Ad Accord for Yahoo and Google
Miguel Helft

Microsoft's four-month-long courtship of Yahoo has finally thrown Yahoo into the arms of their biggest common rival, Google.

Google and Yahoo said Thursday that they had reached an agreement under which Google would deliver ads next to some of Yahoo's search results and on some of its Web sites in the United States and Canada.

The nonexclusive deal is aimed at giving a lift to Yahoo's finances, and the company said it would generate an additional $250 million to $450 million in operating cash flow in the first year.

The agreement will also strengthen Google's dominance over the lucrative search advertising market. It was signed after Yahoo rejected a proposal by Microsoft to acquire both Yahoo's search business and a minority stake in the company. The rejection appears to end months of on-again, off-again negotiations between the two companies.

"Clearly it is time to move on," Jerry Yang, Yahoo's chief executive, said in a conference call. "This agreement with Google helps us to do so," Mr. Yang added, saying that the deal would allow Yahoo to continue to compete in its two main lines of business, search and display advertising.

Wall Street was less confident, sending Yahoo's shares down more than 10 percent, to close at $23.52, after the announcement that there would be no deal with Microsoft — not for the $47.5 billion it initially bid for all of Yahoo, or a smaller deal for any part of it.

The deal is certain to draw scrutiny from antitrust regulators, and the companies have agreed to delay it for three and a half months to give the Justice Department time to review it. Senator Herb Kohl, a Democrat from Wisconsin who is chairman of the Senate antitrust subcommittee, said his committee would closely examine the venture.

The deal is also likely to become fodder in the heated battle between Carl C. Icahn, the activist investor, and Yahoo for control of the company. Mr. Icahn has said that if Microsoft could not be persuaded to renew its bid for all of Yahoo, he would push for Yahoo to complete a search advertising deal with Google. He did not return calls seeking comment on Thursday.

In a statement, Microsoft said that its offer to buy Yahoo's search business was still valid.

Under the agreement with Google, Yahoo will choose search terms for which Google will offer ads. Yahoo will determine the number and placement of ads sold by Google and mix them with some ads it sells itself.

"We think of it as backfilling with Google monetization, rather than outsourcing," Mr. Yang said in an interview.

The four-year agreement, which can be renewed for two terms of three years, will allow Yahoo to continue to invest in improving its own search and search advertising business, Yahoo said. It can be rescinded by either party after a "change in control," like an acquisition, so it would not necessarily deter Microsoft from bidding again.

A Google co-founder, Sergey Brin, said in an interview that the company was happy to have Yahoo as an advertising partner but refused to discuss Google's expected financial gain from the deal.

After withdrawing its $47.5 billion offer on May 3, Microsoft began talking with Yahoo again about a more limited deal. On May 30, the company submitted a formal proposal, according to people knowledgeable about Microsoft's thinking, who agreed to speak on condition that they remain anonymous.

Under the proposal, Microsoft would have taken a 16 percent stake in Yahoo at $35 a share, bought Yahoo's search business and established a revenue-sharing agreement for searches coming from Yahoo, these people said. The deal would have delivered an estimated $1 billion or more in additional operating income for Yahoo, they said.

On Sunday, a group of Microsoft executives discussed that proposal with Yahoo board members during a two-hour face-to-face meeting at Mineta San Jose International Airport. The meeting included Steven A. Ballmer, Microsoft's chief executive, and other top Microsoft officials, as well as Mr. Yang; Yahoo's chairman, Roy Bostock; and other Yahoo directors.

At the meeting, Microsoft executives repeated that they would not consider buying all of Yahoo, in part because any merger deal signed now would be subject to a review by regulators. That process would extend into a new administration, possibly tying up Microsoft's capital for many more months, without certainty that a merger would go forward, according to the people familiar with Microsoft's thinking.

Yahoo agreed to consider the proposal at a full board meeting on Tuesday. On Thursday, Yahoo said that it had concluded that selling its search business alone to Microsoft would not be in its best interests over the long term and that all talks with Microsoft were over.

In the interview, Mr. Yang said that the fact that Microsoft was willing to buy Yahoo in April, and "a few weeks later they were no longer interested," cast doubt on Microsoft's commitment to the merger in the first place.

The search advertising partnership between Google and Yahoo, the No. 1 and No. 2 companies in that business, leaves No. 3 Microsoft even further behind.

"Out in the cold, is where this leaves Microsoft," said Bryan Wiener, the chief executive of 360i, an agency that helps marketers place ads on search engines and other Web sites.

While Google had 61.6 percent of the search market in the United States in April, according to comScore, Mr. Wiener said that Google's dominance of search ads is even greater. Among 360i advertisers, it accounts for 75 percent to 80 percent of dollars spent, he said.

Analysts said they were skeptical that the deal would be good for Yahoo in the long term.

"Obviously, there is a near-term revenue and profit windfall accruing to Yahoo," said Derek Brown, a Cantor Fitzgerald analyst. "But at what cost? What does it say about Yahoo's long-term vision to become a must-buy for advertisers? Does it make Google, not Yahoo, a must-buy for online advertisers?"

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