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WHAT MAKES THE COLLATERAL SOURCE RULE DIFFERENT?

Michael B. Kelly

Paul H. Rubin and Joanna M. Shepherd recently posted a working paper that reports a correlation between tort reforms and the rate of fatal accidents in the states which adopted those tort reforms. They report that accidental deaths (excluding motor vehicle accidents) declined in the year after tort reforms were adopted (as compared to the year before) for a range of reforms: caps on noneconomic damages, caps on punitive damages, higher threshold standards for obtaining punitive damages, and prejudgment interest. But reforms to the collateral source rule had the opposite effect; that is, in states that altered the collateral source rule, the rate of fatal accidents (excluding motor vehicles) increased in the year following the reform.

Both findings raise interesting questions. The first challenges conventional wisdom because, in theory, tort liability should decrease

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3 Id. at 12. The data are somewhat more complex than portrayed here. Before subjecting the data to multiple regression analysis designed to control for other factors that might explain changes in the rate of fatal accidents, two different approaches to collateral source reform produced different results. Fatal accidents increased when states required courts to offset collateral source payments against the damage award, but decreased if the state simply made evidence of collateral payments admissible, without requiring offset. Id. When controlling for other factors, both types of reform to the collateral source rule produced an increase in fatal accidents. Id. at 16. Thus, some of the decrease following reforms admitting evidence of collateral sources appears to result from factors other than tort reform – or other than reform of the collateral source rule. Adding motor vehicle deaths to the data did not substantially change the picture. Id. at 19.

Id. at 16.
accidents. Tort liability forces parties engaged in risk-producing activities to internalize the costs that the activities impose on those adversely affected by the risks they create. Rational parties should take precautions to reduce those risks rather than pay the costs the risks cause – at least up to the point that further reductions would cost more than the harms they would prevent. How could reforms that reduce liability, and thus force parties to internalize a lower portion of the costs suffered as a result of the risks they create, produce a decrease in fatal accidents? Part I below briefly considers this question.

The second finding, however, is even more paradoxical. If reducing tort liability increases safety, why would reductions achieved by the reforms to the collateral source rule differ from reductions achieved via other reforms, such as caps on damages or changes to the prejudgment interest rules? The deterrent effect of damage judgments depends on the total amount of liability (or expected liability), which sets the threshold for precautions a rational party will take. The specific means by which the reduction is achieved arguably should not matter. Part II considers this puzzle.

This paper offers no stunning conclusions – indeed, no conclusions at all. At most, it raises concerns that the data produced by Rubin and Shepherd does not serve their purpose very well. The methodological questions raised in Part I are modest. But as one begins to parse the results of the collateral source rule, it becomes harder to credit inferences from the data on damage caps. The suggestion that more study is necessary will surprise no one.

I. EFFECT OF TORT REFORM ON FATALITY RATES

Rubin and Shepherd discuss several reasons tort reform might reduce accident rates. They argue tort liability deters accidents optimally when five conditions are met: “[D]amages are pecuniary, not non-pecuniary; injurers and victims are strangers, and not in any pre-accident contractual relationship; victims as well as injurers have incentives to take optimal precautions; the system operates costlessly; and actions of tortfeasors are harmful, not protective.”

Where any of these conditions fail, tort liability may impose costs on the defendant that exceed the optimal level of deterrence. For instance, attorneys’ fees and other costs make the liability system costly for potential defendants, even in cases where their conduct did not cause
harm to the plaintiff. These costs may produce excessive precautions. In addition to internalizing the costs of the harms they cause, potential defendants internalize some of the costs of the liability system itself, thus encouraging precautions that exceed the cost of the harm they might generate.

One may quibble with some elements of this list. For instance, the limitation to pecuniary damages rests on the assumption that people would not pay for insurance against pain, distress, and other non-pecuniary losses, and thus that it is inefficient to deter conduct that produces these harms. Yet pain, distress, and indignity are real consequences of a tortfeasor’s wrong, imposing real costs (though often not measured in dollars) on victims. Encouraging tortfeasors to internalize these costs in deciding whether to impose risks on society seems plausible. Similarly, the ability to negotiate before the accident may not necessarily produce a better allocation of risks than the tort system.

