Seducing Citron: How Merrill Influenced Fund and Won Profits

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Long before Robert L. Citron became Merrill Lynch's single largest client, the Wall Street giant courted Orange County's treasurer with a series of sweet deals.

It was a seven-year affair, filled with enticements of lucrative, can't-lose investments aimed at winning the county's multibillion-dollar investment account.

And it ended in a bitter separation and ultimately the nation's largest municipal bankruptcy.

Documents and previously confidential testimony released last week show for the first time how Merrill carefully cultivated Citron and how this affected the way $7 billion in taxpayer funds--deposited in Citron's investment pool by schools, cities and local agencies--were used for Wall Street gambles.

On one occasion, the brokerage swallowed $116,000 in losses on a securities deal that never materialized. Taking that loss was part of a larger business calculation that characterized Citron's relationship with the firm.

"While Merrill is going to have to eat the whole thing, I think Bob [Citron] should know exactly what this cost us. . . . [H]ope we can get some mileage out of it," a top Merrill official wrote in an internal company memo obtained this week.

Some of the deals that followed brought about the county's financial collapse and--years later--Merrill's decision to hand over $467 million to settle county claims and get rid of a criminal grand jury investigation. Even though it paid the whopping sum, Merrill has consistently denied any wrongdoing.

The relationship between Citron and Merrill was symbiotic: Merrill was fighting to develop new products and new markets for them. Citron, for his part, was boastfully proud of the higher-than-average returns his investment pool earned and anxious to maintain his reputation as a financial wizard who kept the county's treasury flush with cash.

An Offer Citron Couldn't Refuse

Merrill's courtship of Citron began in earnest in the late 1980s, when the brokerage made Citron an offer he couldn't refuse: Merrill would guarantee the county a risk-free profit of at least $800,000 if it used the proceeds of a $400-million loan from Merrill to buy the firm's securities. In addition, Merrill would absorb an estimated $100,000 in customary fees and commissions.

Citron bragged about the deal in a news release to Wall Street reporters, sending an anxious shudder through the brokerage's executive suite. Would other Merrill clients demand the same sort of deals? What excuses could they offer for giving less favorable treatment to other customers?

One attorney involved in the civil damage case that Orange County filed against Merrill in the wake of the December 1994 bankruptcy said the brokerage was merely luring Citron into bigger deals. "Merrill's method was the sure way to get Citron's business--offer him a deal where he can't lose."

Soon thereafter, the budding relationship kicked into high gear, records show.

Battling to beat out a rival Wall Street firm, one of Merrill's top executives flew out from New York to meet with Citron at a restaurant near John Wayne Airport.

Over lunch, Emmanuel "Manny" Falzon, the president of Merrill Lynch Money Markets Inc., began selling Citron on the idea that governments, like corporations, could issue medium-term notes to raise money for securities purchases. No other California government entity had ever done it.

Citron had told Merrill officials he would enter into such deals only if he could secure the most favorable interest rates. When Standard & Poor's, the ratings agency, expressed reservations about the deal, Citron backed out, leaving Merrill with a $116,000 bill--from attorneys and the ratings firm.

In a memo dated May 12, 1988, Falzon said the company had no choice but to pick up the tab. But Falzon hoped to get some "mileage" out of it, as he wrote in the memo to colleagues.

The same day, Falzon sent Citron a copy of the bill and a separate letter noting Merrill's goodwill.

"Although the $116,000 was a bitter pill to swallow," Falzon told the treasurer, "I advised [a colleague] that Merrill would pay the entire amount and chalk it up as a bad experience."

Shortly after, Citron returned the favor.

In 1990, Falzon needed to dump some undesirable securities from two New England banks. He turned to Citron when other clients turned up their noses at the offer.

In testimony released this week, Falzon recalled telling Citron "this would be a very large favor that he would be extending to me personally, and also Merrill Lynch."

According to a memo written by another Merrill executive, Citron "was so uncomfortable [with the deal] he felt sick and was having chest pains."

But he reluctantly made the purchase.

