests funds are the Public Employees' Retirement System, the Teachers' Retirement System, the Judicial Retirement System, the Public Employees Retirement System, the National Guard/Naval Militia Retirement Systems, the Alaska Supplemental Annuity Plan, and the Alaska Deferred Compensation Plan (employee directed accounts).

14. The Alaska Permanent Fund Corporation manages the Alaska Permanent Fund and the Alaska Mental Health Trust Fund.

15. Prior to the Merger, the Alaska Funds purchased approximately 1,906,100 shares of AOL securities and 1,199,680 shares of Time Warner securities. Upon the Merger, the Alaska Funds converted approximately 1,199,680 shares of Time Warner securities into 1,799,520 shares of AOLTW securities and approximately 1,906,100 shares of AOL securities into 1,906,100 shares of AOLTW securities. (Under the merger exchange ratio, Time Warner shareholders received 1.5 shares of AOLTW stock for each share of Time Warner stock and AOL shareholders received 1 share of AOLTW for each share of AOL stock.) Between the Merger and March 28, 2003, the Alaska Funds purchased approximately 2,675,700 shares of AOLTW securities.

II. DEFENDANTS

A. AOL/Time Warner

16. AOL is a Delaware corporation with its principal place of business in Dulles, Virginia. As of January 11, 2001, AOL has been a wholly-owned subsidiary of AOLTW. AOL's business consists principally of online Internet access and interactive services, Internet advertising, Internet properties, Internet technologies and various electronic commerce services.

17. Time Warner is a Delaware corporation with its headquarters in New York, New York. As of January 11, 2001, Time Warner has been a wholly-owned subsidiary of AOLTW. Time Warner's principal business is to create and distribute media and entertainment throughout the world. On October 16, 2003, Time Warner changed its name to Historic TW Inc. Because it was called Time Warner for the time periods described herein, Historic TW Inc. is referred to as Time Warner in this Complaint.

18. AOLTW is a Delaware corporation with its headquarters in New York, New York. AOLTW was formed in connection with the Merger of AOL and Time Warner. As a result of the Merger, AOL and Time Warner each became wholly owned subsidiaries of AOLTW. AOLTW is named as a Defendant in its own right for all liabilities of AOLTW arising in conjunction with or after the Merger and for all liabilities of AOL and Time Warner arising in

conjunction with or after the Merger. AOLTW is also named as a successor-in-interest for all liabilities of AOL and Time Warner arising prior to or in conjunction with the Merger. On October 16, 2003, the merged company changed its name to Time Warner, Inc.

B. <u>The Individual Defendants</u>

19. Stephen M. Case. Stephen M. Case ("Case") co-founded AOL in 1985. He became a director of AOL when it first became a public company in September 1992, Chief Executive Officer in April 1993 and Chairman of the Board in October 1995, and held all of these positions until the Merger was consummated. Case was a signatory to the Joint Proxy Statement-Prospectus incorporated into the Merger Registration Statement, and the Stock Option Registration Statements, as well as to AOL's 10-K form dated August 13, 1999, for the period ending June 30, 1999, AOLTW's 10-K, dated September 22, 2000, for the period ending June 30, 2000, and AOL's 10-Q, dated November 9, 2000, for the period ending September 30, 2000, and AOLTW's transition annual reports, filed March 27, 2001, for the period ending December 30, 2000, and March 25, 2002, for the period ending December 3, 2001. Upon the Merger, Case became a director and Chairman of the Board of AOLTW. On January 12, 2003, Case announced his resignation from AOLTW, effective May 1, 2003. Case was a direct participant in Defendants' scheme to defraud the investing public, including Plaintiffs.

20. Robert W. Pittman. Robert W. Pittman ("Pittman") joined AOL in November 1996, and served as President and Chief Executive Officer of AOL Networks, a division of AOL, until February 1998. From February 1998 until the Merger, Pittman was President and Chief Operating Officer of AOL. He was a director of AOL from 1995 until the Merger. Pittman was a signatory to the Joint Proxy Statement-Prospectus incorporated into the Merger Registration Statement and the Stock Option Registration Statements, as well as to AOL's 10-K, filed September 22, 2000, for the period ending June 30, 2000. On January 11, 2001, Pittman became Co-Chief Operating Officer of AOLTW and an affiliated director of the AOLTW Board of Directors. On April 19, 2001, Pittman resumed his prior responsibilities for operations of the AOL subsidiary of AOLTW. In May 2002, Pittman became the sole Chief Operating Officer of AOLTW. On July 18, 2002, the day *The Washington Post* reported on various

accounting improprieties regarding AOL advertising revenue, Pittman resigned. Pittman was a direct participant in Defendants' scheme to defraud the investing public, including Plaintiffs.

21. J. Michael Kelly. From June 1998 until the Merger, J. Michael Kelly ("Kelly") was Senior Vice President, Chief Financial Officer and Assistant Secretary of AOL. Kelly was a signatory to the Merger Registration Statement and the Stock Option Registration Statements, as well as to AOL's 10 K, filed August 13, 1999, for the period ending June 30, 1999, AOL's 8 K, filed March 17, 1999, AOL's 10 K, filed September 22, 2000, for the period ending June 30, 2000, AOL's 10 Q, filed November 9, 2000, for the period ending September 30, 2000, AOLTW's 10 Qs, filed May 15, 2001, and August 14, 2001, for the periods ending March 31, 2001, and June 30, 2001, respectively. Upon the Merger, Kelly became Chief Financial Officer and Executive Vice President of AOLTW. On or about November 1, 2001, Kelly was appointed Chief Operating Officer of the AOL subsidiary of AOLTW. Kelly was a direct participant in Defendants' scheme to defraud the investing public, including Plaintiffs.

22. David M. Colburn. From 1995 until the Merger, David M. Colburn ("Colburn") was Senior Vice President of Business Affairs for AOL. He reported directly to Pittman. Following the Merger, Colburn became Executive Vice President of AOL and President of Business Affairs and Development for AOLTW, and continued to report directly to Pittman. Colburn was AOL's, and thereafter AOLTW's, principal "deal-maker." Colburn was terminated in August 2002 after he was identified as a subject of SEC and Department of Justice ("DOJ") investigations. Colburn was a direct participant in Defendants' scheme to defraud the investing public, including Plaintiffs.

23. Eric Keller. Eric Keller ("Keller") was Senior Executive Vice President of Business Affairs and Development, and reported directly to Colburn at AOL. After the Merger, Keller remained Senior Executive Vice President of Business Affairs and Development and continued to work under and report directly to Colburn. Keller was the number two "deal-maker" at AOL and AOLTW. Various media reports have identified Keller as a subject of SEC and DOJ investigations. Keller was a direct participant in Defendants' scheme to defraud the investing public, including Plaintiffs.

24. Defendants Case, Pittman, Kelly, Colburn, and Keller are sometimes collectively referred to herein as the "Individual Defendants."

C. <u>Defendant Ernst & Young LLP</u>

25. Ernst & Young LLP ("Ernst & Young") is a firm of certified public accountants that maintains its headquarters in New York, New York. At all times relevant to this action, Ernst & Young provided auditing and accounting services to AOL and AOLTW, including but not limited to, conducting audits of AOL and AOLTW's year-end financial statements and reviewing AOL's and AOLTW's quarterly financial statements. In connection therewith, Ernst & Young issued unqualified audit reports related to AOL and AOLTW's financial statements, for the fiscal years 1998, 1999, 2000 and 2001. Ernst & Young also reviewed and approved the unaudited financial statements issued in connection with the Merger, including those provided in the Merger Registration Statement and the Stock Option Registration Statements.

D. <u>Defendant Morgan Stanley & Co.</u>

26. Morgan Stanley & Co. ("Morgan Stanley") is a financial services institution, that, through its subsidiaries and divisions, provides commercial and investment banking services and advisory services. Morgan Stanley's headquarters are located in New York, New York. Morgan Stanley acted as financial adviser to Time Warner in connection with the Merger and issued a false opinion that the Merger was fair to Time Warner and its shareholders.

E. <u>Doe Defendants</u>

27. Plaintiffs are unaware of the true names, capacities and/or specific involvement of those defendants sued herein as DOES 1-100, inclusive, and therefore sue these defendants as fictitious names. Plaintiffs are informed and believe, and thereon allege, that each of the fictitiously-named defendants is responsible in some manner for the occurrences alleged herein; the claims against such defendants arise from the same conduct as set forth herein, and plaintiffs' injuries, as alleged in this complaint were proximately caused by the wrongful conduct.

F. <u>Additional Allegations</u>

28. All of the acts alleged herein committed by each of these defendants were

ratified, approved, or affirmed by the other defendants, and/or done with the knowledge, consent, or permission of the other defendants or their agents, servants, or employees.

29. Plaintiffs are informed and believe, and thereon allege, that at all material times, each of the defendants was the agent and/or employee of each of the remaining defendants, and in doing the acts alleged in the Complaint, was acting within the course and scope of such agency and/or employment.

30. All of the above-named defendants, or agents for these defendants, were responsible in some manner for the occurrences herein mentioned, and the plaintiffs' injuries alleged herein were proximately caused by the defendants.

FACTUAL ALLEGATIONS

I. BACKGROUND

31. AOL was founded, and incorporated in Delaware, in May 1985. AOL's principal business activity is its "America Online" Internet access subscription service. AOL also sells online advertising, and hosts or provides original programming or content, including entertainment, computing support, and electronic magazines and newspapers. In 1992, AOL went public and was listed on the NASDAQ stock exchange. Since September 18, 1996, AOL has been listed on the New York Stock Exchange.

32. AOL experienced significant growth from the internet boom of the 1990s, with revenue growth in both its internet subscriber base and through advertising revenues from dot-com companies. On June 30, 1996, AOL reported 6.2 million subscribers to the AOL service, and annual revenues of $992 million. By mid-1999, AOL reported that its subscriber numbers had risen to approximately 17.6 million, accounting for more than $3.3 billion in revenues for the fiscal year ending June 30, 1999, and that its advertising revenues had grown to more than 20% of AOL's total revenues, or over $1 billion in revenues for the fiscal year ending June 30, 1999.

33. In October 1999, AOL's management approached Time Warner, suggesting a potential merger between the two companies; merger negotiations began shortly thereafter. AOL retained the investment banking firm of Salomon Smith Barney Inc. to provide

financial advice in connection with the potential merger. Time Warner retained Morgan Stanley to provide merger-related financial advice, and to issue a "fairness opinion," i.e., an opinion that the merger transaction was fair to Time Warner shareholders.

34. Ultimately, the companies agreed that AOL shareholders would own 55% of a new AOLTW and Time Warner shareholders would own 45%.

35. On January 10, 2000, AOL and Time Warner announced their intention to merge and form AOLTW in a deal that was valued in excess of $100 billion. At a joint AOL and Time Warner press conference held to announce the Merger that day, AOL and Time Warner executives, including Defendants Case, Pittman, and Kelly, spoke of the future success of AOLTW.