The most interesting condition, however, is the last one. It reminds us that tort liability affects people whose primary service is to reduce risks. Doctors, pharmaceutical producers, and manufacturers of medical equipment come immediately to mind. Reducing the availability of their goods and services may make the world less safe rather than safer.

5. Attorneys’ fees impose large costs, whether defendants litigate weak claims fully or settle them to avoid the cost of litigation. In either event, the costs are not produced by wrongful conduct, but are added to the costs of legitimate claims. Beyond attorneys’ fees, the costs to a business of spending time on the litigation can be significant. For example, every hour a doctor spends on discovery or trial is an hour not devoted to patient care and, thus, to earning income. Unlike attorneys’ fees, the latter costs are unlikely to be covered by insurance.

6. Rubin & Shepherd, supra note 1, at 7. Unwillingness to insure suggests that the expected cost of insurance against pain, distress, lost joy, and indignity exceeds the expected gain of payments for those losses. This equation does not change when the insurance is purchased through the price of goods and services rather than via a first-party insurer. Nor would it get better when the premium also includes the cost of litigation, as it does when insured through defendant’s liability insurer.

7. The absence of insurance may reflect the fact that policies covering pain are not offered, rather than that they are not desired. One can assume that if people wanted pain policies, insurers would offer them. As the joke goes, if a $20 bill were really on the sidewalk, someone would already have picked it up. Other factors might explain the absence of such policies. The difficulty administering pain insurance may make it an unattractive venture, despite demand. While this suggests that people will not pay enough to overcome the administrative costs imposed by moral hazard, it does not necessarily mean that defendants should be free to externalize these costs, or that economists should be free to assume that the absence of insurance proves that coverage would be inefficient.

8. As a Contracts professor, I have considerable faith in negotiations and the efficiency of contracts, perhaps a little more than most Torts instructors. But even among those of us with faith in the free market, blind assertions of universal efficiency are rare.
Indeed, Rubin and Shepherd’s data on fatal accidents might be largely attributable to shortages of care after an accident rather than to the rate at which serious accidents occur.  

But the argument goes a little deeper. As tort liability affects providers of goods or services, it drives up their prices. Higher prices may lead buyers to postpone purchases of new goods and services. If newer products include better safety features, postponing replacement purchases may leave consumers subject to the higher risks of their older products. The same could apply to services, as postponing repairs or upgrades leaves people with less safe alternatives. Thus, the tort system may deter conduct that would increase safety.

The data Rubin and Shepherd present suggest that some tort reforms, particularly those that reduce the magnitude of the liability, have exactly this affect. The following questions may aid scholars in probing this data and lead to more probative results as further study progresses.

Two aspects of the study may impair its value. First, it reports only fatal accidents. Second, it reports data only for the year immediately preceding and immediately following enactment of various tort reforms. Each choice limits the ability to extrapolate from the data.

Fatal accidents appear to be a rather small sample of all accidents. In addition, they may be the segment least affected by tort reform because most wrongful death statutes already limit recovery to pecuniary losses, and caps on nonpecuniary damages do not reduce liability for fatalities. Thus, the decision to rely on data regarding fatal accidents seems to have been a practical decision because the data is easier to generate.

Fatal accidents are relevant because a reduction in fatal accidents

9. Rubin & Shepherd note research suggesting that emergency physicians are drawn to states with tort reform, “findings [that] may be particularly relevant for our analysis of accidental deaths, for a lack of emergency physicians will result in more accidents that lead to death.” Rubin & Shepherd, supra note 1, at 6.

10. See id. at 5. The ability to price discriminate among states may raise questions. Medical care tends to be state specific. Perhaps repair services, too, are obtained locally. Mass-produced goods, however, can be obtained by mail or online, making it difficult for a producer to charge less in states where tort reforms reduce liability costs. These improvements should be observed nationwide, not just in states with reforms. In addition, the price adjustments after tort reform may be modest if insurance costs depend on nationwide experience.