$200-Million Coo Placates 'Pigeon'

Merrill officials knew that Citron was a quirky character. He was fond of star charts, loud ties, turquoise jewelry and homeopathic remedies. He was also a "pigeon" willing to absorb any new investments the brokerage was pushing, county attorneys charged in the newly released depositions.

But one of Merrill top executives believed Falzon crossed the line when he cast off $200 million worth of undesirable securities on Citron.

"This trade, in my opinion, was unethical, immoral, and possibly illegal," wrote Michael G. Stamenson in a January 1990 internal memo that was among the newly obtained documents.

The Master of Orange County; A Merrill Lynch Broker Survives Municipal Bankruptcy

By LESLIE WAYNE with ANDREW POLLACK
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It is the embarrassing remnant of another era, caught on videotape.

The year is 1992, and Michael Stamenson is Merrill Lynch's No. 1 salesman worldwide. His client, Orange County, Calif., is by far Merrill's biggest account, snapping up billions of dollars in exotic securities. An ex-marine with a seven-figure income, Mr. Stamenson is the featured star in a training tape that exhorts young Merrill brokers to become a ''master of the universe,'' just like him.

To become a successful Merrill broker, Mr. Stamenson tells the recruits, they need the ''tenacity of a rattlesnake, the heart of a black widow spider and the hide of an alligator.''

That tape, now under court seal, was a prominent exhibit in a lawsuit brought by Orange County that resulted last month in an agreement in which Merrill Lynch & Company paid $400 million to settle claims it helped push the county into bankruptcy with reckless investment advice. Giving that advice, and selling those high-risk securities was Mr. Stamenson, then on top of the world, at the top of his game.

Mr. Stamenson, 58, may no longer be a master of the universe. But, considering the wreckage left behind, he has survived relatively unscathed. He remains on Merrill's payroll at $750,000 a year -- a $250,000 base and a $500,000 bonus. He is not working at his regular job, but spends his days as a prime witness in the waves of litigation flowing from Orange County's $1.6 billion investment losses and December 1994 bankruptcy.

Merrill, which is trying to disentangle itself from this fiasco, has paid dearly in dollars and in public image. In addition to the $400 million settlement, Merrill reached a $30 million settlement with the county to end a grand jury investigation; paid $37 million more in settlements with smaller municipalities in Orange County, and is about to pay $3 million to the Securities and Exchange Commission.

Yet Mr. Stamenson, the man at the center, is likely to escape any legal punishment and remains protected by his organization. Merrill said yesterday, as it has in the past, that it ''acted properly and professionally in its dealings with Orange County'' as, it says, did Mr. Stamenson. Mr. Stamenson retains his Merrill stock options and deferred compensation. By contrast, Orange County's former treasurer and deputy treasurer pleaded guilty to criminal charges.

By the accounts of former colleagues and customers, Mr. Stamenson was an aggressive salesman who knew how to manipulate clients' weaknesses and made soothing reassurances if they balked at risky investments. There is ample evidence both he and his superiors ignored danger signals as things began spinning out of control in Orange County.

A 1993 memo from Edson V. Mitchell and William S. Broeksmit, two Merrill executives no longer with the firm, for example, warned Merrill management of ''potential adverse consequences for Orange

County in the event of a substantial increase in interest rates and the flight of hot money" from the county's investment pool.

That memo, circulated among Merrill top managers, including David H. Komansky, Merrill's current chief executive and then Mr. Stamenson's boss, recommended halting sales of risky securities to Orange County. But the firm never did so.

The circling of the wagons around Mr. Stamenson began just five days after the Orange County bankruptcy, when Mr. Komansky voiced support: "I would say that Stamenson is exceptional as far as understanding the investment philosophies and goals of the clients he works with."

Last month, in an internal Merrill document given to Merrill brokers in case clients should ask about the $400 million settlement -- "Q&As for Orange County Settlement" -- a canned answer was prepared concerning Mr. Stamenson: "Mr. Stamenson remains an employee in good standing. As we've indicated previously, Mr. Stamenson has been spending most of his time in legal preparations. Now that the litigation has ended, his next assignment will be determined in due course."

