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IN RETROSPECT

How the AOL-Time Warner Merger Went So Wrong

By TIM ARANGO

A decade ago, America Online merged with Time Warner in a deal valued at a stunning $350 billion. It was then, and is now, the largest merger in American business history.

The Internet, it was believed, was soon to vaporize mainstream media business models on the spot. America Online's frothy stock price made it worth twice as much as Time Warner's with less than half the cash flow.

When the deal was announced on Jan. 10, 2000, Stephen M. Case, a co-founder of AOL, said, "This is a historic moment in which new media has truly come of age." His counterpart at Time Warner, the philosopher chief executive Gerald M. Levin, who was fond of quoting the Bible and Camus, said the Internet had begun to "create unprecedented and instantaneous access to every form of media and to unleash immense possibilities for economic growth, human understanding and creative expression."

The trail of despair in subsequent years included countless job losses, the decimation of retirement accounts, investigations by the Securities and Exchange Commission and the Justice Department, and countless executive upheavals. Today, the combined values of the companies, which have been separated, is about one-seventh of their worth on the day of the merger.

To call the transaction the worst in history, as it is now taught in business schools, does not begin to tell the story of how some of the brightest minds in technology and media collaborated to produce a deal now regarded by many as a colossal mistake.

How did it happen?

The romance between Mr. Case and Mr. Levin, they said in interviews with The New York Times, began in the fall of 1999 at a celebration of the 50th anniversary of the People's Republic of China at Tiananmen Square.

MR. LEVIN I was seated for some reason in front of Steve Case and his wife and so we had a little chitchat. It was a stunning evening to be a part of that history. But this next thing that registered on me was that they seem to have a very sweet relationship and I liked that, and we had some fun, joked around, and so from a personality point of view we talked.

MR. CASE There was all kinds of hoopla and parades in Tiananmen Square and a state dinner at the Hall of the People, and I remember Jerry had decided to have the Time Warner board meet in China that week and they were on a trip but they also attended some of these functions, so at these different functions I talked to various Time Warner board members, but I don't think I had any direct conversations with Jerry about the merger until probably a month later.

MR. LEVIN We're now back in the United States and I think Steve Case called me on the phone and in that conversation more than alluded to putting the companies together. I had my traditional script and quasi-legal background that when someone calls you on the phone, make sure they understand you're not for sale, which we certainly weren't, and decline any overture, which I did over the phone.

In fact, Mr. Case and his team, including Robert W. Pittman, the company's president, had been plotting for months about how to use its high-priced stock to make a big acquisition. The company hired the investment bank Salomon Smith Barney, and its top media banker Eduardo Mestre, to consider various targets.

MR. MESTRE It was one of the highlights of my career because I remember vividly sitting down with the AOL executives and going through with them their vision of how to combine AOL with a more traditional company in creating what at that time was going to be perceived as a company of the future.

MR. PITTMAN It was a very heady time because 1999 was the first year the thesis that everybody was going to be on the Internet and every business was going to be on the Internet and it was going to be a primary means of communication finally was accepted; 1999 was the year it sort of kicked in, and I think when it kicked in people started saying, "O.K., what's the big dream, what's the big idea, what do we need to do now?"

We were actually deep in discussions with eBay to buy eBay and add them, had a little bit of discussion with Larry Probst over at Electronic Arts, and Steve had an idea that we should merge with Time Warner and me and a couple other people said there's no chance that's ever going to happen and I sort of paid no attention to it.

Meanwhile, Mr. Levin was thinking deeply about how to transform Time Warner for the digital age.

MR. LEVIN We were emerging from not just old media but from an analog world into a digital world, and philosophically people were beginning to understand that the digital world was a transformational universe.

Before AOL, Mr. Levin, prodded by Gordon Crawford, senior vice president at Capital Research Global Investors in Los Angeles, then the largest institutional shareholder of Time Warner, discussed a merger with Yahoo's founder, Jerry Yang.

