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## Spitzer accuses H& R Block of defrauding investors

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Four years ago, H&R Block (HRB), facing criticism from consumer groups over some of its practices, launched a program called the Express IRA that it said would encourage low-income people to save for retirement.

Wednesday, New York Attorney General Eliot Spitzer said that program had done precisely the opposite. In a \$250 million lawsuit, Spitzer said Block defrauded hundreds of thousands of people by persuading them to invest in a "poorly performing, fee-ridden 'retirement vehicle' " that was guaranteed to lose money.

The lawsuit charges that 85% of people who opened Block's Express IRA accounts paid more in fees than they earned in interest. It also says Block failed to disclose the fees.

Spitzer also charged that more than 150,000 H&R Block customers closed their accounts, triggering additional fees and nearly \$6 million in tax penalties.

H&R Block denied the charges and said it would vigorously fight them. But Spitzer's lawsuit is just the latest blow to the company's public image in recent months. It also comes at a sensitive time for Block: in the midst of the tax-filing season, when it earns most of its revenue.

Among Block's recent troubles, all disclosed in February:

- Block said it had understated its income tax liability last year by \$32 million. The accounting error was a particularly embarrassing admission for the nation's largest tax-preparation company. It forced Block to restate earnings for fiscal years 2004 and 2005, along with the first two quarters of this year.
- The company said third-quarter profit fell 68%, reflecting the costs of settling class-action lawsuits targeting its refund-anticipation loans. Refund-anticipation loans are high-interest advances on refund checks. Last year, Block agreed to pay \$62.5 million to settle lawsuits involving customers in more than two dozen states.
- In a sign that Block's problems with refund-anticipation loans aren't over, California Attorney General Bill Lockyer filed a new lawsuit, alleging that the company misled customers about the costs of the loans. That lawsuit seeks more than \$20 million in fines, plus refunds for the alleged

abuses.

Spitzer's lawsuit alleges that Block misled more than 500,000 customers when it promoted "great rates" on the Express IRA. In fact, Spitzer said, the customers' contributions were invested in federally insured money market accounts with interest rates that didn't even keep pace with inflation. What little interest they did earn was wiped out by fees, Spitzer said.

For the past several years, an Express IRA with a balance of \$323 — the median amount invested in the account — has earned about \$3 in interest a year, Spitzer said.

That's nowhere near enough to cover the \$10 annual maintenance fee, the \$15 fee to set up an account and a \$15 "re-contribution fee," the lawsuit said. Customers who closed the accounts lost even more, the lawsuit said, because they had to pay a \$25 termination fee.

Spitzer said more than 150,000 customers ended up closing the accounts, paying additional fees and nearly \$6 million in tax penalties.

H&R Block marketed the Express IRAs to customers whose taxes it prepared. But "instead of providing these families with accurate information that would have allowed them to make informed choices, H&R Block steered them into retirement accounts that actually shrank over time," Spitzer said in a statement.

### **CEO's response**

The company's CEO, Mark Ernst, disputed the charges and said in an interview Wednesday: "We firmly believe this is a very good product, designed to serve a population that doesn't have a savings alternative."

Block has hired Robert Abrams, himself a former New York attorney general, to defend itself against the charges. In a statement, Abrams said that 78% of accounts opened from 2001 to 2005 have shown "positive net tax savings benefits and interest earnings."

Spitzer, who is running for governor of New York, is a formidable foe. His investigations against Corporate America and Wall Street have triggered huge settlements.

In September 2003, he announced an investigation into the mutual fund industry. Janus Capital, Bank of America, Putnam Investments and Strong Capital all ended up paying multimillion-dollar fines. Spitzer also took on the brokerage industry, charging that many Wall Street analysts gave bullish ratings to stocks that were dogs. In April 2003, 10 brokerage firms agreed to pay \$1.4 billion in penalties and restitution to state and local authorities.

Wednesday, H&R Block's shares fell sharply, closing at \$20.63, down \$1.37, for a loss of 6.2%. H&R Block's core business of tax preparation and its future earnings stream aren't likely to suffer, says Kartik Mehta, research analyst at FTN Midwest Research.

The IRA part of its business is negligible, he said, so the biggest damage to the company's earnings will arise if H&R Block pays out a huge settlement or loses the \$250 million lawsuit. A \$250 million payout would reduce its annual earnings by 40 cents a share, he said.

But the damage to Block's image is harder to quantify. One key issue facing H&R Block is how the negative publicity and allegations of fraud will play among the millions of taxpayers who've relied on Block over the years, said Tim Fidler, director of research at Ariel Capital Management, which owns shares in the company.

Block's brand "is predicated on customer trust," Fidler said. "Was the IRA product well-designed? It would seem not. But it is hard to believe that they would wantonly create a product that was clearly

fraudulent."

Still, at Wednesday's news conference to announce the lawsuit, one consumer advocate urged low-income families to stay away from H&R Block.

"Our organization strongly encourages people to get their taxes done at free tax-prep sites, which will prepare people's taxes professionally, with zero incentive to rip people off," said Sarah Ludwig, director of the Neighborhood Economic Development Advocacy Project in New York.

And Chi Chi Wu, an attorney with the National Consumer Law Center, said the allegations confirm her organization's "worst fears" about allowing tax preparers to sell other products, such as investments and mortgages.

In defending the product, Ernst noted that Block customers can open an Express IRA for as little as \$300. That's lower than the minimum required by most financial institutions, which tend to avoid small accounts because of high administrative costs. Customers can avoid fees, he said, by saving more than \$1,000 or agreeing to contribute at least \$25 a month.

In addition, Spitzer overlooked the Express IRA's tax benefits, Ernst contended. Many customers who opened Express IRAs were eligible for the retirement saver's credit — a tax credit for low-income individuals.

Ernst also said the Express IRA has not been profitable for Block. "We've lost \$12 million in developing and marketing this program," he said. "We do that because we think by helping our clients to systematically save for the future, we can better serve our clients."

In a statement, Block also said its fees are "repeatedly and accurately disclosed." The information is disclosed when the IRA is discussed with a Block tax preparer, on the account application form and in the "new client welcome package," Block said.

Block said it has eliminated the "re-contribution fee" and said clients don't pay the annual maintenance fee the first year.

Still, Block's Express IRAs run counter to conventional wisdom for retirement savings. Financial planners typically urge people to seek growth in such accounts by investing in stocks and bonds, which tend to appreciate over time.

By contrast, Block's Express IRAs invest only in federally insured money market accounts. In recent years, the interest rate on these accounts has lagged behind the inflation rate, making them inappropriate investments for a long-term retirement savings plan, Spitzer's lawsuit said.

### **Higher rates**

In a statement, Block said its IRAs earn competitive interest rates. The company raised the interest rate three times in 2005, and increased it to 3% in January, the company said. Moreover, first-time savers don't want to take risks with their money, Ernst said.

"We found that clients are attracted to the FDIC (Federal Deposit Insurance Corp.) feature of the product," he said.

Spitzer's lawsuit also alleges that Block failed to disclose to customers that its tax preparers received financial incentives for opening Express IRA accounts. According to Spitzer's lawsuit, in 2004, tax preparers received \$25 for each Express IRA opened, up to a maximum of \$100. The reward was in addition to a payment of \$5.50 for every Express IRA, according to Spitzer's lawsuit.

*The writer has no relationship with the company. Contributing: Adam Shell and John Waggoner*