36. At the January 10, 2000 press conference, AOL and Time Warner executives projected that the financial results of AOLTW included a "revenue base of $40 billion" and an "EBITDA[1] base of $10 billion."

37. The AOL and Time Warner merger agreement contained a term known as a "no material adverse change" provision, which enabled either AOL or Time Warner to withdraw from the merger if the other party experienced a "material adverse change" in its business. As a result, AOL executives knew that the AOL stock price and business prospects had to be maintained at a high enough level to ensure the consummation of the Merger.

38. At the time, AOL appeared to be a successful company due to its reportedly large subscriber base and substantial advertising revenues. AOL's reported advertising revenues were particularly significant due to the slowing of AOL's subscription revenues as a result of increased competition. However, by early 2000, the "Internet boom" had begun to decline, and many of AOL's advertising clients were experiencing significant business declines or facing bankruptcy.

39. In the days following the announcement of the merger, AOL's stock price fell by more than 19%, dropping $8.25 from $72.75 on January 10, 2000, to $64.50 on January 11, 2000, and dropping an additional $4.50 from $64.50 to $60.00 on January 12, 2000.

[1] "EBITDA" stands for "Earnings before Income Taxes, Depreciation and Amortization."

This decline alarmed AOL executives, and forced them to address concerns that were being raised by the investment community and financial media about AOL's business prospects.

II. DEFENDANTS' FRAUDULENT SCHEME

40. For AOL, the success of the merger depended on continued public perception of AOL as a robust and growing company. In January 2000, AOL began a public relations campaign to highlight the strength of AOL's business and AOLTW's prospects for growth, and to dispel any impression that AOL was experiencing any negative effects from the slowed economy.

41. Internal AOL documents and discussions between the Defendants, however, reveal that AOL knew by September 2000 that over $100 million of its advertising revenues were at risk for fiscal year 2001 (July 1, 2000 – June 30, 2001) alone. In order to bridge the gap and create the illusion of financial strength, AOL and AOLTW engaged in a series of sham deals and fraudulent accounting practices. False financial reports incorporating these transactions were then reported in SEC filings and press releases.

42. Both pre- and post-Merger, AOL and AOLTW represented that their financial statements were prepared in conformity with generally accepted accounting principles ("GAAP"), the uniform rules, conventions and procedures that define accepted accounting practice. However, from at least June 1999 through June 2002, AOL falsely reported its financial results by manipulating and misrepresenting the revenues it earned through advertising commerce and through its subscriber base. Some or all of these false and misleading financial results were incorporated in SEC Filings, press releases, the Merger Registration Statement and the Stock Option Registration Statements. Moreover, Defendants referenced and relied upon such false financial reports in their public statements regarding the financial health of and/or future prospects for AOL and/or AOLTW.

43. After the Merger on January 11, 2001, Defendants continued to overstate AOLTW's advertising revenue. In its first post-merger earnings report, i.e., the first quarter 2001 results, AOLTW reported results which exceeded "Wall Street" expectations. These results — brought on by the improper classification of revenue and sham transactions described in detail in

paragraphs 45-126 — reassured investors, and led the stock price to rise from $43.90 on April 17, 2001, to $49.00 on April 18, 2001, and to as high as $58.51 in May 2001. Even when the Internet-related advertising market eventually became so weak that AOLTW was forced to publicly report decreases in advertising revenue, AOLTW continued to inflate artificially these revenues to soften the stock market's reaction.

44. In another attempt to inflate the stock price after the Merger, AOLTW announced, and then completed, a stock repurchase of more than $5 billion of its own securities on the open market, publicly reasoning that the stock price was under-valued. During this same period, however, from July 14, 2000, through November 30, 2002, certain insiders sold millions of their own AOLTW shares to the public at substantially inflated prices, as set forth in more detail in paragraphs 147-150. Defendants publicly denied any apparent discrepancy, and reported various false and misleading reasons for the selling.

A. AOL and AOLTW's Fraudulent Advertising Transactions

45. Examples of Defendants' fraudulent transactions and/or improper accounting, in violation of GAAP, during the relevant period include, but are not limited to, the following, as more fully discussed in paragraphs 45 to 115, below:

a. Improperly inflating advertising revenues in violation of GAAP through "round-trip" or barter transactions involving reciprocal purchase and sale transactions between AOL or AOLTW and other companies, the economic substance of which were either falsely reported or accounted for or which did not exist;

b. Improper classification of gains, including contract termination fees from failing Internet companies, as advertising revenue;

c. One-time gains in the form of contract termination or restructuring fees;

d. Improperly manipulating advertising contracts to prematurely record advertising revenues;

e. Improperly classifying legal settlements as advertising revenue;

f. Improperly recognizing revenues associated with Cable Channel

Fees;

g. Improperly inflating advertising revenues through the recognition of advertising revenue in transactions in which AOL acted solely as a broker or intermediary; and

h. Improperly accounting for cross-platform advertising transactions (advertising services provided by more than one AOLTW division), including the double-booking of advertising revenue..

1. <u>Improper Barter or "Round Trip" Transactions</u>

46. GAAP, as set forth by the Financial Accounting Standards Board ("FASB") Statement of Concepts No. 2 requires that financial statements reflect the true nature of a transaction and represent what it purports to represent. In 1984, FASB created the Emerging Issues Task Force ("EITF") to addresses the proper method for reporting certain types of "barter" or "swap" transactions, among other issues. In January 2000, EITF published Issue 99-17, which states, in pertinent part:

> The Task Force reached a consensus that revenue and expense should be recognized at fair value from an advertising barter transaction only if the fair value from an advertising transaction is determinable based on the entity's own historical practice of receiving cash, marketable securities, or other consideration that is readily convertible to a known amount of cash for similar advertising from buyers unrelated to the counterparty in the barter transaction. An exchange between the parties to a barter transaction of offsetting monetary consideration, such as a swap of checks for equal amounts, does not evidence the fair value of the transaction. If the fair value of the advertising surrendered in the barter transaction is not determinable within the limits of the Issue, the barter transaction should be recorded based on the carrying amount of the advertising surrendered, which likely will be zero.

And:

> Entities should disclose the amount of revenue and expense recognized from advertising barter transactions for each income statement period presented. In addition, if an entity engages in advertising barter transactions for which the fair value is not determinable with the limits of this Issue, information regarding the volume and type of advertising surrendered and received (such as the number of equivocal pages, the number of minutes, or the overall percentage of advertising volume) should be disclosed for each income statement period presented.

47. Contrary to GAAP, AOL devised a series of sham barter-type transactions

which were designed as a means for AOL to improperly report advertising revenues.

a. Sun Microsystems, Inc.

48. In November 1998, AOL entered into a deal with Sun Microsystems, Inc. ("Sun"), designed to inflate AOL's advertising revenues, in violation of GAAP.

49. A *New York Times* article entitled, "Ouster at AOL, but Where Does Trail End?," dated September 1, 2002, reported that AOL agreed to buy $500 million in computer equipment from Sun at full price, *i.e.*, not at a discounted price which would be typical for a large company, and in return, Sun agreed to pay AOL $350 million for advertising services. Under Accounting Policy Board ("APB") Statement of Policy No. 29, revenue resulting from the deal should have been reported net of the overpayment rather than on a gross basis. Under EITF 99-17, revenues and expenses need to be recorded at fair market value which likely would have been zero or close to it.

50. In violation of GAAP, AOL recorded the transaction based on an inflated list purchase price for the computer equipment, resulting in an overstatement of advertising revenue of approximately $150 million from the quarter ending December 1998 through the quarter ending December 31, 2001.

b. Hughes Electronic Corporation

51. AOL also improperly accounted for a June 21, 1999, round-trip/barter transaction involving AOL's receipt of restricted stock in Hughes Electronics Corporation ("Hughes") in exchange for advertising which allowed AOL and AOLTW to overstate advertising revenue. By overvaluing the stock received from the deal, AOL artificially inflated the advertising revenues it reported by tens of millions of dollars per quarter over a 2-1/2 year period.

52. AOL invested $1.5 billion in General Motors ("GM") Series H 6.25% automatically Convertible Preferred Stock. GM immediately invested the $1.5 billion received from AOL in the stock of its subsidiary, Hughes. In return, Hughes committed to increase its sales and marketing expenditures to AOL over the next three years by approximately $1.5 billion. By recognizing advertising revenue at the full purported value of the stock, AOL violated GAAP.

53. The advertising revenues were overstated in violation of GAAP, particularly APB 29, Statement of Financial Accounting 123 and EITF 00-08, because AOL did not properly value the barter instrument — the stock — exchanged for the advertising services.

54. The stock was not publicly-traded, but was a class of stock that had been created only for AOL and was not convertible until June 2002 (three years later). Accordingly, the value of the stock at the time of the transaction was not $1.5 billion, and the associated AOL advertising services recorded based on that inflated amount over the period of the deal was improper. At a minimum, the value of the stock should have been adjusted to reflect the time value from the three-year delay and its marketability.

55. Through this transaction, AOL's and AOLTW's advertising revenues were overstated beginning in the quarter ending September 30, 1999, through the quarter ending June 30, 2000.

56. In its Form 10-K for the fiscal year ending December 31, 2001, filed on March 25, 2002, AOLTW reported a charge of "approximately $270 million to reflect an other-than-temporary decline in the carrying value of AOLTW's investment in Hughes Electronics Corp. ("Hughes"), an available-for-sale investment."

57. Moreover, on November 14, 2002, in its Form 10-Q for the quarter ending September 30, 2002, the Company reported:

> Included in the non-cash pretax charges for three and nine month periods ended September 30, 2002 are charges related to the writedown of AOL Time Warner's investment in Hughes Electronics Corp. ("Hughes") of $505 million for both the three and nine months periods.

c. <u>Gateway Inc.</u>

58. In or around October 1999, Gateway and AOL entered into a transaction involving the bundling of AOL's internet services on Gateway Inc.'s ("Gateway") computers. Through this deal, AOL overstated advertising revenue by $470 million in violation of the directives set forth in APB 29.

59. Pursuant to the agreement, each time a Gateway computer purchaser subscribed to the AOL service, Gateway would receive a fee or "bounty" from AOL. According

to an April 2, 2003 *Washington Post* article entitled "Gateway to Amend Financial Reports - SEC Had Raised Concerns Over AOL Deal," while AOL paid a "bounty," Gateway would pay AOL for providing a free year of internet service on its computers. According to reports, the two payments were for the same amount so that the companies were simply swapping money.

60. As a result, AOL overstated its advertising revenue by $340 million in 2000 and $130 million in 2001 by recognizing the fees paid by Gateway as revenue.

d. Bertelsmann AG

61. In connection with a transaction with Bertelsmann AG ("Bertelsmann"), in which AOL purchased Bertelsmann's interest in a joint venture, AOL overstated advertising revenue by nearly $400 million.