MR. CRAWFORD I was involved in putting the two of them together and kind of following the course of those discussions over the year, and over the course of 1999 those discussions morphed from the discussion of a partial stake to a full merger, and then in the late fall Jerry Yang decided he did not want to pursue it any further and I think terminated the discussions.

Shortly after Mr. Case's initial phone call to Mr. Levin, the pair met for dinner and wine at the Rihga Royal, a hotel in Midtown Manhattan.

MR. LEVIN Steve and I met at a hotel for several hours. The idea was not to talk about any transactional detail but to talk about philosophy and values, and it was several hours. I took away the fact that he had good values, which was important to me — that his company was a real company.

MR. CASE Initially, he was a little reluctant, just thinking it through, but did agree that it made sense for us to meet. So a week or two later we met and had dinner at a hotel in New York, and we were talking about what this company might be together and some of the benefits that could accrue strategically as well as how the company together might have a broader impact on society, and that kind of led to a series of discussions.

Both sides assembled negotiating teams, and alerted a handful of top executives and bankers. At Time Warner, Mr. Levin kept only a small circle of people in the loop, including Richard D. Parsons, the company's president.

MR. PARSONS Jerry came into my office and said that he had been talking with Steve, who he had gotten to know on a trip that he had taken abroad to China. And Jerry and Steve had gone and met, had a few dinners after that, and he said we have been talking to Steve about this and that he thought this was something we ought to do and him and Steve were sort of going down the road to see how it could work and he wanted to get my views.

Fundamentally I thought it was a good idea.

Making the Deal

The deal was sealed at a dinner in early January at Mr. Case's house in McLean, Va. The transaction was spun to the world as a merger of equals, but in reality AOL, with its more valuable stock, was acquiring Time Warner. AOL would own 55 percent of the new company and Time Warner, 45 percent. But the new board would have an equal number of AOL and Time Warner directors. Mr. Levin would be chief executive, and Mr. Case would be chairman.

Over a weekend, the two sides conducted due diligence, with teams of lawyers camped out in two law offices in Manhattan.

Miraculously, news of the deal did not leak during the talks, and word trickled out only hours before the announcement on Jan. 10, 2000.

Over that weekend, Mr. Levin and Mr. Case began notifying more of the executives. Among these were Don Logan, then head of Time Inc., and Ted Leonsis, a division president at AOL. Many executives, including Timothy A. Boggs, then head of government relations at Time Warner, found out about the deal the day of the announcement in an 8 a.m. conference call. (Mr. Boggs is now associate rector at St. Albans Parish in Washington. Mr. Logan owns a minor-league baseball team in Birmingham, Ala., and Mr. Leonsis is an owner of the Washington Capitals and the Washington Wizards.)

None were pleased with the news.

MR. LOGAN Dumbest idea I had ever heard in my life.

MR. LEONSIS I was one of the loudest advocates for not doing the deal.

MR. BOGGS Just real regret and dread. My job was to make the case for this deal to governments around the world and to get all the regulatory clearances that were needed and to work with our antitrust lawyers to get those clearances to make the case to Congress and the media, to some extent, about this merger, and I was just frankly stunned and a bit knocked back on my heels by the prospect of securing all of those approvals.

I knew and I loved Time Warner. I saw it as a company with a vision and a set of values, and I saw AOL in a much less favorable light, much more opportunistic, made up of folks who were really trying to merely exploit the market they were in as opposed to developing something that was enduring, and I was very leery about this deal.

The announcement was hailed as a momentous coming of age for the Internet and the triumph of the New Economy.

MR. MESTRE If you go back and read what was written in The Journal and what was written in The Times about this transaction, you would have thought that it was the second coming of the Messiah. I'm sure that if one were to read those today one would find it amusing, maybe dated, but it was, for financial reporting, it was as soaring and this is the great epiphany-of-life kind of journalism and you read it and it brought tears to your eyes.

Nina Munk, of Vanity Fair, wrote the book "Fools Rush In: Steve Case, Jerry Levin, and the Unmaking of AOL Time Warner."

