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A Growing Conflict in Wall St. Buyouts.

It goes by a rather innocuous-sounding name, the sort of phrase you might breeze past in a loan document: “designated lender counsel.”

But pay attention, because it’s the latest conflict-ridden practice on Wall Street.

Over the last several years, a new, insidious relationship has quietly developed between the nation’s largest private equity firms, the banks that lend them billions to fund their buyouts and the law firms that advise on these deals.

Historically, when a bank, like JPMorgan Chase, made a loan to a private equity firm planning a big acquisition, like the Blackstone Group, the bank would hire an outside law firm to scrutinize the loan and the transaction.

That made a lot of sense: Loans made to finance private equity deals are some of the riskiest because they typically involve a lot of debt. They are called “leveraged buyouts” for a reason. Having a team of lawyers review an often complex loan document could keep a bank from making a deal that might later come back to haunt it. The Federal Reserve, so worried about these kinds of loans, has since the financial crisis sought to make it tougher for big banks to make highly leveraged loans by issuing rules that determine the amount of money they can lend.

But neither the Federal Reserve nor any other regulator has addressed this latest private equity maneuver.

Instead of allowing a bank to hire its own lawyers to vet a potential loan, many large private equity firms — Blackstone, Apollo Global Management, Kohlberg Kravis Roberts and Carlyle Group among them — now regularly require the banks to use a specific law firm that they designate, hence the term “designated lender counsel.” The private equity firms pay for the law firm’s services, too.

Think about it this way: It is, in effect, the equivalent of your employer giving you an employment agreement and telling you that the only lawyer who can look it over is the one the company has retained.

Bankers and their in-house lawyers privately complain that the private equity firms are assigning them law firms that have little allegiance to them and might not necessarily have their best interests at heart. But given the pressure to secure these big loan deals — which can be worth hundreds of millions of dollars in fees — few are willing to publicly criticize the practice.

Indeed, when I called private equity firms — representatives from which all refused to speak on the record about this practice — they all said that if the banks were really that upset about it, the firms would have already heard complaints.

But that ignores the influence that private equity firms have over the banks, and the banks’ lack of incentive to speak up.

“The borrower has a lot of muscle, a lot of leverage,” Robert Profusek, a partner at the law firm Jones Day and one of the few lawyers who would speak on the record about this issue, said of the private equity firms. “When you’re competing for business, you’re not going to turn it down because you can’t use law firm A rather than law firm B.” (Mr. Profusek’s firm does some work as designated lender counsel.)

Not all private equity firms are pushing the banks to hire their recommended law firms. Notably, Clayton, Dubilier & Rice, one of the pioneers of the leveraged buyout industry, does not engage in the practice. A representative for the firm declined to comment.

When I was reporting this column, many private equity executives and lawyers suggested that the practice had taken place for many years. “There’s nothing new here,” one dealmaker said. Another called it “irrelevant.” They said that the law firms assigned to work for the banks had a fiduciary duty to give them proper advice and that there would be too much reputational risk in rolling over for a private equity firm.

That might be true, but it doesn’t change the fact that the law firms doing this work have two “clients”: the private equity firms that refer them all the business and the banks, to whom they owe the fiduciary duty.

In the past, each bank lending money on a deal would hire its own law firm, which resulted in multiple law firms scrutinizing every transaction. Even then, assuming the deal was completed, the private equity firm paid the legal fees.

Private equity firms defend the practice, saying it saves clients from having to pay double or triple the amount in legal fees. The firms also say that this practice takes place on big corporate loan deals. For many decades, large American companies that regularly issue debt, like I.B.M. and General Electric, have designated a law firm to represent the banks underwriting loans. The companies justify this because the deals are boilerplate.

But in the private equity arena, it’s very different. There is no great efficiency to having one law firm handle all of it, because each transaction is specific to a different company. It might be a real estate deal one day, and a technology or pharmaceutical deal the next.

“Most of the due diligence isn’t about the firm, it’s about the portfolio company. So it isn’t like you build up this knowledge base,” Mr. Profusek said.

Some law firms, like Paul Hastings, have made a lucrative business serving as a designated lender counsel, aggressively marketing their services to the real client: the private equity firms. According to the Thomson Reuters Deals Intelligence, in 2010 Paul Hastings had virtually no relationship with banks making leveraged loans; today, it is the No. 2 ranked law firm in this business. A spokeswoman for Paul Hastings declined to comment.

The banking industry’s association, the Securities Industry and Financial Markets Association, issued a report in 2013 that raised red flags about using designated lender counsel in the context of municipal bond offerings. The association said that the practice should be disclosed by the municipalities in their bond offering documents. “Any undue influence by an issuer, however, that calls into question the qualifications or independence of underwriter’s counsel may create risk to the issuer,” it wrote.

Of course, the choice of which law firm will represent a bank on a big private deal will not lead to the next financial crisis. But if regulators care about reducing risk and eliminating conflicts in the markets, this practice might be a good one to examine.

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