62. In March 2000, AOL and Bertelsmann restructured a previously-negotiated AOL Europe joint venture, and undertook a new strategic alliance. The agreement consisted of a put and call arrangement allowing AOL to purchase, in two installments, Bertelsmann's 50% interest in AOL Europe for consideration totaling approximately $6.7 billion.

63. According to a March 31, 2003 *Wall Street Journal* article, "A person familiar with the situation said that when Bertelsmann initially asked AOL to be paid in cash for its AOL Europe stake, it had offered a discount on the sale price in exchange. The person said AOL's response was that it wasn't interested in a cash discount, but wanted a bigger ad deal. Bertelsmann accounted for the advertising as a cost of the sale, the person said." AOL agreed to pay in cash at a nondiscounted price in exchange for Bertelsmann's agreement to purchase $400 million in AOL advertising.

64. Because AOL would have received a cash discount had it not insisted upon the advertising deal, AOL overpaid for Bertelsmann's interest and overstated its advertising revenues, starting with the quarter ending March 31, 2001 through the quarter ending June 30, 2002. That Bertelsmann recognized the advertising purchase as a cost of the sale provides further evidence that AOLTW improperly reported advertising revenue in connection with the Bertelsmann deal.

65. AOLTW's form 10-K for 2002 indicated as follows with respect to the

Bertelsmann deal:

> Although the advertisements purchased by Bertelsmann in these transactions were in fact run, the SEC staff has expressed to the Company its preliminary view that at least some portion of the revenue recognized by the Company for that advertising should have been treated as a reduction in the purchase price paid by the company to Bertelsmann rather than as advertising revenue.
>
> * * *
>
> It is not yet possible to predict the outcome of these investigations, but it is possible that further restatement of the Company's financial statements may be necessary.

e. Veritas

66. AOL also engaged in barter transactions with Veritas Software ("Veritas"), an independent supplier of storage software products and services. In September 2000, AOL agreed to pay Veritas $50 million for $30 million worth of software products in exchange for Veritas' purchase of $20 million of advertising from AOL.

67. AOL improperly recorded the payment by Veritas as advertising revenue.

f. Homestore, Inc.

68. Between late 2000 and 2001, AOL and AOLTW entered into sixteen separate sham transactions with Homestore, Inc. designed to improperly inflate revenue figures for both companies. A criminal investigation of Homestore relating to these transactions and others has already resulted in guilty pleas by four Homestore executives.

69. The Homestore round trip transactions were devised by Defendant Keller with (at least) the approval of Defendant Colburn. In summary, Homestore would pay a third party for services, usually at more than the market value, and for services it did not need. Then, the third party would use most or all of that money to purchase advertising from AOL and AOLTW. AOL and AOLTW, in turn, would purchase advertising from Homestore in the same amount it received from the third party. The scheme allowed both Homestore and AOL/AOLTW to report bogus advertising revenues. Moreover, because AOL/AOLTW owned 3.9 million shares of Homestore, Inc. stock, AOL and AOLTW further benefited from Homestore's artificial inflation of its revenues.

70. In the fourth calendar quarter of 2000 and the first calendar quarter of 2001, AOL and Homestore fabricated transactions of this type with GlobeXplorer, Inc., PurchasePro, Inc., Investor Plus, FX Consultants, Classmates.com, Wizshop.com and EasyRoommates.

71. These transactions should have been "recorded based on the carrying amount of the advertising surrendered, which likely will be zero" as set forth in EITF 99-17.

72. In June 2001, AOLTW placed Defendant Keller on administrative leave.

g. <u>WorldCom Inc.</u>

73. In 1998, WorldCom Inc. ("WorldCom") and AOL entered into a "multi-year, multi-million dollar agreement" pursuant to which AOL paid at least $900 million a year to WorldCom to carry the bulk of its internet traffic, and AOL became WorldCom's largest customer. In July 2001, WorldCom and AOLTW entered into a massive barter deal in which WorldCom agreed to buy over $200 million in advertising across all AOLTW properties in exchange for AOLTW continuing to keep its network traffic on WorldCom's network. AOLTW also agreed to buy internet capacity from UUNet, a unit of WorldCom, to expand AOLTW's online network. The reciprocal transactions were used by AOLTW as a vehicle to improperly recognize advertising revenue in violation of GAAP.

74. An August 22, 2002 *Wall Street Journal* article entitled, "Questionable AOL Revenue Has WorldCom Link," reported that, according to people familiar with the SEC's investigation of AOLTW, a substantial portion of the $49 million of potentially overstated advertising revenue reported by AOLTW in its August 14, 2002 filing involved revenue connected to the WorldCom deal. According to the article, the deal had been negotiated in part by Defendant Colburn.

h. <u>Qwest Communications</u>

75. In or about July 2001, AOLTW entered into a reciprocal transaction with Qwest Communications ("Qwest"), through which AOLTW agreed to purchase digital subscriber lines and network transport capacity at inflated prices in exchange for Qwest's agreement to advertise in AOLTW's media properties. AOLTW entered into a similar transaction with

KPNQwest, relating to network capacity in Europe.

76. On August 23, 2002, *The New York Times* reported in an article titled "AOL's Swap Deals With 2 Others Said to Be a Focus of the S.E.C.," that the swap deal with Qwest was one of the three deals valued at $49 million that AOLTW disclosed it was investigating on August 14, 2002.

i. Compaq, Nortel and Foundry

77. A *New York Times* article dated August 12, 2002, titled "AOL's Inventive Barter Deals Draw Scrutiny of Investigators," reported that AOL also entered into barter deals, in which it sold advertising in exchange for equipment or services, with Compaq Computer, Nortel Networks and Foundry Networks. An AOL spokesperson said the exchanges were appropriately valued, including the amount of advertising revenue it reported.

2. Improper Classification of Gains as Advertising Revenue

78. FASB Statement of Financial Accounting Concepts ("Concept") Number 6 states in Paragraph 78 that:

> Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

79. Concept Number 6 states in Paragraph 82 that:

> Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

a. PurchasePro

80. AOL entered into an agreement with PurchasePro in which it improperly classified as advertising revenues the repricing of stock rights it received in conjunction with a marketing partnership, in violation of FASB Concept 6.

81. In an unorthodox agreement reached in December 2000, AOL paid PurchasePro $9.5 million in cash in exchange for a repricing of stock warrants from $63 to 1 cent, which it valued at $30 million. AOL then booked the difference, $20.5 million, as advertising

and commerce revenue for the quarter ending December 31, 2000.

82. As defined in FASB Concept 6, this amount should have been recognized as a gain, and not as revenue.

b. Homestore House and Home Channel

83. In May 2000, Homestore and AOL entered into a five-year agreement through which AOL artificially inflated its advertising revenues by improperly accounting for the stock it received as part of the deal. At the time, Homestore was the largest Internet-based provider of residential real estate listings and related content in the world. Through the deal, Homestore would provide home and real estate content for AOL, and Homestore and AOL would share in any revenue generated by such content.

84. Pursuant to the Homestore transaction, AOL established the “House & Home channel” on AOL. AOL provided Homestore with the exclusive right to provide content on the channel and the right to share in revenue generated by traffic on the channel. In exchange, AOL received 3.9 million shares of Homestore stock at a guaranteed value of $68.50 per share and $20 million in cash, and AOL was named as a beneficiary of a $90 million line of credit guaranteeing certain payments to AOL in the event that Homestore’s stock did not reach the guaranteed price.

85. The Homestore transaction was devised by Keller at AOL, with the approval of Colburn. Critical to the transaction was AOL’s requirement that the transaction be set up in a way in which AOL would be guaranteed the recognition of not less than $50 million per year for five years. According to AOL, and Individual Defendants Colburn and Keller, the transaction was worth over $287 million to AOL (over $50 million per year) over the course of the agreement, as a result of the value attributed to the Homestore stock and the $20 million payment.

86. In essence, AOL’s plan (as implemented by Keller and Colburn) was to recognize as revenue the value of the Homestore stock, which, in turn, had been inflated by AOL’s creation of the House and Home channel.

87. If Homestore stock did not continue to trade at least a $68.50 per share

level, AOL could use the $90 million line of credit to continue to recognize the $50 million per year that it expected to record as a result of the Homestore agreement. Homestore did not want AOL to draw on the line of credit used to guarantee AOL revenues, however, as it would mean that the House & Home channel was not meeting revenue expectations. Nor did AOL want to be required to draw on the line of credit, as that could cause investor perception that AOL's advertising "backlog" was weak.

88. Accordingly, due to the Homestore transaction structure, both AOL and Homestore were invested in the success of the House & Home channel. In order to maintain the price of its stock and to avoid AOL's use of the line of credit, Homestore relied on AOL to provide revenues associated with promised traffic on the House and Home channel.

c. <u>Kinko's</u>

89. AOL began investing in Kinko's in 2000, and eventually owned more than 10% of the company. In return, Kinko's purchased advertising from AOL. AOL improperly recognized this as revenues in 2001, and not return on an investment.

3. <u>One-Time Gains in the Form of Contract Termination or Restructuring Fees</u>

90. AOL also improperly classified the gains it received from insolvent companies as revenues.

91. AOL knew it had customers who were facing financial problems due to the growing economic downturn, and who could not pay on their contracts. According to a July 18, 2002 article in *The Washington Post*, AOL did not want to sue customers that were unable to pay for the contracts that they had signed because it would have raised unwanted questions and negative attention from the investment community regarding AOL's advertising business. Instead, AOL restructured a number of contracts with customers by shortening the length of advertising deals and requiring the companies to pay a one-time fee associated with the restructuring. AOL improperly accounted for the newly structured contract and the associated restructuring fees as advertising revenue.

92. This accounting violates FASB Concept 6, paragraphs 78 and 82 because

such one-time gains are not part of an "entity's ongoing major or central operations."

93. The July 18, 2002, *Washington Post* article reported that from July 2000 through March 2001, AOL had booked $56 million (or about 3% of its advertising and commerce revenue) from such termination or restructuring fees from internet companies.

94. An example of such a restructure occurred with DrKoop.com ("DrKoop"). In July 1999, AOL and DrKoop signed a four-year agreement whereby DrKoop was designated the primary provider of healthcare content to AOL. The agreement obligated DrKoop to make payments to AOL totaling $89 million in cash over a four-year period, and provided AOL with more than 1.5 million immediately vested warrants to purchase shares of DrKoop common stock at $15.94 per share, with the right to purchase an additional 4.3 million warrants based on the performance of the contract.

95. On April 12, 2000, DrKoop and AOL agreed to amend the contract, pursuant to which AOL acquired 3.5 million shares of common stock in DrKoop. Koop was relieved of any further obligation to make cash payments to AOL under the original agreement and all warrants previously earned were cancelled. The value of the 3.5 million shares received by AOL was approximately $9.6 million. AOL violated GAAP by recording the termination fees associated with the effective termination of the agreement as advertising revenue from continuing operations rather than one-time gains.