MS. MUNK I had one of my sources who told me he was listening to the radio on his way into work that morning when the deal was announced and he practically drove off the road. The Wall Street Journal, I think, had 19 or 20 separate articles on the intricacies of the deal and what it meant. The word "transformative" was used again and again, and we really believed with the rare exception of a very small number of skeptics, we really believed that this deal captured a transformation and that it spoke to a new direction that the world was taking.

But some wanted to talk fashion: Mr. Levin showed up to the press conference without a tie, while Mr. Case dressed up.

MR. LEVIN What most people don't recall is that I had stopped wearing a tie and jacket for quite some time. Once we had a music company in our building, I thought it was a constraint to wear a tie and jacket, so it wasn't planned but it was kind of a refreshing symbol. I was extremely happy — "high," I was going to say — on an emotional high because I think when you actually announce something, it's the reflection of the news coming back at you. It makes it real. It puts it out on the stage. It validates what was internal before.

MR. CASE The day of the announcement was bittersweet, frankly. On the one hand, obviously, it was an exciting time in bringing together the leading Internet company and the leading media company to create a new company that really had the potential to lead in this new century. At the same time, I recognized that my role was going to change.

It was a moment of achievement after a decade or in some cases, in our case two decades, of trying to prove that this concept had real merit, suddenly the Internet had arrived and we're beginning this new century with a combination of these two great companies.

On the steps of a church on the Upper West Side of Manhattan, Tim Armstrong, then an executive at an upstart called Google and now AOL's chief executive, read about the deal.

MR. ARMSTRONG I couldn't believe it. I just remember reading the deal and thinking the world had changed.

The deal took a year to be approved by regulators. Robert Pitofsky, then the head of the Federal Trade Commission, allowed the deal to go forward, even as the F.T.C.'s own economists warned the deal did not make financial sense. It was the most significant media case to come before the commission, according to Mr. Pitofsky, since 1964, when CBS bought a big league baseball team.

MR. PITOFSKY Now we have large communications cases, but at the time it was probably the biggest. There was CBS-New York Yankees; that would be the closest you could come to something like this.

Our economists at the time said this deal doesn't make economic sense. I didn't see it that way, and I don't think the other commissioners did, but the economists immediately saw it didn't make financial sense.

First Signs of a Clash

The optimism surrounding the deal was brief. In May of 2000, the dot-com bubble began to burst and online advertising began to slow, making it difficult for AOL to meet the financial forecasts on which the deal was based. The world began moving quickly to high-speed Internet access, putting AOL's ubiquitous dial-up service in jeopardy.

The companies had another problem: both sides seemed to hate one another.

MR. PARSONS I remember saying at a vital board meeting where we approved this, that life was going to be different going forward because they're very different cultures, but I have to tell you, I underestimated how different.

MR. LEONSIS The news release that they showed us and the positioning was that AOL would be the crown jewel, and I'd say, "Well if we're the crown jewel, why are all our best and most important people leaving here and going to New York?" In fact, if we were the crown jewel, you would go and take all of the best, most talented people at Time Warner and bring them here.

In the summer of 2001, Alec Klein, then a reporter at The Washington Post, received an anonymous phone call.

MR. KLEIN He tells me that someone had been suspended at AOL, a midlevel executive, and he tells me very little more than that and then hangs up on me.

So I'd call so-and-so, and that person would say, "I don't know anything, but why don't you try these three other people?" and I kept doing this. Eventually I called the guy and I said: "Hi, this is Alec Klein of The Washington Post." And the first thing out of his mouth was, "How did you find me?" I realized, here is the anonymous tipster who had first called me.

I persuaded him to meet me, and when we met he started to tell me more about what was going on and I started to meet other people through him and it started to grow into this network of different sources, all of whom had these secret documents from AOL.

Mr. Klein's work uncovered that AOL had been improperly inflating its advertising revenue, and his stories that were published in 2002 prompted investigations by the S.E.C. and the Department of Justice. Eventually the company paid hefty fines and was forced to restate past earnings.

