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IN THIS ISSUE

THE CIRCULATION SCANDALS OF 2004: THE LITIGATION SO FAR

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The newspaper and magazine industry underwent major scrutiny in 2004. The rates paid for print advertising are in most cases based on circulation volume as reported by the publisher to audit bureaus. The audit bureaus are then responsible for the dissemination of circulation data that are reported by member companies to advertisers. Advertising rates are a major source of revenue for print publications and a principal driver of profits.

Scandals involving inflated circulation numbers at one magazine and four newspapers in the last year have become front page news: Gruner + Jahr's *Rosie* magazine, *Newsday* and *Hoy* in New York, the *Chicago Sun-Times* and the *Dallas Morning News*. This bulletin updates the scandals and resulting litigation, and describes a few simple things you can do to ensure that your company is not next on the hot seat.

SUMMARY OF THE PROBLEM AND THE CIVIL LITIGATION

ROSIE

When Gruner + Jahr USA (G + J) sued Rosie O'Donnell in New York state court for breach of contract, alleging that she breached her contract by walking away from the magazine that bore her name (the former *McCall's*), O'Donnell countersued, claiming that G + J cut her out of certain editorial decisions that she was entitled to make under the contract. O'Donnell also claimed that, when circulation decreased and G + J was in danger of falling below the threshold revenue point that was required in O'Donnell's contract, G + J began "managing" its financials by inflating its circulation numbers. The result: after a bench trial in November 2003, the Judge declared a draw. More recently, G + J filed suit against its independent circulation agent, Publishers Communications Systems, in federal court in Florida, claiming that the agent provided faulty subscription data that could cause a number of G + J's publications, including

Family Circle, *Parents*, *Child, Inc.* and *Fast Company*, to fall short of guarantees made to advertisers.

NEW YORK NEWSDAY AND HOY

In February 2004, on the heels of the *Rosie* trial, questions about the circulation reporting at *New York Newsday* (*Newsday*) and *Hoy*, a daily Spanish language paper launched by *Newsday* in 1998, came to light when a class-action complaint was filed in federal court in Long Island.

The plaintiffs, led by the Crab House of Douglaston, Inc., are advertisers in both *Newsday* and *Hoy*, and allege that they were harmed by a pattern of activity that began in August 1995, when the papers inflated the circulation figures that were reported to the Audit Bureau of Circulation (ABC). The complaint alleges that because of the inflated circulation figures, the advertisers were required to pay higher rates. The allegedly false sales figures were also reported in annual statements and securities filings. In addition, approximately 50 auto dealers that had advertised in *Newsday*, led by Arnold Chevrolet, also filed suit. Tribune Company investors have filed suit against the directors of the company, claiming that the board was too slow to act in the face of clear evidence of the inflated circulation figures.

The Tribune Company initially denied the charges, but admitted in June that, for the reporting period ending September 2003, its circulation figures were inflated by as much as 17% at *Newsday* and 50% at *Hoy*.

Motions to dismiss the *Crab House* and *Arnold Chevrolet* cases are in the process of being briefed; the directors have indicated they will also move to dismiss the investor lawsuit.

THE CHICAGO SUN-TIMES

In the summer of 2004, the scandal had another participant: Hollinger International, the publisher of the *Chicago Sun-Times*. On June 15, Hollinger announced that it was launching an internal investigation into

continued on page 2

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continued from page 1

circulation figures at the paper. Lawsuits by advertisers, once again including auto dealers, followed.

In December, Hollinger announced that its internal investigation revealed that, beginning in 1998, executives at the paper had overstated its average circulation, in increasing amounts over time, culminating in an 11.6% overstatement in the 12 month period ending in April 2004. Hollinger also announced that it had circulation issues at some of its other papers, including the *Jerusalem Post*, the *Daily Southtown* and *The Star*.

THE DALLAS MORNING NEWS

Meanwhile, the owner of the *Dallas Morning News*, the Belo Corporation, announced in August that the average circulation of the paper for the six months ended September 2003 was overstated by 1.5% on a daily basis, and 5% on Sundays.