4. Improper Manipulation of Advertising Contracts to Prematurely Record Advertising Revenue

96. AOL also manipulated the terms of advertising contracts to allow it to report revenues associated with those contracts at the end of a fiscal quarter, when pressure to meet earnings forecasts was highest. AOL and/or AOLTW would flood a client's website at the end of a quarter, despite the consequences and/or the intent of the advertising contract. This practice is known as "front loading" or "jackpotting" revenues, and violates the GAAP concept of representational faithfulness as it pertains to the definition of revenues.

97. FASB Concept 5, Paragraph 83b states:

> Revenues are not recognized until earned. . . and revenues are considered to have been earned when the entity has substantially

> accomplished what it must do to be entitled to the benefits represented by the revenues.

98. FASB Concept 2, Paragraph 63 states:

> Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations.

99. An example of jackpotting occurred just prior to the close of the Merger. In December 2000, the BA division at AOL signed a deal with Telefonica, SA ("Telefonica") a Spanish telecommunications company, to sell $15 million worth of online advertising, that was intended to be spread out over several years. However, the pressure to generate advertising revenues for the quarter ending December 31, 2000 led AOL to manipulate the deal in order to record all $15 million as advertising revenues during that period. Because AOL needed to run the advertising in order to claim the revenues, it placed the ads on the AOL welcome screen even though the Telefonica advertising link on AOL's English welcome screen took users to a Spanish-language site and that Telefonica could not handle the volume of users clicking through to their site.

100. In order to gain Telefonica's agreement to run the ads in December, AOL promised that in return, it would run millions of dollars worth of ads after December as a "bonus." Without this so-called bonus, Telefonica would have insisted on running the ads over several quarters, as originally agreed upon. AOL's recognition of all $15 million in revenue from the deal during the quarter ending December was in violation of GAAP as the deal was for a longer-term commitment. Revenues from the Telefonica deal should have been recognized over the course of the entire length of the contract, not as one "jackpot" for the quarter ending December 31, 2000.

5. <u>Improper Classification of Legal Settlements as Advertising Revenue</u>

101. Yet another way that AOL inflated its advertising revenues was through the fraudulent conversion of legal settlements into advertising revenues.

a. **24dogs.com**

102. When AOL purchased MovieFone in 1999, it inherited a $22.8 million arbitration award against a former subsidiary of Wembley PLC which had not yet been collected, plus interest. AOL offered Wembley a deal — Wembley could purchase $23.8 million worth of online advertising for its 24dogs.com website in exchange for a satisfaction of the judgment but the deal needed to be completed before September 30, 2000, the end of the fiscal quarter. As the end of the fiscal quarter approached, and before reaching an agreement with Wembley, AOL began to run ads for Wembley's 24dogs.com site without Wembley's consent everywhere on AOL's website, even multiple ads on a single web page. The ads generated so much customer traffic that Wembley's internet site crashed. Due to its "jackpotting," AOL booked $16.2 million of advertising revenue from this deal in the quarter ending September 30, 2000.

103. This form of revenue recognition violated FASB Statement Number 141, regarding business combinations. Paragraph 37 which states:

> The following is general guidance for assigning amounts to assets acquired and liabilities assumed, except goodwill:
>
> b. Receivables at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary;
>
> f. Other assets, including land, natural resources, and nonmarketable securities, at appraised values; . . .

104. The assets of the acquired company (including MovieFone's uncollected judgment) should have been recorded on the opening balance sheet at the time of acquisition, and not as revenues after the fact.

b. **Ticketmaster**

105. Also in the fiscal quarter ending September 2000, AOL improperly inflated its advertising revenues by settling pending litigation against Ticketmaster in exchange for Ticketmaster's agreement to purchase $13 million in advertising from AOL.

106. AOL reported this $13 million as revenues rather than income, in violation of GAAP, and resulting in a $13 million overstatement of its revenues for the quarter.

6. Improper Recognition of Advertising Revenue Associated with Cable Channel Fees

107. AOLTW also inflated its advertising revenues by misclassifying new cable channel fees as advertising revenue, thereby misrepresenting the revenue, in violation of GAAP. Time Warner, as a cable operator pays a monthly licensing fee to each of the channels that it provides with its cable. When a new channel is added, however, that channel pays a one-time fee to the cable operator. While most cable operators use this fee to offset its monthly licensing fees, AOLTW classified the new channel fee as advertising revenue, to the tune of $230 million in 2002 alone.

7. Improper Recognition of Advertising Revenue in Broker Deal

108. The SEC issues Staff Accounting Bulletins ("SAB") that "represent interpretations and policies" followed by the SEC "in administering the disclosure requirements of the federal securities laws." SEC Staff Accounting Bulletin ("SAB") 101, issued on December 3, 1999 states:

> In assessing whether revenue should be reported gross with separate display of cost of sales to arrive at gross profit or on a net basis, the staff considers whether the registrant:
>
> 1. acts as principal in the transaction,
> 2. takes title to the products,
> 3. has risks and rewards of ownership, such as risk of loss for collection, delivery or returns, and
> 4. acts as an agent or broker (including performance services, in substance as an agent or broker) with compensation on a commission or fee basis.
>
> If the company performs as an agent or broker without assuming the risks and rewards of ownership of the goods, sales should be reported on a net basis.

109. AOL and AOLTW manipulated their advertising revenues by improperly recognizing revenues where AOL served as a broker selling advertising for third party entities and earned a commission for such sales. For example, AOL and AOLTW entered an agreement with eBay Inc. ("eBay"), to sell advertisements on behalf of eBay, essentially serving as a broker and for which they received a commission. Instead of reporting revenues on a net basis, as dictated by GAAP, AOL and AOLTW booked the revenues generated for eBay through the sale

of ads as its own revenue, effectively using eBay's revenues to inflate its own, and then counted the payments it sent to eBay as expenses.

110. As a result, AOL and AOLTW overstated advertising revenues for each quarter beginning with the quarter ending September 30, 1999 through the quarter ending September 30, 2001.

8. **Improper Inflation of Advertising Revenue Through Cross-Platform Deals**

111. After the Merger, AOLTW used its strength to pressure Time Warner clients to convert cable programming purchases into purchases of online advertising with AOL, thereby inflating AOL's advertising revenues.

112. GAAP requires that transactions which involve the purchase of products across multiple media platforms be recognized by the appropriate party and at the relative fair market value of the service provided. Specifically, the American Institute of Certified Public Accountants issued in their Statement of Position 97-2 in paragraph 10 that:

> If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element.

a. **The Golf Channel**

113. In June 2001, the Golf Channel entered into a five-year, $200 million advertising deal in order to have its programming aired on Time Warner Cable. As reported in *The Washington Post* on July 18, 2002, Time Warner essentially forced the Golf Channel to spend $15 million of the $200 million on online advertising with AOL, something it would not have done otherwise. The $15 million transferred from the $200 million cable deal was not legitimate AOL advertising revenue under SOP 97-2, ¶ 10, because there was no relative fair value in the AOL advertising for the Golf Channel.

b. **Oxygen Media**

114. AOLTW entered into a similar deal with Oxygen Media, providing that Time Warner Cable would carry the Oxygen Channel if Oxygen would spend $100 million in advertising with AOL.

115. Significantly, a *Wall Street Journal* article dated October 24, 2002 indicated that the revenue from the deal was double-booked in both the online and cable segments. This deal served to inflate AOLTW's advertising revenues over five quarters beginning with the quarter ending June 30, 2001, through the quarter ending June 30, 2002.

B. <u>AOL and AOLTW's Fraudulent Inflation of Subscriber Numbers</u>

116. Prior to, during and after the Merger, AOL and AOLTW through SEC filings and other public statements reported that growth in the number of subscribers to their online service was a key factor in the companies' growth and success. Given the emphasis they placed on these figures, AOL and AOLTW were under intense pressure from the investing community to deliver on their promises. In order to report continuing increases in the number of subscribers to their online service, AOL and AOLTW engaged in a fraudulent scheme and course of conduct which improperly inflated the number of subscribers that AOL and AOLTW reported.

117. AOL entered into a series of "bulk-sales" deals through which AOL would sell a bulk quantity of AOL subscriptions to AOL marketing partners, who would then resell the subscriptions to their employees. Marketing partners such as J.C. Penny, Target and Sears bought 250,000, 350,000 and 185,000 subscriptions, respectively, from AOL, and then attempted to resell the subscriptions to their employees. Other companies including Office Depot Inc., McDonalds Corp., WalMart Stores Inc., Kinkos Inc., Home Depot Inc., Hewlett-Packard Co., Philips Electronics NV and UAL Corp's United Airlines also purchased bulk quantities of AOL subscriptions. Combined, these additional companies have more than 2.5 million employees.

118. AOL and AOLTW improperly reported these bulk sales to falsely boost their subscriber numbers. Rather than report the number of these subscriptions that were actually activated by employees of the companies, AOL and AOLTW reported the number of bulk subscriptions that were sold to the marketing partners. According to a *New York Times* article published on July 25, 2003, "people familiar with the situation say America Online generated at least 830,000 subscribers through these bulk sales . . . That would have accounted for 16.7% of the total subscriber growth" during the relevant period. According to an October 23, 2003 article in *The Washington Post*, the SEC is investigating the way AOL had counted its subscriber

numbers, including with respect to bulk sales.

119. AOLTW also inflated their subscriber numbers by including in their reports customers who had received free-trials for the AOL service and were not paying any subscription fees. In an amendment to their form 10-Q originally filed on August 14, 2002, and refiled with the SEC on January 28, 2003, AOLTW disclosed that of the 26.5 million subscribers it had reported as of June 30, 2002, approximately 12% were "under various free-trial, member service and retention programs."

120. AOLTW also inflated their subscriber numbers by including in their reports customers who were not paying for the full AOL service, but who paid for lower priced and limited usage plans. In an amendment to their form 10-Q originally filed on August 14, 2002, and refiled with the SEC on January 28, 2003, AOLTW disclosed that of the 26.5 million subscribers it had reported as of June 30, 2002, approximately 16% were on lower-priced and limited usage plans.

121. Together these schemes inflated by more than 8 million the number of subscribers that AOLTW reported in forms filed with the SEC by AOL prior to the merger and AOLTW after the Merger.

122. AOLTW also allegedly inflated their subscriber numbers in other ways, including through the following: (1) including customers who cancelled their subscriptions but were given six months of free access to the AOL service; (2) including accounts held by AOL or AOLTW employees who did not pay for the accounts; and (3) listing separate screen names as a separate account even though each account could use up to six screen names.

123. The improperly inflated subscriber numbers served to maintain the inflated price of AOL stock prior to the Merger, and helped to inflate the value of AOLTW stock after the Merger.

124. The investing public became aware of these series of transactions in part through an article published in *The New York Times* on July 25, 2003. On July 30th, 2003, the SEC announced that it was expanding the scope of its previously announced investigation into AOL and AOLTW to include an investigation of AOL's subscription program.