After Bankruptcy, A Merrill Embrace

Mr. Stamenson is the man who knows too much. Because his actions and his close relationship to the Orange County Treasurer, Robert Citron, were fully known to his Merrill superiors, it would be difficult for Merrill to contend he was a rogue broker and cut him loose.

"It's not uncommon in corporate defense cases to worry about cutting off the guy who's at the center of it," said a lawyer for an Orange County municipality that sued Merrill. Like most people interviewed, he spoke only on condition he not be named.

"You frequently see the person at the center of the storm continue to be well compensated by the corporate entity, while they are denying all wrongdoing," the lawyer added. "The company can cut someone off or embrace them. In the mix, they have to think about: 'What are the risks if I cut this person off? What happens if he starts saying things to others?' "

Today, Mr. Stamenson, who did not respond to requests to be interviewed, is a recluse from his friends. He has no client responsibilities. He spends his days in an endless series of depositions. He has gained and lost so much weight on his 5-foot-8-inch frame that one lawyer said his videotaped depositions "look like ads for a weight-loss program."

"I really don't know what the future holds for him," Richard Marmaro, Mr. Stamenson's lawyer, said. "I don't think he knows." Mr. Marmaro added there had "never been any finding of wrongdoing" against his client.

Mr. Stamenson no longer enjoys an income that once came to around $3 million a year, but he is still paid more than most Americans. He has a young second wife whom he married just before the county's bankruptcy filing. He has his real estate: a $1.2 million, 5,200-square-foot, 13-room house on a street, called, coincidentally, Merrill Circle, in suburban San Francisco; a $755,000 town house in the Sierra Nevada foothills, and a $600,000 weekend getaway condo in Lake Tahoe, Nev.

While he no longer gives the lavish parties he once did -- complete with valet parking for his guests and a tour of his library filled with acrylic tombstone mementos of his Merrill deals -- his life is a far cry from his humble beginnings as the son of a Greek immigrant on a California farm.

Mr. Stamenson worked his way through college, graduating from California State University at Fullerton, majoring in business administration, before joining Merrill in 1971 as a retail broker in Santa Ana.

"He was one of the best salesmen I ever met," said a former Merrill co-worker of Mr. Stamenson, who asked not to be identified. "He knew how to manipulate and control customers. He could penetrate an account deeply and then tell them what to buy."

A Knack for Wooing County Treasurers

What happened next is a tale of a salesman who smelled opportunity in the sleepy backwater of municipal finance and struck a mother lode. When California enacted Proposition 13, which cut property taxes, in 1978, municipalities sought new sources of income, and Mr. Stamenson found them in exotic investments like derivatives, which carried much higher commissions than, say, plain-vanilla Treasury debt. (Derivatives gain their value from other securities to which they are linked.)

"He always came to conferences and was really good at making presentations to county treasurers," Don Merz, the Sonoma County Treasurer, said. "He was good at describing what securities were."

Chriss Street, an Orange County businessman and former broker, said Mr. Stamenson "picked a nobody client in the county treasurers."

"No one in their wildest imagination could foresee how much money could eventually be made from county treasurers," Mr. Street said. "He positioned himself with the right customer as the customer grew up."

In 1984, Mr. Stamenson was Merrill's salesman on its San Jose, Calif., account, which lost $60 million by using many of the same risky strategies that were later used in Orange County. But his role in that debacle did nothing to hinder his close relationship with Mr. Citron, nor derail his career with Merrill. The brokerage house played a relatively small role and settled for $750,000.

Although many transcripts relating to Merrill's Orange County settlement are still under seal, there is evidence Merrill put profits above caution and allowed a hard-driving sales culture, from the bottom to the top, to prevail over warnings of a potential financial disaster from cooler heads within. Even Merrill's current chief executive, Mr. Komansky, who was then the head of its debt and equity group, was listed as a recipient of memos raising red flags about Orange County, but did nothing.

Orange County's investment strategy was risky by anyone's standards; more so, since it involved public money. Starting in 1992, a series of Merrill executives urged caution, to no avail.