11. See supra note 2.

12. See Rubin & Shepherd, supra note 1, at 10.

13. See id. at 11.

14. If defendants were following the old wisdom that it is cheaper to kill a victim than to injure them, a reduction in fatalities might flow from reducing the gap between damages for death and damages for severe injuries. That, however, seems a pretty far-fetched explanation of the data.
may reflect a reduction in total accidents. The overall rate of serious accidents probably correlates with the rate of fatal accidents. In addition, efforts to reduce accidents generally should reduce both fatal and nonfatal accidents. A risk producer rarely knows whether the accident resulting from the risks it creates will be fatal; its precautions probably reduce the aggregate risk. Thus, the findings may have value, but their usefulness is unclear at this time.15

The second issue, using only data from one year immediately preceding and following enactment of various tort reform statutes, causes more concern for Rubin and Shepherd’s study and explanatory theory.16 First, the study does not test whether the reforms have any enduring effect. Second, Rubin and Shepherd’s explanatory theory assumes that the reduction in accidents would follow immediately upon enactment of tort reforms.

Tort reforms, once enacted, should continue to affect the liability system over their life. Any reduction in the rate of fatal accidents, however brief, is welcome. But if the theory outlined above is correct, the differences between states with and without tort reform should remain evident in the second and third year after enactment. People in states with tort reform will experience cheaper access to goods and services that enhance safety, producing continued improvements relative to people in other states. Perhaps Rubin and Shepherd are already working to analyze longer term effects of tort reforms.

Including later years is a critical concern given the second issue, the assumption that tort reforms immediately affect accident rates. Intuitively, it seems unlikely that tort reforms will have an immediate affect on defendants’ finances or practices.17 For one thing, the dates when tort reform statutes take effect may differ from the date of enactment.18 In addition, the reforms may apply prospectively to

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15. Greater availability of emergency care physicians reduces the fatalities resulting from accidents without reducing the number of accidents. If this factor explains much of the effects observed, extrapolation to nonfatal accidents may be quite weak. See supra note 9.

16. Including later years in the data can pose some problems. As time passes, other changes occur that might affect the rate of fatal accidents, for better or worse. Looking at the period just after enactment helps control for those other changes. A five-year average might obscure the effects in the first year, misleading us to believe that tort reform harms safety – or it might exaggerate the effects of the first year by including reductions caused by factors unrelated to tort reform. Still, Rubin and Shepherd seem adept at the statistical techniques for isolating the effects of tort reform.

17. Even Rubin & Shepherd expressed some surprise that the results were observable within one year of enactment. See Rubin & Shepherd, supra note 1, at 14.

18. Rubin and Shepherd refer to “death rate trends in the years before and after the enactment of certain tort reforms.” Rubin & Shepherd, supra note 1, at 11; see also id. at 12 (“enactment,” “enacted”), 13 (“enacted”). Perhaps their language was simply imprecise; they may use the
accidents occurring after the effective date or to cases filed after the effective date, rather than to all cases tried after the effective date. Yet in the first two cases, defendants continue to pay unreformed awards for at least a year after the effective dates. Finally, these savings will redound to defendants only after insurers incorporate them into their premiums.

Considering the ways tort reform might improve the accident rate, an immediate effect in the first year seems quite unlikely. The theory requires that safer goods and services become cheaper, allowing more people to use them, thus reducing accident rates. For that to work, the defendant must experience a savings – or at least anticipate a savings – that it can pass on to customers. For most defendants, that will mean reduced insurance costs (relative to states without tort reform), though for some (who self-insure) it might mean reduced damage awards.

Insurers might build expected reductions into their premiums the minute the reforms are enacted. But it seems equally likely that they will hesitate long enough to gather actuarial data on the degree that damage awards decline, then pass on the savings in rate reductions. When they do, the potential defendants will experience reduced costs. Those savings might be passed on to customers immediately, increasing the number of people who can afford these safety enhancements. As more people take advantage of the new opportunities, the rate of fatal accidents declines.

How much can be crammed into the first year after the statute takes effect? Note the assumptions required: (1) That optimism over the effect of the reform will cause insurers to lower premiums immediately rather than await actual savings; (2) That policy renewal dates will occur early enough after the effective date to permit insureds to reap savings in the first year, or that similar optimism about reduced premiums produces an

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effective dates of tort reform statutes. The following sentences of text raise problems that apply, to some degree, even if the authors used the effective date of the reforms.