C. AOL and AOLTW's Fraudulent Inflation of Goodwill

125. AOL's artificially-inflated advertising revenues also caused the value of the Company's goodwill, created as part of the Merger, to be vastly inflated. Indeed, the Company materially overstated and accounted for the value of goodwill prior to, in conjunction with, and after the Merger.

126. Goodwill is defined by APB Statement of Policy No. 16 as the premium paid by one company to acquire another when the purchase price exceeds the fair market value of the acquired company's underlying identifiable tangible and intangible assets. Because the value attributed to AOL by the merger agreement was artificially high due to the revenue overstatements described above, the goodwill it reported was also inflated.

III. THE MATERIALLY FALSE AND MISLEADING STATEMENTS AND OMISSIONS OF MATERIAL FACT REGARDING ARTIFICIALLY INFLATED ADVERTISING REVENUE

127. AOL's and AOLTW's reported advertising and commerce revenue during the time period was overstated as a result of AOL's sham transactions and improper accounting. In connection with this, defendants made material misrepresentations and omitted material facts, in at least fifteen quarterly reports and three annual reports of AOL and AOLTW, as well as in press releases and AOLTW's consolidated pro forma financial statements which were incorporated into the Merger Registration Statement, the Joint Proxy Statement-Prospectus and the Stock Option Registration Statements as follows:

a. Materially overstated AOL and AOLTW advertising and commerce revenue and backlog, and percentage growth;

b. Materially overstated AOL advertising revenue in consolidated pro forma financial statements;

c. Failed to disclose that AOL and AOLTW had engaged in sham transactions and improper accounting, resulting in overstated advertising revenue, backlog and percentage comparisons of certain financial results;

d. Failed to disclose the true, current and anticipated condition of AOL's advertising revenue and advertising business, both before and after the Merger;

e. Falsely represented that the subject financial statements were prepared in accordance with GAAP and Article 10 of Regulation S-X;

f. Falsely represented that the audited financial statements were audited in conformance with generally accepted accounting standards ("GAAS"), a set of guidelines approved and adopted by the American Institute of Certified Public Accountants ("AICPA"), and used by auditors when conducting audits of a company's finances to ensure accuracy, consistency and verifiability of auditors' actions and reports;

g. Falsely represented that the subject financial reports fairly presented the results of the companies' operations, particularly with respect to the advertising and commerce revenue of AOL, including the advertising and commerce revenue of the Company's AOL business segment; and

h. Falsely represented the results of the companies' operations, particularly with respect to the advertising and commerce revenue of AOL, and the Company's AOL business segment.

128. AOL, AOLTW and Individual Defendants also made numerous statements to market analysts and the media, that materially overstated AOL and AOLTW advertising revenue and falsely represented or failed to disclose the effect on AOL and AOLTW of an industry-wide deterioration of the internet advertising market.

129. These material misrepresentations and omissions caused investors to purchase or otherwise acquire AOL and/or AOLTW stock at artificially inflated prices.

130. A summary of the overstated revenues are included in the table below:

Financial Report (ending date/period)	AOL Advertising & Commerce Revenues Reported	Advertising Backlog Reported	Improper Deals Which Render the Reported Revenues False and Misleading	Amount Restated or Written Down by AOLTW
10-Q (12/31/98) – 3 mos. – 6 mos.	 $126 million $229 million	 $729 million	 Sun	 (none to date)
10-Q (03/31/99) – 3 mos. – 9 mos.	 $210 million $530 million	 $1.3 billion	 Sun	 (none to date)

Financial Report (ending date/period)	AOL Advertising & Commerce Revenues Reported	Advertising Backlog Reported	Improper Deals Which Render the Reported Revenues False and Misleading	Amount Restated or Written Down by AOLTW
10-K (06/30/99) – 3 mos. – fiscal year	$235 million $765 million	$1.5 billion	Sun, Hughes	$775 million charge to earnings based on writedown of asset (Hughes)
10-Q (09/30/99) – 3 mos.	$272 million	$2 billion	Sun, Hughes, eBay	(none to date)
10-Q (12/31/99) – 3 mos. – 6 mos.	$352 million $624 million	$2.4 billion	Sun, Hughes, eBay	(none to date)
10-Q, 10-Q/A (03/31/00) – 3 mos. – 9 mos.	$463 million $1.087 billion	$2.7 billion	Sun, Gateway, DrKoop.com, Homestore	(none to date)
10-K, 10-K/A (06/30/00) – 3 mos. – fiscal year	$513 million $ 1.6 billion	$3 billion	Sun, Hughes, Gateway, Homestore, DrKoop.com, eBay, Ticketmaster, 24dogs.com	(none to date)
10-Q (09/30/00) – 3 mos.	$534 million	$3 billion	Sun, Gateway, 24dogs.com, Homestore, Ticketmaster, eBay, Hughes, Veritas, Telefonica SA, PurchasePro, WorldCom	$66 million
10-K (12/31/00) – 3 mos. – fiscal year	$605 million $2.1 billion	Not reported	Sun, eBay, Gateway, 24dogs.com, Homestore, Veritas, Telefonica SA, WorldCom, Ticketmaster, DrKoop.com, Hughes, PurchasePro	$22 million (6 mos) $88 million (1 year)
10-Q (03/31/01) – 3 mos.	$721 million	Not reported	Sun, eBay, Homestore, Gateway, Veritas, Telefonica SA, WorldCom, PurchasePro, Bertelsmann	$13 million; $16.3 million (potential)[2]
10-Q (06/30/01) – 3 mos. – 6 mos.	$715 million $1.4 billion	Not reported	Sun, eBay, Homestore, Veritas, WorldCom, Oxygen Media, PurchasePro, Bertelsmann	$28 million; $65.5 million (potential)

[2] "potential" refers to the $400 million in revenues AOLTW announced on March 28, 2003 that it might have to restate in connection with the Bertelsmann deal.

Financial Report (ending date/period)	AOL Advertising & Commerce Revenues Reported	Advertising Backlog Reported	Improper Deals Which Render the Reported Revenues False and Misleading	Amount Restated or Written Down by AOLTW
10-Q (09/30/01) – 3 mos. – 9 mos.	$624 million $2.7 billion	Not reported	Sun, eBay, Oxygen Media, Veritas, Telefonica SA, Gateway, PurchasePro, WorldCom, Homestore, Golf Channel, Bertelsmann	$16 million; $39.8 million (potential)
10-K (12/31/01) – 3 mos. – fiscal year	$628 million $2.4 billion	Not reported	Sun, Oxygen, eBay, PurchasePro, Telefonica SA, Golf Channel, Gateway Veritas, WorldCom, Homestore, Bertelsmann	$17 million (quarter); $0.5 million (potential)
10-Q (3/31/02) – 3 mos.	$501 million	Not reported	Oxygen, Gateway, Homestore, Worldcom, Bertelsmann	$6 million; $80.3 million (potential)
10-Q (6/30/02) – 3 mos. – 6 mos.	$412 million	$860 million	Oxygen, Gateway, Homestore, Bertelsmann	$84.4 million (potential)

A. <u>False and Misleading Statements and Omissions in Form 8-K Filings</u>

131. On January 20, 2000, AOL filed with the SEC its Current Report on Form 8-K dated January 19, 2000 which was signed by Defendant Kelly and incorporated AOL's press release of January 19, 2000 announcing AOL's record financial results for the quarter ending December 31, 1999. The Form 10-Q for the same period, containing substantially the same financial information, was filed on or about February 14, 2000, and signed by Defendants Case and Kelly.

132. On April 3, 2000, AOL filed with the SEC its Current Report on Form 8-K dated April 3, 2000, that incorporated AOLTW's pro forma consolidated condensed financial statements for the six months ending December 31, 1999, the year ending June 30, 1999, and the year ending December 31, 1999. The pro forma consolidated condensed financial statements were materially false and misleading, because they included AOL's fraudulently inflated advertising revenue reported for the respective fiscal periods, as discussed above.

B. False and Misleading Statements and Omissions in The Merger Registration Statement And Joint Proxy Statement-Prospectus

133. On February 11, 2000, AOLTW filed with the SEC and disseminated to the public the Merger Registration Statement, which included the Joint Proxy Statement-Prospectus. AOLTW made four amendments to the Merger Registration Statement, the last of which was filed and became effective with the SEC on May 19, 2000.

134. The Merger Registration Statement was signed by Defendants Case, Levin, Parsons, Turner, Pittman and Kelly.

135. The Joint Proxy Statement-Prospectus was signed by Defendant Case, as Chairman and Chief Executive Officer of AOL, and Defendant Levin, as Chairman of Time Warner, and sent to shareholders of both companies on or about May 23, 2000.

136. The Merger Registration Statement and Joint Proxy Statement-Prospectus also incorporated by reference the documents set forth below, each of which included some or all of the materially untrue and misleading statements referred to herein:

SEC Filing	Date Filed
AOL's Annual Report; Form 10-K (fiscal year ending June 30, 1999)	August 13, 1999
AOL's Quarterly Report; Form 10-Q (quarterly period ending September 30, 1999)	November 2, 1999
AOL's Quarterly Report; Form 10-Q (quarterly period ending December 31, 1999)	February 14, 2000
AOL's Quarterly Report; Form 10-Q (quarterly period ending March 31, 2000)	May 17, 2000
AOL's Form 8-K dated January 19, 2000 (quarter ending December 31, 1999)	January 20, 2000
AOL's Current Report on Form 8-K incorporating AOLTW pro forma consolidated condensed financial statements for the three months ending September 30, 1999, the year ending June 30, 1999, nine months ending September 30, 1999 and year ending December 31, 1998	February 11, 2000
AOL's Current Report on Form 8-K incorporating AOLTW pro forma consolidated condensed financial statements for the six months ending December 31, 1999, the year ending June 30, 1999, and the year ending December 31,1999	April 3, 2000
AOL's Current Report on Form 8-K (quarter ending March 31, 2000)	April 21, 2000
The Joint Proxy Statement-Prospectus filed with the SEC and sent to Time Warner and AOL shareholders on or about May 23, 2000	on or about May 19, 2000

137. AOL and Time Warner financial estimates in the Merger Registration

Statement included total EBITDA synergies of “approximately $1 billion in the first full year of operations, producing an EBITDA growth rate of approximately 30% in that first year.”

138. The Merger Registration Statement and Joint Proxy Statement-Prospectus also included Annex A, the Second Amended and Restated Agreement and Plan of Merger (the “Merger Agreement”). The Merger Agreement represented and warranted that none of the SEC reports contained any untrue statement of material fact or any misleading omissions; and that the financial statements fairly presented AOL’s consolidated financial results in conformity with GAAP and in conformity with the applicable provisions, rules and regulations of the Securities Act and the Exchange Act.