Under Mr. Stamenson's tutelage, Merrill helped arrange for Orange County to borrow billions of dollars short-term, in the form of so-called reverse repurchase agreements, which were then used to buy long-term interest-sensitive securities from Merrill, primarily Government agency debt and a type of derivative called an inverse floater.

Should interest rates fall, Orange County would reap enormous gains from this strategy. But, if rates rose, as they did in 1994 when the Federal Reserve tightened monetary policy, the value of the interest-sensitive securities would plummet, as they did, causing the bankruptcy.

Big Trades Brought High Fives at Office

For years, Orange County was Merrill's biggest client. In two years alone, 1993 and 1994, it bought more than $6.3 billion in interest-sensitive securities from Merrill. Lawyers who have seen the numbers say that Merrill made more than $100 million from Orange County between July 1991 and December 1994.

Mr. Stamenson, whose "gross production credits" (a commission formula based on securities sales) were $50 million to $70 million a year in an organization where big producers were doing $5 million to $10 million a year, was rewarded with an ever-increasing salary and a shining Steuben star to show his rising status in the Merrill galaxy.

"Merrill knew exactly what Mike Stamenson was doing," added the former Merrill co-worker. "They were going along with it because he was making them a ton of dough."

Mr. Stamenson was Mr. Citron's No. 1 adviser, and Mr. Citron was his No. 1 client -- a client whose elephantine trades were often greeted with "high fives" by employees at Merrill's San Francisco office. The relationship was so close that Mr. Stamenson would write "Bullet Points" for Mr. Citron to tell the Orange County Board of Supervisors. Mr. Stamenson, along with other Merrill executives, gave $4,000 to Mr. Citron's re-election campaign, 10 percent of the total.

And when Mr. Citron became concerned that rising interest rates would undermine his investments, Mr. Stamenson produced a Merrill economist to quell his fears -- wrongly as it turned out.

"Stamenson was almost as arrogant as Citron himself," Zane Mann, publisher of the California Municipal Bond Advisor, said. "They made a good pair. It was always known that Merrill would stand by Stamenson. Merrill had plenty of time to censure him before that."

Both Sides Saw Potential for Disaster

As early as 1992, when Mr. Stamenson was picked to star in the training videotape, evidence submitted in the trial shows that Merrill was already concerned about potential legal liability in Orange County.

A telephone conversation between Mr. Stamenson and Mr. Citron, recorded Nov. 9, 1992, and obtained by the Orange County District Attorney, shows both men and Merrill were fully aware of the high potential for a financial disaster.

In that conversation, Mr. Stamenson tells Mr. Citron how he was hastily summoned to New York on a moment's notice to answer questions about an article in the trade publication Derivatives Week that "went through Merrill Lynch like an ICBM," questioning the Orange County strategy.

At the New York meeting were "very senior" people, according to Mr. Stamenson, including "everybody from, what appeared to me, just quite flippantly I'm putting this, from the janitor to the chairman of the board." So worried were Merrill's top managers that they called Mr. Stamenson back for a second meeting days later, flying him from a London vacation on the Concorde.

''They said, 'What the hell's going on?' '' Mr. Stamenson recounted on the phone to Mr. Citron. He said Merrill executives feared Mr. Citron had ''too many of your eggs in one basket'' and that Merrill might be facing ''a bailout phenomenon.''

Mr. Citron, in the taped conversation, says he had already been called by a Merrill executive ''saying, 'Hey, we've got a legal problem here that Merrill Lynch has this great liability if something happens like, uh, San Jose or West Virginia, and we want to protect ourselves, O.K.?' ''

''And I'm saying, I'm saying to Merrill Lynch, 'Yeah, that's fine,' '' Mr. Citron continued, '' 'but where were you, you know, for the year and a half that you were, you know, selling me this stuff?' ''

To which, Mr. Stamenson replied, ''Uh, we are not uh, we are not embarrassed or, or uh, or uh, by any of the things that we have sold you so far or any of the guidance that we have given you.''