19. A defendant with a claims-made policy up for renewal immediately after the enactment may see an immediate reduction in premiums if the reform applies to claims made after the effective date of the statute.

20. Reducing the time devoted to lawsuits by corporate personnel might have a more immediate effect. This, however, seems to require a reduced number of lawsuits, not a reduced amount at issue in the lawsuits. Even a modest claim allows plaintiff to conduct discovery, which costs employee time and money. Of course, if tort reform leads more plaintiffs not to sue or leads them to settle before discovery, these savings might figure into the calculation. The immediate effect might be modest if the reform applied to accidents occurring after the effective date of the statute. Even an accident the next day is unlikely to reach the discovery stage for several months, so savings will occur in the last half of the year. A law applying to all claims filed after the effective date would produce savings sooner, though still only for part of the year.
immediate price decrease in anticipation of savings; (3) That the insureds pass the savings on to their customers;\(^{21}\) (4) That customers recognize the savings and decide to upgrade to safer goods and services;\(^{22}\) (5) That the upgrades are completed early enough in the year that a significant number of fatal accidents do not occur.\(^{23}\)

This is arm-chair scholarship. Rubin and Shepherd easily might respond (patiently or scornfully): “Read the results. It seems to have happened.” It is unclear why it happened, and why it seems to have happened across the board in response to tort reforms in different years and different states. Some data (from other careful, scholarly, empiricists) suggests that tort reforms may not have immediate effects. For example, William Sage notes that malpractice reforms seem to increase the number of physicians in a state, but that the effect begins to be felt about three years after the enactment of reforms.\(^{24}\) But that is a thin reed upon which to assess the data analyzed by Rubin and Shepherd.

Yet one wonders whether some other mechanism explains the observed data. Might tort reform have an immediate effect on consumers, even though it has no (or little) immediate effect on providers? Reducing the amount plaintiffs can recover would logically lead potential victims to invest more in safety. This might involve buying safer products, even at higher prices, rather than risk uncompensated losses via the tort system. It might involve conducting themselves in a safer manner – reducing risky activity, taking more precautions against remote risks, etc. This kind of change seems likely to follow enactment of the law when the publicity is greatest, not necessarily its effective date. It would apply regardless of how

\(^{21}\) I will not argue that either the insurer or the insured will decide not to reduce prices. Competitive pressure should encourage price reductions. Whether local price reductions are possible at all in a national or international market is another question, one taken up shortly.

\(^{22}\) Advertising of new low prices seems likely to produce relatively quick recognition of the lower prices.

\(^{23}\) Even when aware of newly affordable prices, some consumers move slowly to make significant investments, or to replace their less safe goods with safer goods, unless the less safe goods are worn out. For instance, having once bought a child’s car seat, a price reduction is unlikely to persuade parents to buy a second, newer one immediately. They may bemoan the fact that they could have afforded the better model if the price decrease had occurred sooner. But relatively few rush to discard their original seat just because a better one no longer costs more than the one they bought.

\(^{24}\) William M. Sage, Prof. of Law, Columbia Law School (Remarks at University of San Diego, Nov. 3, 2005). The increase does not stem from an exodus of doctors or from an influx of experienced practitioners. Rather, it arises from delayed retirements and greater attractiveness to doctors deciding where to begin their practice.
prospective the statute was into later years; any loss prevented by consumers would be affected by the reform, even though the effect of the statute (in reducing compensation) would be felt years later.

One might hail this as an indication that tort reform is effective, but it is not clear that tort reform is efficient. Perhaps prevention by consumers is less costly than prevention by producers. Alternatively, however, consumers might over-invest in prevention, exaggerating risks, misjudging their source, etc. Producers can reduce the risk for all, rather than relying on consumers individually to reduce risks (or not).

One might argue that prevention by consumers assumes an unlikely level of rationality. Do consumers pay attention to tort reform statutes? Do they project the likely implications for themselves? Do they adjust the riskiness of their conduct in response?

