

Design defect exclusions: Navigating risk in Canadian builders risk insurance

Builders risk insurance shields projects from unexpected losses. Design defect exclusions remain a key challenge, defining coverage when flaws occur.

WHY DESIGN DEFECT EXCLUSIONS EXIST

At their core, these exclusions reflect a fundamental principle: defects in design or workmanship are business risks, not accidental perils. Insurers aim to cover fortuitous events, not the cost of correcting inherent flaws. However, the scope of these exclusions, and how courts interpret them, can significantly influence claims outcomes.

Two primary frameworks dominate this space: LEG (London Engineering Group) clauses and DE (design error) clauses. Both seek to balance coverage with risk control, but they do so in distinct ways.

LEG CLAUSES: THE CANADIAN STANDARD

LEG clauses are widely adopted in Canadian builders risk policies. They offer three levels of exclusion:

- LEG 1/96: The strictest form; excludes all loss or damage caused by defects in design, materials or workmanship.
- LEG 2/96: More moderate; covers resulting damage but excludes the cost of correcting the defect itself.
- LEG 3/06: The most generous; covers damage and repair costs, excluding only betterment or improvements beyond the original design.

Canadian courts have clarified these principles. In *Ledcor v. Northbridge* (2016), the Supreme Court of Canada ruled that while the cost of fixing a defect is excluded, damage caused by that defect is covered. This interpretation reinforces LEG 2 and LEG 3 as practical solutions for complex projects.

DE CLAUSES: PRECISION AND FLEXIBILITY

DE clauses emerged to provide more nuanced options. They range from DE1 (broad exclusion) to DE5 (minimal exclusion), allowing insurers to tailor coverage:

- DE1 excludes all defect related loss.
- DE2 to DE4 progressively allow coverage for consequential damage.
- DE5 mirrors LEG 3, excluding only betterment costs.

While less common in Canada, DE clauses are gaining traction for projects requiring bespoke risk management, such as large infrastructure builds or projects with innovative design elements.

LEGAL LANDSCAPE IN CANADA

Canadian jurisprudence emphasizes broad coverage under builders risk policies. Courts generally interpret ambiguities in favour of insureds, as seen in *Acciona v. Allianz* and *Ledcor*. This means insurers must draft exclusions with precision to avoid unintended exposure.

BROKER AND UNDERWRITER INSIGHTS

FOR BROKERS

- Advocate for clarity: Ensure clients understand what is excluded and what is covered. Misinterpretation can lead to costly disputes.
- Match coverage to project risk: High complexity projects may warrant LEG 3 or DE5 for broader protection.
- Negotiate endorsements: Consider “ensuing loss” provisions to cover damage resulting from defects.

FOR UNDERWRITERS

- Assess design complexity: Innovative materials or engineering methods increase defect risk.
- Balance premium and exposure: Broader clauses like LEG 3 raise premiums but reduce litigation risk.
- Stay ahead of case law: Canadian courts lean toward insured friendly interpretations; anticipate this trend when drafting exclusions.

MARKET TRENDS AND STRATEGIC CONSIDERATIONS

- LEG clauses remain dominant in Canada, especially for large scale projects.
- DE clauses offer flexibility for projects with unique design risks.
- Risk appetite matters: Owners seeking maximum protection may prefer LEG 3 or DE5, while insurers with conservative risk profiles may lean toward LEG 1 or DE1.

- Negotiation is key: Endorsements and carve outs can fine tune coverage, balancing cost and protection.

CONCLUSION

Choosing between LEG and DE exclusions isn't just a technical decision; it's a strategic one. In Canada's evolving construction landscape, understanding these clauses ensures projects are protected without exposing insurers to unmanageable risk. For brokers and contractors, this knowledge is essential for structuring policies that align with both legal precedent and practical realities.



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