139. Ernst & Young consented to the use and incorporation by reference of its report dated July 21, 1999, (except for Note 3, which is dated May 12, 2000) relating to the consolidated financial statements of AOL for the three years ending June 30, 1999 and its report dated July 20, 2000, relating to the AOL’s consolidated financial statements for the year ending June 30, 2000. Ernst & Young falsely represented that the audited financial statements of AOL included or incorporated by reference in the Merger Registration Statement and Joint Proxy Statement-Prospectus were prepared in accordance with GAAP and audited in conformance with GAAS.

140. AOL and Time Warner, though the Joint Proxy Statement-Prospectus, told shareholders that,

> Your vote is very important, regardless of the number of shares you own. Whether or not you plan to attend the special meeting, please vote as soon as possible to make sure that your shares are represented at the meeting. If you do not vote, it will have the same effect as voting against the merger. We strongly support this combination of our companies and join with our boards of directors in enthusiastically recommending that you vote in favor of the merger.

141. The Merger required and received the affirmative vote of the AOL and Time Warner shareholders at the respective Special Stockholder Meetings.

142. All of the financial statements of AOL and the pro forma financial statements for AOLTW contained or incorporated by reference in the Merger Registration Statement and Joint Proxy Statement-Prospectus were untrue because they materially overstated

AOL advertising and commerce revenue and AOL advertising and commerce backlog, and the real value of goodwill.

143. AOLTW improperly delayed recording the impairment of goodwill until the quarter ending March 31, 2002, as disclosed in the Form 10-Q filed May 6, 2002. At that time, AOLTW wrote off $54 billion in a massive charge against assets in its 2002 first quarter financial report, which was characterized by the media as "the largest write-down in history." In the second quarter, AOLTW wrote down an additional $45.5 billion due to the company's declining value for a total writedown of nearly $100 billion for the year.

144. The Fairness Opinion of Morgan Stanley included or incorporated by reference in the Merger Registration Statement and Joint Proxy Statement-Prospectus falsely represented that the exchange ratio was "fair from a financial point of view" to Time Warner stockholders because AOL stock was overvalued and AOL had engaged in sham transactions and improper accounting.

145. All of the financial statements of AOL contained or incorporated by reference in the Merger Registration Statement and Joint Proxy Statement-Prospectus falsely represented that they were prepared in accordance with GAAP and Article 10 of Regulation S-X.

146. For the same reasons set forth above, AOL's representations and warranties in the Merger Agreement attached as Annex A to the Merger Registration Statement and Joint Proxy Statement-Prospectus that: (1) AOL's financial statements were prepared in conformity with GAAP; and (2) AOL's SEC filings were free of material misstatements and omissions were similarly untrue and misleading.

IV. INSIDER SALES OF AOL, TIME WARNER AND AOLTW STOCK AND AOLTW STOCK RE-PURCHASE

147. While AOL before the Merger and AOLTW after the Merger were engaged in the fraudulent activity related to their advertising and subscriber businesses, officers and directors of AOL, Time Warner and AOLTW took advantage of inflated stock prices to sell substantial portions of their personal stock holdings.

148. Between July 14, 2000, and August 30, 2000, prior to the completion of the

merger and after the onset of fraudulent activities, AOL insiders, including the individual Defendants listed below, sold substantial portions of their personal AOL stock holdings:

Insider	Shares Sold	Proceeds from the Sale of Shares
Stephen Case	1,000,000	$ 56,367,000
J. Michael Kelly	70,000	$ 3,999,800
Robert Pittman	394,745	$ 21,833,346
TOTALS	**1,464,745**	**$ 82,200,146**

149. Between January 1, 2001 and November 30, 2002, immediately prior to and after the completion of the Merger and while fraudulent activities were inflating the price of AOL and AOLTW stock, certain Individual Defendants, as listed below, who were aware of and/or principle players in the misconduct, along with other insiders sold substantial portions of their personal holdings of AOL and AOLTW stock:

Insider	Shares Sold	Proceeds from the Sale of Shares
Stephen Case	2,000,000	$100,396,300
David Colburn	180,000	$ 9,060,600
J. Michael Kelly	400,000	$ 19,072,000
Robert Pittman	1,500,000	$ 72,715,000
TOTALS	**4,080,000**	**$201,243,900**

150. Between July 14, 2000, and November 30, 2002, company insiders (including the Individual Defendants as set forth in paragraph 148 and numerous other individuals) sold more than $936 million worth of their personally held AOL and AOLTW stock. During this same period AOL and then AOLTW, was engaged in a series of fraudulent activities, many of which were being conducted with the direct knowledge of the Individual Defendants.

151. Significantly, only days after the Merger closed, and the day after the bullish analysts' conference in New York at which AOLTW assured investors of the Merger's success and forecasts for future growth, AOLTW executives began to spend over a billion dollars of AOLTW's corporate funds to repurchase millions of shares, claiming that they were undervalued. This was simply another means to inflate artificially the stock price – while AOLTW insiders caused AOLTW to spend $1.3 billion to repurchase 30.2 million shares of

AOLTW stock, during the same period, AOLTW insiders sold millions of shares of their own stock.

V. ERNST & YOUNG'S ROLE IN THE WRONGDOING

152. Ernst & Young was AOL's and Time Warner's purportedly independent auditor at all times relevant to this action. For each fiscal year 1999, 2000, 2001 and the transaction period ending December 31, 2000, Ernst & Young issued "clean" opinions on the companies' financial statements, indicating that they fairly presented the companies' financial condition and results of operation in conformity with GAAP and that the statements had been audited by Ernst & Young in accordance with GAAS. Ernst & Young also issued audit reports for AOL's 1998 financial statements and AOLTW's 2001 financial statements, representing that these audits complied with GAAS and that the financial statements were prepared in conformity GAAP.

153. During the relevant periods, AOL and AOLTW were significant clients for Ernst & Young, and Ernst & Young provided significant consulting and financial services in addition to its "independent" auditor services.

154. As an independent auditor, Ernst & Young owed a duty to AOL's and AOLTW's shareholders. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility and owes ultimate allegiance to the corporation's creditors and shareholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

155. Ernst & Young violated its professional responsibilities. Ernst & Young's audit reports concerning AOL's fiscal 1998, 1999 and 2000 financial statements and its audit report concerning AOL Time Warner's 2001 financial statements were false and misleading as those financial statements were not prepared in accordance with GAAP, nor had Ernst & Young conducted its audits in accordance with GAAS.

156. Ernst & Young violated GAAS, and is liable to Plaintiffs in at least the following ways: a) Ernst & Young did not exercise due professional care in the performance of

the audit; b) Ernst & Young failed to exercise due care to obtain competent evidential matter sufficient to form the basis of the "clean" opinions issued; c) Ernst & Young violated the general standard of independence; d) Ernst & Young failed to properly plan the engagement by failing to establish a plan and procedures reasonably designed to look for and detect errors, irregularities, red flags and/or risk factors such as significant, unusual, or highly complex transactions, especially those close to year end or unusually rapid growth or profitability, especially compared with that of other companies in the same industry; and e) Ernst & Young failed to make a proper study of existing internal controls, such as accounting, financial and managerial controls.

157. Ernst & Young knew or was deliberately reckless in failing to discover after conducting its audits that AOL's and AOLTW's financial statements violated GAAP. Ernst & Young auditors knew or were deliberately reckless in not knowing that revenues recognized by AOL and AOLTW had not been earned at the time recognized or had been improperly classified as revenues, as detailed above.

158. Ernst & Young's audits were so deficient that they constituted an egregious refusal to investigate the doubtful, and often were based upon accounting decisions that no reasonable accountant following GAAP would have made under the same circumstances.

159. Ernst & Young's conduct, as described herein, demonstrates that it acted with the intent to defraud or with deliberate recklessness as to the truth and adequacy of the financial reports and whether they were prepared in accordance with GAAP.

VI. THE ROLE OF MORGAN STANLEY IN THE WRONGDOING

160. In the Merger, Morgan Stanley played an indispensable role in disseminating false and misleading information to investors and the market regarding the quality, strength and growth of AOL's business, as well as the quality, strength and growth prospects of the company to be created by the Merger, and most importantly, the fairness of the terms of the Merger to the Time Warner shareholders.

161. The structure of the fees to be paid to Morgan Stanley provided it with enormous financial incentive to take whatever steps were necessary to bring about completion of the Merger, such as by inflating the price of AOL's stock in advance of the Merger, by

disseminating false and misleading information regarding the strength, quality and growth of AOL's business, by securing the approval of the Time Warner shareholders to the Merger, and by supporting the price of AOLTW stock after the Merger.

162. Morgan Stanley received only a small part of its potential total compensation of $70 million when the Merger agreement was signed. It received the vast bulk of its compensation upon the actual closing of the Merger. Morgan Stanley was promised additional bonus compensation worth $15 million if the new AOLTW stock traded at high levels in the weeks following the consummation of the Merger – which it did.

163. Pursuant to its due diligence obligations, Morgan Stanley was required to and did review the financial statements of AOL and AOLTW, including those included in or referred to in the Registration Statements. The Registration Statements prepared and approved by these defendants and filed with the SEC were materially false and misleading.

164. In the period after the Merger was announced, and up to and including the shareholder approval of the Merger, Morgan Stanley issued false and misleading research reports about AOL, Time Warner and AOLTW that helped to artificially inflate the price of AOL stock and make AOL appear to be a more successful company than it really was. Morgan Stanley issued the critical "fairness opinion" contained in the Merger Registration Statement which represented that the terms of the Merger were fair from a financial point of view to Time Warner shareholders when it knew, or should have known, that this opinion was false and it had no reasonable grounds for believing that the transaction was, in fact, fair.

165. After the shareholder vote approving the deal and up through and including the closing of the Merger, Morgan Stanley continued to feed false and misleading reports to the market.

166. Even after the Merger, Morgan Stanley continued to perpetuate the illusion of the Merger's success by continuously issuing false and misleading research reports.

167. Morgan Stanley also took steps to ensure that it would be protected financially from any violations of their obligations in connection with the Merger. Morgan Stanley required that AOL, Time Warner and AOLTW indemnify it and hold it harmless from

any financial impact, including securities law liabilities in connection with the Merger transaction. Morgan Stanley knew that it was essentially risk-free financially for it to participate in and further the wrongdoing, while pocketing fees of $70 million. Thus, Morgan Stanley lent its considerable expertise and reputation to the successful consummation of the Merger which created AOLTW.

VII. DEFENDANTS' MISCONDUCT IS REVEALED – FALL-OUT AND CONSEQUENCES

168. On July 18, 2002, *The Washington Post* published the first of two articles, based on statements of former Company employees and confidential documents, which reported allegations that AOLTW and AOL artificially inflated AOL's advertising revenue, enabling Defendants to report to the public materially false advertising revenue. The article reported that AOLTW denied the allegations and quoted from a lawyer retained by AOLTW:

> The accounting for all these transactions is appropriate and in accordance with generally accepted accounting principles .... The disclosures in AOL's financial statements are appropriate and accurate. AOL's statements provide our investors with all appropriate material information about our business.