Read Rubin and Shepherd’s data; tort reform apparently has reduced the number of fatal accidents. Skepticism about the mechanism proposed by this article seems well judged. But so is skepticism about the mechanism proposed by Rubin and Shepherd, which is similarly based on assumptions about rational economic behavior.25 The results do not support either hypothesis more strongly than the other. It is simply too soon to conclude that tort reform promotes safety by making safety more affordable for consumers.

II. EFFECT OF COLLATERAL SOURCE RULE ON FATALITY RATES

If one assumes that everything Rubin and Shepherd argue is correct, a serious puzzle still remains. Why would reforming the collateral source rule differ from damage caps and other tort reforms? Why would fatal accidents increase when that reform was enacted? The effect was observed for two different versions of reform: offsetting collateral benefits against damages, and making evidence of collateral benefits admissible (apparently without requiring an offset, but leaving the jury able to adjust their award on this basis).26 The offset approach relates more strongly to increases in fatal accidents.

Rubin and Shepherd address this topic briefly, noting prior evidence of this effect27 and then observing:

25. See Rubin & Shepherd, supra note 1, at 1. Rubin and Shepherd originally noted four assumptions on which tort liability efficiently deters. The February revision added a fifth: that “victims as well as injurers have incentives to take optimal precautions.” Id. This revision permits them to claim both mechanisms within their thesis. The revised paper does not claim that precautions by consumers are more efficient than precautions by providers.


27. Id. at 6 (citing Jonathan Klick & Thomas Stratmann, Does Medical Malpractice Reform
Apparently for this variable, the externality increasing effect outweighs the safety increasing effect. Note that other reforms reduce the amount of damage payments for a harmful event, while collateral source reform may lead injurers to paying [sic] nothing at all in certain circumstances. Thus, it may not be surprising that this reform has larger injury increasing effects than do others. A more efficient reform might be increased subrogation (in which the injured party’s insurance company pays the victim and then collects from the injurer) since this will maintain incentives for internalization while still avoiding double compensation to victims.28

This is the entire discussion, not an excerpt of it.

Rubin & Shepherd’s explanation seems plausible, but incomplete. For one thing, collateral source limitations often will not eliminate plaintiff’s damages. Collateral sources reduce damages only by the amount of plaintiff’s recovery from other sources of compensation, such as insurance. But many losses will be uncompensated. While many Americans have health insurance, disability insurance, covering income lost during recovery, is much less common. Even under health insurance, large deductibles, coinsurance, and limitations on coverage or procedures may leave substantial expenses uncompensated. Insurance almost never compensates for nonpecuniary losses. Punitive damages, too, would be unaffected. Thus, the collateral source rule rarely will allow “injurers to pay nothing at all . . . .”29

Reforms to the collateral source rule could eliminate plaintiff’s recovery, however, if they undermine a plaintiff’s willingness to sue. By reducing, perhaps severely, the most easily proven aspect of damages, reforms to the collateral source rule may make a lawsuit seem like more hassle than it is worth. Larger claims seem likely to be brought: those where (uninsured or partially insured) disability is permanent, those where pain and suffering loom large, and those where anger runs higher. But a plaintiff whose primary loss is pecuniary and who has recovered most of it via insurance may decide to waive the rest of the claim or to settle it quickly.

In this regard, a synergy may exist between reforms of the collateral source rule and damage caps. Damage caps may reduce the other reasons to file a claim. If collateral source reform reduces pecuniary damages and a damage cap reduces other damages, even more claims


29. Id.
may go unfiled or settle early. The combined effect of the two rules will reduce lawsuits far more than either one alone.

The order in which various reforms are adopted might affect the results. Where collateral source reform precedes damage caps, the remaining reasons to sue may keep a sufficient flow of litigation to encourage substantial precautions by defendants. But, where damage caps have already reduced the incentive for litigation, adding changes to the collateral source rule may produce a drastic decline in litigation and, thus, a corresponding decline in the incentive for injurers to take precautions against the risks they create. The results reported by Rubin and Shepherd do not permit an evaluation of these potential interactions. Perhaps they will consider this possibility in future studies.