The accounting scandal became a rallying cry for the Time Warner side. In 2003, Mr. Case stepped down as chairman. Today he runs his own private investment firm.

MR. CASE For whatever reason, right or wrong, I had become kind of a magnet for a lot of anger and frustration, particularly with the Time Warner employees and also with shareholders and if we really were going to get the company on the right track and really capitalize on the promise of the merger, probably the best thing I could do was step aside and get out of the way.

Mr. Levin, whose son Jonathan was murdered in 1997, had announced his retirement in December 2001. Today, he runs a holistic healing center in Santa Monica, Calif.

MR. LEVIN When 9/11 occurred, it was obviously an emotional experience for everyone. For me, it was more personal because of the death of my son and probably never having really achieved any resolution.

We had a board meeting scheduled for the 3rd of October, which was right after 9/11, and I said we can't have a board meeting, we're supposed to be in New York. And most people, particularly the AOL people, said business has to go forward and I was just emotional and got very upset. I then went to some Wall Street presentation — and I made quite a few of them — and when I was making my normal presentation, someone raised their hand and asked, can you give us the margin deterioration that will occur from all the extra spending on account of 9/11. I thought the question was out of line; I not only said it was out of line, I really emotionally went after the person asking the question, got up and walked out.

The Deal Unwinds

Many investors and employees lost millions of dollars, but no one lost more than Ted Turner, who at the time was the largest individual shareholder in the combined company.

MR. TURNER I'd like to forget it. That's what goes through my mind. I almost didn't do this interview because I didn't want to dig it up again. Let it pass into history.

The Time Warner-AOL merger should pass into history like the Vietnam War and the Iraq and Afghanistan wars. It's one of the biggest disasters that have occurred to our country.

I lost 80 percent of my worth and subsequently lost my job. We looked it up to see if I was the biggest loser of all time because I lost about $8 billion. But I don't think I was the biggest loser of all time. I think at one point Microsoft stock went down more than that for Bill Gates. I think he's the biggest winner and the biggest loser. I was in the top three or four of all time.

Jeffrey L. Bewkes, the current chief of Time Warner, once dressed down Mr. Case in a meeting, saying, according to Mr. Klein's reporting: "The only division that's not performing is yours. Every one of us is growing, making the numbers. The only problem in this construct is AOL."

MR. BEWKES I really have a strong point of view that it has never been an issue of culture at Time Warner. I know you're going to have people, for various reasons that they have individually, say there was the issue of culture at Time Warner. I think that in fact the employees at AOL and Time Warner worked together quite well to try to make the most of the merger, but they didn't solve the business fundamental challenges at AOL anymore than was solved at Yahoo, MSN, Lycos or I.A.C.

The enduring debate is whether the deal collapsed because the concept was flawed at the start, or because the cultures were too different and the execution of the merger was a failure.

MR. CASE It was a good idea, but the execution of it wasn't what it needed to be, and I accept responsibility for that. Everybody involved, I think, needs to accept responsibility for that, but that doesn't take away from the core strategic value of the idea.

MR. LEVIN I used to think at the time it was a clash of cultures and a misreading of the dot-com bubble, but I now upon reflection believe that the transaction was undone by the Internet itself.

I think it's something that no one could have foreseen, and to this day, whether Apple is going to dominate entertainment or whether Amazon is going to dominate publishing, all the old business plans are out the window. How do you get paid for content? And the consumer has access to everything and now it's going to be on a handheld device, so what I call the rolling thunder of the Internet started actually to eat its own, which was AOL. AOL was the Google of its time. It was how you got to the Internet, but it was using some old media business ideas that were undone by the Internet itself, and that's why Google came along.

MR. PARSONS The business model sort of collapsed under us, and then finally this cultural matter. As I said, it was beyond certainly my abilities to figure out how to blend the old media and the new media culture. They were like different species, and in fact, they were species that were inherently at war.