The article quoted Defendant Ernst & Young as stating that it "stands by its original view that the accounting and disclosures were appropriate."

169. The second of *The Washington Post* articles regarding the fraud, published the next day, July 19, 2002, further detailed allegations of prior improper reporting of AOL advertising revenues. AOLTW's shares dropped in value nearly 12% from the close on July 17 to the close on July 19.

170. On June 19, 2001, Eric Keller was suspended due to an internal investigation into AOL's transactions with PurchasePro. On December 5, 2001, Gerald Levin retired from his position as CEO of AOLTW, and was replaced by Richard Parsons. On July 19, 2002, Robert Pittman resigned from his position as COO. On August 9, 2002, David Colburn was locked out of his Dulles, Virginia office and was terminated. On January 12, 2003, Stephen Case announced he would step down as Chairman of AOLTW and was replaced by Richard Parsons on January 16th.

171. On May 6, 2002, AOLTW filed its 10-Q for the quarter ending March 31, 2002, and wrote down $54 billion of goodwill in a charge against assets. In the next quarter, AOLTW wrote down an additional $45.5 billion of goodwill.

172. On July 24, 2002, AOLTW announced that it was the subject of an SEC investigation into accounting practices related to the company's advertising business. As a result, AOLTW's stock price dropped by over 15% the next day.

173. On July 25, 2002, after AOLTW disclosed that the SEC had launched a civil investigation into its accounting practices, several Wall Street analysts immediately downgraded the Company's stock.

174. Only after the existence of the SEC investigation regarding the improper recognition of AOL advertising revenue was revealed by AOLTW did Defendants' improper conduct and its effect become clear to the marketplace. After the Company acknowledged the SEC investigation, AOLTW shares declined by 15.4% to close at $9.64. Thus, AOLTW common stock had plummeted in value by more than 77% from its trading price of AOL common stock at January 1999 to AOLTW's trading price in July 2002, as adjusted for stock splits and the Merger. The value of AOLTW stock from when it first started trading, until the adverse disclosures in July 2002, declined by nearly 80%.

175. On July 30, 2002, AOLTW confirmed that the Department of Justice had initiated a criminal investigation into accounting practices engaged in by the company in association with the company's advertising business. By August 6, 2002, AOLTW's stock dropped nearly 20% from its July 30 close.

176. On August 14, 2002, AOLTW disclosed through a press release and its Form 10-Q for the second quarter 2002, that it had begun an investigation into $49 million worth of transactions which may have been inappropriately recognized as advertising and commerce revenues, and stated that it was continuing to review other transactions.

177. On October 23, 2002, AOLTW publicly stated that its previously announced financial results for each of the quarters ending September 30, 2000, through June 30, 2002, were incorrect and had to be restated. AOLTW disclosed that it would be restating $190

million worth of advertising and commerce transactions which were accounted for improperly between July 1, 2000 and June 30, 2002. AOLTW publicly cautioned investors not to rely upon previously issued financial statements, including the audited financial statements for 2000 and 2001 contained in AOLTW's Form 10-K for the year ended December 31, 2001.

178. In particular, AOLTW restated its advertising and commerce revenues as follows:

Quarter Ending	Amount Restated
9/30/00	$66 million
12/31/00	$22 million
3/31/01	$13 million
6/30/01	$28 million
9/30/01	$16 million
12/31/01	$17 million
3/31/02	$6 million

179. On February 5, 2003, *The Wall Street Journal* reported the FBI had sought to question former several former PurchasePro.com Inc. officers about their dealings with AOLTW, and that the DOJ and SEC were investigating former executives, including Eric Keller and David M. Colburn.

180. On March 28, 2003, AOLTW reported in its Form 10-K filing that it might further restate AOL's advertising revenue, up to $400 million for the years 2001 and 2002. AOLTW attributed to two transactions with Bertelsmann AG, which were the subject of an SEC investigation, and warned that the possibility for "further restatement of the Company's financial statements may be necessary," with respect to a "range of other transactions" being investigated by both the SEC and the DOJ.

181. AOLTW has not restated its improper report of revenue for the periods before the quarter ending September 30, 2000, or with respect to other transactions described in paragraphs 45-126.

182. On July 25, 2003 *The Wall Street Journal* published an article detailing

how AOL had inflated their reported subscriber numbers.

183. On July 30, 2003, the SEC announced that it was expanding its previously announced investigation into AOLTW to include an inquiry into the way the AOL unit had reported their subscriber metrics.

184. On September 18th, 2003 the Board of Directors of AOLTW voted to drop AOL from the AOLTW name, and on October 16, 2003, AOLTW was officially renamed and began operating as Time Warner, Inc.

FIRST CAUSE OF ACTION

For Violation of AS 45.55.930
(Against all Defendants)

185. Plaintiffs incorporate paragraphs 1-156 and 160-184 as if set forth fully herein, except allegations of fraud.

186. This cause of action is brought against all Defendants. Plaintiffs assert only strict liability and negligence claims under the statute—fraudulent intent is not an element of this claim.

187. Defendants are liable to plaintiffs for their involvement in the sale of securities to plaintiffs by means of untrue statements of material fact and omissions of material fact.

188. AOL and AOLTW were the sellers of the securities.

189. Individual Defendants Case, Pittman, and Kellysigned the Stock Option Registration Statements. Individual Defendants Kelly signed the Merger Registration Statement. Individual Defendants Case, and Pittman signed the Joint Proxy Statement-Prospectus which was incorporated into the Merger Registration Statement. Defendants Case, Pittman and Kelly also signed various financial reports issued by AOL or AOLTW. Each of these documents contained untrue statements of material fact or omissions of material fact. All of the Individual Defendants were officers of the sellers. Additionally, Individual Defendants Case and Pittman were directors of the sellers. The Individual Defendants, by reason of their management positions and their positions on AOL's, Time Warner's and AOLTW's boards of directors had power, influence and

control, and exercised it, whether indirectly or directly over the sellers.

190. Defendant Morgan Stanley was the advisor and underwriter for Time Warner in connection with the Merger. Morgan Stanley consented to the inclusion of its fairness opinion – its opinion that the terms of the Merger were fair to the Time Warner shareholders – in the Merger Registration Statement. This defendant was the agent of the seller and materially aided in the sale of securities.

191. Defendant Ernst & Young, as the accountant for AOL, Time Warner and AOLTW, reviewed and approved the unaudited financial statements issued in connection with the Merger, including those in the Merger Registration Statement and Stock Option Registration Statement. Ernst & Young also issued unqualified opinions following the audits of AOL's, Time Warner's, and AOLTW's financial statements for the years 1998-2001, as applicable, and consented to the inclusion of its opinions on AOL's 1998-2000 financial statements in the Merger Registration Statement. Defendant Ernst & Young was an agent of the seller, and materially aided in the sale of securities.

192. On February 11, 2000, AOL and Time Warner, their officers, directors, and financial advisors as well as Ernst & Young, filed the initial draft of the Merger Registration Statement with the SEC to issue and register the new AOLTW shares which would be sold in an initial public offering. Amendment No. 4 to the Merger Registration Statement was filed and became effective with the SEC on May 19, 2000. On January 11, 2001, AOL and Time Warner filed a series of registration statements (the "Stock Option Registration Statements") with the SEC which were signed by certain directors of AOL and Time Warner. The Merger Registration Statement stated:

> AOL Time Warner will file a registration statement covering the issuance the shares of AOL Time Warner common stock subject to each America Online and Time Warner option and restricted shares and will maintain the effectiveness that registration statement for as long as any of the options or restricted shares remain outstanding.

193. The Stock Option Registration Statements incorporated the following documents by reference: (a) America Online, Inc.'s Annual Report on Form 10-K for the fiscal year ended June 30, 2000 (filing date September 22, 2000), as amended by Amendment No. 1

thereto or Form 10-K/A dated October 27, 2000 (filing date October 30, 2000); and (b) America Online, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2000 (filing date November 9, 2000). Each of these documents contained material misstatements or omissions, as described above.

194. AOL and AOLTW are strictly liable for the false Merger Registration Statement and Stock Option Registration Statements, and also for each of the financial reports they filed for the periods ending December 31, 1999, through the periods ending June 30, 2002. Each of the defendants named in this cause of action and jointly and severally liable in that they directly and/or indirectly controlled AOLTW, and/or materially aided in the sale of securities.

195. Defendants owed to purchasers of AOL and AOLTW securities, the duty to make a reasonable and diligent investigation of the statements contained in their financial reports, and in the Merger Registration Statement and Stock Option Registration Statements at the time they became effective, to ensure that there were no untrue statements of material fact or material omissions which served to render statements misleading.

196. Defendants knew or in the exercise of reasonable care should have known of the material misstatements and omissions contained in the financial reports or Registration Statements.

197. None of the defendants named in this cause of action made a reasonable investigation or possessed reasonable grounds for the belief that the statements contained in the financial reports, Merger Registration Statement and Stock Option Registration Statements were true or that there was not any omission of material fact necessary to make the statements not misleading.

198. The defendants issued, caused to be issued, and participated in the issuance of the materially false and misleading written statements in the financial reports, Merger Registration Statement and Stock Option Registration Statements, which misrepresented or failed to disclose, among other matters, the facts set forth herein, in violation of AS 45.55.930 of the Alaska statutes.

199. Plaintiffs did not know and could not have known of misstatements and

omissions of material fact contained in the financial reports and Registration Statements.

200. As a direct and proximate result of defendants' wrongful conduct, the market price for AOL and AOLTW securities was artificially inflated, and plaintiffs suffered substantial damages in connection with the purchase of AOL and AOLTW securities issued pursuant to and/or traceable to the registration statements.

201. This action was brought within six years after the discovery of the untrue statement and omissions.

SECOND CAUSE OF ACTION

For Violation of AS 45.55.010
(Against All Defendants)

202. Plaintiffs incorporate by reference paragraphs 1-184 as if set forth fully herein. This Count is asserted against all defendants.

203. The defendants knew, or were reckless in failing to know, of the material omissions from, and misrepresentations contained in, the statements as set forth above. Each of the defendants knew or had access to the material, adverse, non-public information about AOL's and AOLTW's true financial condition and then existing business conditions, which was not disclosed; and directly or indirectly participated in drafting, reviewing and/or approving the misleading statements, releases, reports and other public representations of and about AOL and/or AOLTW.

204. Defendants, with knowledge of or reckless disregard for the truth, disseminated or approved the releases, statements and reports, referred to above, which were misleading in that they contained misrepresentations and failed to disclose material facts necessary in order to the statements made, in light of the circumstances under which they were made, not misleading.