At least one more factor deserves brief discussion. Collateral source reform tends to strike at smaller claims, while damage caps strike at larger claims. Because smaller claims substantially outnumber larger claims, a damage cap will affect relatively few suits. Tampering with the collateral source rule, on the other hand, may affect every lawsuit to some extent. It is likely to deter many suits rather than just a few, producing substantial savings to injurers. Eliminating suits produces savings in employee time far in excess of reforms that allow the suit to proceed but merely cap damages. Even if the amount saved per suit is relatively small, the volume of suits affected may give this reform a much larger impact than damage caps.

Many object that tort reform limits the recovery of those who suffered the greatest losses at the hand of tortfeasors (by capping their damages rather than allowing full compensation). This focus on the largest awards benefits a few plaintiffs and their attorneys – who can retire on 30% of a very big award, but can barely make a living on 30% of many small awards. Perhaps Rubin and Shepherd will help us refocus on the more common smaller claims. Deterring these seems much more significant.

This mechanism does not differ greatly from that suggested by Rubin and Shepherd. It fleshes out the way suits may disappear.

In exploring the way collateral source reform might over-deter litigation and under-deter risk-creation by injurers, the decision to use data for only one year becomes more significant. To the extent that tort reforms discourage plaintiffs from filing suits, that effect seems likely to occur in the first year. If tort reforms apply to all cases tried after the

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30. That is one reason that median damage awards are much lower than average damage awards.
effective date, settlements or voluntary dismissals seem likely for a large number of pending cases. If the reforms apply to cases filed after the effective date, filings would begin to decline almost immediately. If tort reforms applied to accidents that occurred after the effective date, then filings would taper off during the year.\(^{31}\)

As a result, defendants would realize an immediate savings from these reforms. Potential defendants save the transaction costs of suits when suits are deterred entirely. No time need be spent investigating records to inform their attorneys about the allegations, no time goes into preparing documents for discovery or answering interrogatories, no time is wasted by lawyers interviewing employees. The incentive effects are immediate and Rubin and Shepherd identify them: an increase in fatal accidents, apparently related to the decrease in precautions potential defendants take.

This differs substantially from damage caps. Damage caps will produce savings, if at all, in future years, as cases come to trial.\(^{32}\) Defendants may not know whether particular precautions will prevent a smaller claim or a larger one. Precautions may prevent accidents, with only luck determining whether they will be severe or minor. As a result, defendants retain an incentive to minimize total accidents. A damage cap, therefore, might not save some defendants a dime, as they might be unlucky enough to cause a really serious accident. Larger companies may have enough volume to expect that they will cause some large damages in the future, but a smaller company may have no basis upon which to book the savings immediately. The prospect looks better, but until the company experiences a savings, either in judgments or in premiums, it doesn’t know whether it can reduce precautions. These reductions in precautions will occur in future years, as experience mounts.

This leaves a particularly gruesome possibility: perhaps the reduction in fatal accidents following damage caps is temporary. Once real reductions are felt, precautions will be reduced, and fatalities will rise. This mirrors the results from the collateral source rule. Rubin and Shepherd may have discovered that the collateral source reform

\(^{31}\) Until the statute of limitations ran on injuries that occurred before the effective date, filings would remain undeterred by the reforms. But filings for new accidents would not keep pace with prior years, causing a gradual reduction in filings.

\(^{32}\) Settlements of cases that will be governed by the damage caps also produce savings, as lawyers negotiate amounts with an eye on the likely recovery at trial. Depending on the retroactivity of the tort reform, these savings may be realized in future years rather than immediately. Perhaps the incentive to take precautions disappears immediately. The cap will apply to future accidents, even if it does not apply to past accidents.
undermines the incentive to take precautions that will minimize accidents. But if the lead time differs between the two types of reforms, their data may have missed the fact that, in subsequent years, damage caps may have exactly the same effect. The timing of the effect, not the direction of the change, may differ between the two types of reforms.

These suggestions are no more than hypotheses. Empiricists such as Rubin and Shepherd deserve praise for trying to test hypotheses such as these against actual data. Perhaps these thoughts will help Rubin and Shepherd refine their approach in the next round of analyses of their data. In the meantime, these doubts should dampen the enthusiasm for tort reforms. Whatever the case for them, it seems too soon to place a reduction in fatal accidents among the justifications.