Within three weeks of Belo's announcement, a shareholder securities class action was filed against Belo in federal court in Dallas. The complaint alleges that the false statements about circulation constituted a "fraudulent scheme" under the securities laws and that, as a result of the paper's overstated figures, Belo (and its officers and directors) omitted material adverse information about its own revenues in its financial statements. Similar suits followed and have been consolidated. The motion to dismiss phase will commence shortly.

GOVERNMENT INVESTIGATIONS

On the heels of the *Crab House* lawsuit, *Newsday* announced that the SEC had commenced an investigation into the allegedly misstated circulation figures in order to educate itself about the issues, and state and local law enforcement inquiries followed.

More recently, a law enforcement task force led by the United States Attorney for the Eastern District of New York and the Department of the Treasury expanded a federal grand jury investigation into the *Newsday/Hoy* situation. The SEC is also reportedly looking at the circulation practices of at least a half dozen publicly traded newspaper companies.

ACTIONS MEDIA COMPANIES THAT REPORT CIRCULATION INFORMATION SHOULD BE TAKING

In the wake of the foregoing, all media firms that report circulation information, whether it be to the ABC or another audit bureau or reporting agency, need to take action.

1. CONDUCT INTERNAL AUDITS

First, if you have not already conducted an internal audit of your circulation figures, do so now. No company's compliance with the rules that govern it will be perfect. In particular, early detection of minor lapses or errors is critical.

The *Sun-Times* experience is illustrative: according to the reports of the internal investigation, the initial impact of the improper practices was that circulation was overstated by just 3,000 copies, or 0.57%, for the 12 months ended April 1998. However, over time, the managers involved increased their misdeeds so that circulation inflation mushroomed to more than 50,000 copies, or 11.6% for the 12 months ending April 2004.

If you discover something more significant than a minor, correctable error, you cannot stick your head in the sand; the last thing you want is for your CEO and CFO to sign incorrect certifications of your company's financial statements under Sarbanes-Oxley. Even if you are a privately held company, investors and lenders rely on your financial statements.

Caution in planning your internal investigations is imperative: the results may at some point become discoverable in a variety of proceedings. Suffice it to say, attorney involvement is critical to navigate the waters, and efforts to preserve the attorney-client privilege and work-product doctrine, to the extent possible, should be taken.

2. ADD ADDITIONAL INSTITUTIONAL CONTROLS

In addition to determining whether past practices need to be discontinued or corrected, progressive change is good business: more than ever, advertisers and investors need to be assured that publishers are taking a proactive approach to correctly report circulation and revenues.

Some firms have adopted voluntary Sarbanes-Oxley-type certifications requiring senior executives to certify quarterly circulation reports. Others have publicized the fact that they are sending detailed questionnaires to their publishers, circulation directors and finance directors, seeking to uncover whether any financial incentives are provided to distributors to hold or dump or otherwise dispose of unsold papers rather than return them to the publisher.

Other measures to ensure correct reporting include (1) checking matches between databases of home subscribers and reported home-delivery figures; (2) creating new divisions, such as a department of circulation compliance, with strong senior leadership; and (3) requesting preapproval of circulation

promotion programs by the ABC or other reporting agencies.

At the end of the day, you have to design a compliance program that fits your business, but it seems that having a circulation compliance director, with strong backing from management, is a must. It is also not enough to send out one questionnaire at the beginning of a process to detect past problems; sustained, long-term programs are necessary to detect issues early.

3. REVIEW INSURANCE POLICIES AND NOTIFY CARRIERS

At the first inkling of trouble, you need to review your existing policies for potential coverage, both of defense costs and for potential liabilities. Coverage for both may be available under existing comprehensive general liability policies, special media liability policies, directors and officers policies, and other excess coverage that may be available. There are contract interpretation issues for your lawyers, but the key here is to notify the insurers as quickly as possible after your discovery of a potential issue to avoid denial based on late notice. Further, policies being renewed or commenced should be reviewed to make sure their language includes the types of claims being made in connection with the circulation scandals of 2004. ■

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