205. Defendants, individually and via a scheme, directly and indirectly, participated in a course of conduct to conceal material, adverse information regarding the then-existing business conditions and finances of AOL and/or AOLTW, as specified herein. Defendants employed devices, schemes and artifices to defraud, and engaged in acts, practices,

and a course of conduct as herein alleged to commit a fraud on the integrity of the market for the Company's securities and to maintain artificially high market prices for the securities of AOL and/or AOLTW. This included the following acts or omissions in connection with the sale of AOL and/or AOLTW securities by Defendants and/or the purchase of AOL and/or AOLTW securities by plaintiffs: (1) the formulation, making of and/or participation in the making of untrue statements of material facts; (2) the omission to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and (3) the engagement in acts, practices and a course of conduct as described in detail above, which operated as a fraud and deceit upon plaintiffs.

206. For the purpose of inducing the purchase of AOLTW stock by others, each of the defendants named in this cause of action made statements which were, at the time and in light of the circumstances under which they were made, false and misleading with respect to material facts or which omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. Each such defendant knew or had reasonable grounds to believe that the statements made by them were false or misleading. Each of the defendants knowingly and willfully participated in or materially aided and abetted the preparation, issuance and circulation of the Merger Registration Statement and Stock Option Registration Statements with knowledge of or in reckless disregard for their falsity and the intent to cause plaintiffs, their agents and others to rely thereon.

207. AOLTW conducts business in Alaska. Many thousands of shares of AOLTW stock were sold or offered for sale in Alaska. Defendants' false and misleading statements were intended to, and did, enter into and were disseminated in Alaska by way of the nationwide release of press releases, nationwide telephone conference calls and interviews which the participating defendant knew or should have known would be disseminated on a national basis.

208. At the time plaintiffs or their agents purchased AOLTW stock, they did not know of any of the alleged false and/or misleading statements and omissions.

209. Plaintiffs have suffered substantial damages in that, in reliance on the false

and misleading statements made by Defendants, as described in detail above, as well as on the integrity of the regulatory process and the market, they paid artificially inflated prices for AOL and/or AOLTW securities as a result of defendants' violations of Alaska law. Plaintiffs or their agents would not have purchased AOL and/or AOLTW securities at the prices they paid, or at all, if they had been aware that the market prices had been artificially and falsely inflated by defendants' misleading statements and concealment. At the time of the purchases of AOL and/or AOLTW securities by plaintiffs, the fair and true market value of said securities was substantially less than the prices paid for them.

210. Defendants' violations of the provisions of the Alaska statutes as alleged herein, proximately damaged plaintiffs in their purchases of AOLTW stock.

THIRD CAUSE OF ACTION

For Common Law Fraud (Against All Defendants)

211. Plaintiffs incorporate paragraphs 1-184 as if set forth fully herein.

212. This cause of action is brought against all defendants.

213. As alleged herein, defendants each made or participated in making material misrepresentations, or omitted to disclose material facts, to plaintiffs, their agents, and the investing public regarding AOL and AOLTW. Each of the defendants knowingly participated in the making issuance and publication of prospectuses, financial statements, balance sheets and other document respecting AOL's, Time Warner's and AOLTW's assets, liabilities, capital, business, earnings, and accounts which were false in material respects.

214. The defendants knew, or were reckless in failing to know, of the material omissions from, and misrepresentations contained in, the statements as set forth above. Each of the defendants knew or had access to the material, adverse, non-public information about AOL's and AOLTW's true financial condition and then existing business conditions, which was not disclosed; and directly or indirectly participated in drafting, reviewing and/or approving the misleading statements, releases, reports and other public representations of and about AOL and/or AOLTW.

215. Defendants' misrepresentations and omissions were material in that they could reasonably be expected to influence an investor's judgment in connection with the purchase and/or sale of AOL or AOLTW securities.

216. Defendants' misrepresentations and omissions were made intentionally or recklessly, in order to induce reliance thereon by plaintiffs and their agents, and the investing public when making investment decisions.

217. Plaintiffs and/or their agents actually and justifiably relied on defendants' representations and statements in connection with their purchase and sale of AOL and AOLTW stock in the Merger and thereafter.

218. At the time the Merger was approved and/or their AOLTW stock was purchased by, or on behalf of, plaintiffs, neither plaintiffs nor their agents knew of any of the false and/or misleading statements and omissions.

219. Plaintiffs and/or their agents were unaware of the existence of this cause of action until the information began to be revealed publicly. A reasonable person in these circumstances would not have enough information to alert him or her that he or she has a potential cause of action until recently, and certainly not before July 2002, when the first media reports about AOL's and AOLTW's conduct surfaced.

220. As a direct and proximate result of the fraud and deceit of defendants, plaintiffs have suffered damages.

221. Defendants' conduct in making or participating in making material misrepresentations, or omitting to disclose material facts, was outrageous or undertaken with reckless indifference to the interests of others.

FOURTH CAUSE OF ACTION

For Negligent Misrepresentation (Against All Defendants)

222. Plaintiffs incorporate paragraphs 1-156 and 160-184 as if set forth fully herein, except allegations of fraud.

223. This cause of action is brought against all defendants.

224. As alleged herein, defendants each made or participated in making material misrepresentations, or omitted to disclose material facts, to plaintiffs, their agents, and the investing public regarding AOL and AOLTW. Each of the defendants knowingly participated in the making issuance and publication of prospectuses, financial statements, balance sheets and other document respecting AOL's, Time Warner's and AOLTW's assets, liabilities, capital, business, earnings, and accounts which were false in material respects.

225. The defendants knew, or should have known, of the material omissions from, and misrepresentations contained in, the statements as set forth above. Each of the defendants knew or had access to the material, adverse, non-public information about AOL's and AOLTW's true financial condition and then existing business conditions, which was not disclosed; and directly or indirectly participated in drafting, reviewing and/or approving the misleading statements, releases, reports and other public representations of and about AOL and/or AOLTW.

226. Defendants' misrepresentations and omissions were material in that they could reasonably be expected to influence an investor's judgment in connection with the purchase and/or sale of AOL or AOLTW securities.

227. When Defendants made their misleading statements, releases, reports and other public representations of and about AOL and/or AOLTW, they knew, or in the exercise of reasonable care should have known, that they were false or misleading.

228. Defendants knew or should have known that the information contained in their statements and the information they failed to disclose were desired for a serious purpose, and that Plaintiffs relied upon their statements and omissions in connection with their purchase and sale of AOL and AOLTW stock in the Merger and thereafter.

229. Plaintiffs and/or their agents actually and justifiably relied on defendants' representations and statements in connection with their purchase and sale of AOL and AOLTW stock in the Merger and thereafter.

230. At the time the Merger was approved and/or their AOLTW stock was purchased by, or on behalf of, plaintiffs, neither plaintiffs nor their agents knew of any of the

false and/or misleading statements and omissions.

231. Plaintiffs and/or their agents were unaware of the existence of this cause of action until the information began to be revealed publicly. A reasonable person in these circumstances would not have enough information to alert him or her that he or she has a potential cause of action until recently, and certainly not before July 2002, when the first media reports about AOL's and AOLTW's conduct surfaced.

232. As a direct and proximate result of the negligent misrepresentation of defendants, plaintiffs have suffered damages.

233. Plaintiffs' damages were certain and/or foreseeable.

FIFTH CAUSE OF ACTION

For Professional Negligence/Malpractice (Against Defendant Ernst & Young)

234. Plaintiffs incorporate paragraphs 1-156 and 160-184 as if set forth fully herein, except allegations of fraud.

235. This cause of action is brought against Ernst & Young.

236. Ernst & Young is in the business of auditing financial statements of public companies, issuing opinion letters concerning the financial statements audited, and providing any certifying such information for the benefit of investors and others to use in their dealings with others.

237. As the purportedly independent auditor of AOL, Time Warner and AOLTW, Ernst & Young owed the shareholding public, including plaintiffs a duty of reasonable care in connection with the provision of information concerning the financial condition of AOL, Time Warner and AOLTW, including Ernst & Young's certifications that the companies' financial statements fairly and accurately reported their financial condition and were presented in accordance with GAAP.

238. Ernst & Young knew and intended that its reports concerning AOL's, Time Warner's and AOLTW's financial statements would be publicly disseminated in SEC filings, and distributed to prospective purchasers of the stock as part of the Merger Registration Statement,

and that such purchasers would rely, and had a right to rely, upon the information provided by Ernst & Young concerning the financial condition of AOL and AOLTW in making their investment decisions.

239. Ernst & Young breached its professional duties by failing to exercise the degree of care ordinarily exercised under the circumstances by reputable independent auditors, as discussed above.

240. Ernst & Young knew and intended that its audit opinions and the annual financial statements of AOL, Time Warner and AOLTW to which they related would be incorporated by reference in and constituted a material part of the Merger Registration Statement and Ernst & Young expressly consented to such incorporation. Ernst & Young understood that a primary intent of AOL, Time Warner and AOLTW was for Ernst & Young's professional services to benefit or influence prospective purchasers of AOLTW shares including plaintiffs -- the primary purpose for having an accounting firm certify financial statements is to provide independent certification of the accuracy of a company's financial reports to those who must rely upon those financial statements when deciding whether to transact in the company's securities.

241. Neither plaintiffs nor their agents knew that Ernst & Young had failed to exercise the degree of care ordinarily exercised by reputable independent auditors, or that the representations made by Ernst & Young (including the representations by defendants which were certified by Ernst & Young), were false and/or misleading.

242. As a direct and proximate results of the Ernst & Young's professional malpractice, and in reliance thereon, plaintiffs suffered damages in connection with their purchases of AOLTW shares.

PRAYER FOR RELIEF

WHEREFORE, plaintiffs pray for judgment as follows:

A. Awarding preliminary and permanent injunctive relief in favor of plaintiffs against defendants and their counsel, agents and all persons acting under, in concert with, or for them, including an accounting of and the imposition of a constructive trust and/or an asset freeze or defendants' insider trading proceeds;

B. Ordering an accounting of defendants' insider-trading proceeds;

C. Ordering disgorgement of defendants' insider-trading proceeds;

D. Awarding restitution to plaintiffs, consisting of the purchase price of the securities, plus interest at 8% per year;

E. Awarding compensatory damages in favor of plaintiffs against all defendants, jointly and severally, for all damages sustained as a result of defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;

F. Awarding punitive damages in favor of plaintiffs against all defendants, jointly and severally, to the extent that defendants' conduct was outrageous or undertaken with reckless indifference to the interests of others;

G. Awarding rescission in favor of plaintiffs to the extent that they still hold their AOLTW securities and recissionary damages to the extent that they do not;

H. Awarding plaintiffs their reasonable costs and expenses incurred in this action, including reasonable actual attorney's fees and expert witness costs, pursuant to AS 45.55.930 or in the alternative, attorney's fees and costs pursuant to Civil Rule 79 and 82; and

I. Such other and further relief as the Court may deem just and proper.

JURY DEMAND

Plaintiffs demand a trial by jury.

Dated: April 1, 2004

Respectfully submitted,

STATE OF ALASKA ATTORNEY GENERAL'S OFFICE

By: ______________________
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CASE FORMALLY ASSIGNED TO JUDGE PATRICIA COLLINS BY ORDER OF THE PRESIDING JUDGE