

## Early Warning Tools For Insolvency Prevention: Implementation in the Romanian Legal Framework

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### Abstract

*On the 17<sup>th</sup> of July 2022, the Law no. 216/2022 for the amendment and completion of the Law no. 85/2014 regarding insolvency prevention and insolvency proceedings and other normative acts has entered into force. Therefore, the Law no. 85/2014, which regulates pre-insolvency and insolvency proceedings, meets the requirements of the Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency), the latter entering into force on the 10<sup>th</sup> of July 2019. The Directive is focused on three main objectives: (1) the availability of preventive restructuring frameworks, (2) offering a second chance for honest entrepreneurs, and (3) regulating measures to increase the efficiency of restructuring, insolvency and discharge proceeding. The focus of this paper is represented by an analysis of early warning tools regulated in Romania, which are meant to be used for identifying financial difficulties faced by viable enterprises, in order to avoid its unnecessary liquidation by adopting safeguard measures. The development of early warning tools is part of the Directive’s first objective, being closely related to accessing safeguard proceedings.*

**Key words:** financial difficulties, preventive restructuring, insolvency, insolvency prevention, early warning tools

**J.E.L. classification:** K29

### 1. Introduction

This paper aims at analyzing the early warning tools, regulated by the Law no. 85/2014 regarding insolvency prevention and insolvency proceedings (published in the Romanian Official Journal no. 466 / 25.06.2014), which have been recently introduced into the Romanian legislation, through the Law no. 216/2022 for the amendment and completion of the Law no. 85/2014 (...) and other normative acts (published in the Romanian Official Journal no. 709 / 14.07.2022), the latter having transposed the Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency), hereinafter referred to as “The Directive”.

The transposition of the Directive (EU) 2019/1023 was set to be fulfilled until the 17<sup>th</sup> of July 2021. However, if Member States were to encounter any difficulties in the process of the transposition of the Directive’s provisions, they had been granted with a maximum one year extension of the deadline, under the condition of notifying the Commission in advance, until the 17<sup>th</sup> of January 2021, in order to avoid the commencement of the infringement proceeding. Of course, due to the effects of the COVID-19 pandemic, most Member States, including Romania, had requested an extension of the deadline, the only countries having already transposed the Directive’s provisions into their national law by July 2021 being France, Germany, Greece and The Netherlands.

However, by this time, all Member States, including Romania, have implemented into their national law the Directive’s provisions.

The Directive justifies the need of Member States to having a legal framework of early warning tools in the recital (17), which states that small and medium enterprises (hereinafter referred to as “SME”), do not have the means to cope with financial difficulties, especially restructuring costs, and are more likely to be liquidated rather than restructured, even if they are viable. An unnecessary liquidation has consequences such as job losses, the insolvency of other creditors caused by the so-called “domino effect” or low recovery rates of claims, and the loss of tax contributors for the state.

As the statistics show [Flash Eurobarometer, 354, (2012), Entrepreneurship in the E.U. and beyond, p. 72], in most Member States, if people were to set up a business, they would fear the possibility of going bankrupt (43%) and the risk of losing personal assets (37%) the most. “Fear of bankruptcy is explained by the length and the costs that a proceeding would imply. Entrepreneurs often lack the capital they need to initiate a business, so they finance it by applying for a loan.” (Corina Georgiana Costea, 2018, p. 38). In most of the cases, when starting a business, entrepreneurs guarantee the loan with their personal assets, which are at risk of being enforced if the enterprise were to face financial distress. Moreover, worrying statistics have surfaced regarding the average lifetime of the enterprises in the European Union, which has been estimated to 5 years. All of these arguments have led to the conclusion that Member States’ legislation must be harmonized, by also regulating early restructuring frameworks and early warning tools.

## 2. Theoretical background

Early warning tools meant to prevent the installation of the state of insolvency are a rather new concept for most countries. In 2014, INSOL Europe has submitted a study to the European Commission, entitled *Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States’ relevant provisions and practices* (Stefania Bariatti, Robert van Galen, 2014), in which the legal restructuring frameworks from 28 Member states were analyzed. The conclusion of this study have shown that 13 Member States do not have legal frameworks for preventive restructuring. In the absence of these proceedings, early warning tools would not have any function.

However, since all Member States have now regulated preventive restructuring options for financially distressed, yet viable enterprises, early warning tools had been made available, and Romania makes no exception.

Early warning mechanisms have been regulated in France since the 1<sup>st</sup> of March 1984, and the French doctrine states that it has a high rate of success, therefore contributing to lower rates of insolvency and bankruptcy cases. Named as “*procédure d’alerte*”, its success has been especially recognized due to the fact that the French Commercial Code offers the right to initiate such a proceeding to several interested parties. Statistically, in Île-de-France, in 2015, the number of summonses issued by the President of the Court increased from almost 4.500, in the year 2014, to approximately 5.700. It is to be underlined that, in France, early warning mechanisms can be internal and may be triggered by the following categories of persons: auditors, associates and the social and economic committees. The economic and social committee is the employee representative body in the company, and it is mandatory to be implemented in companies with more than 11 employees.

However, early warning mechanisms can also be external and may be initiated by the following entitled persons: approved prevention groups, the president of the Commercial Court and the prosecutor, as a representative of the Public Ministry. “The legislator considered that internal prevention would not suffice, especially because internal alert bodies do not always provide the required guarantees of specialized competence or the necessary authority.” (Dominique Vidal, Giulio Cesare Giorgini, 2016-2017, p. 78) Approved prevention groups are non-governmental organizations, constituted from professionals such as insolvency practitioners, lawyers, accountants, auditors etc., which work voluntarily. Companies may apply to become members of such organizations, in exchange of an annually low tax. At least once a year, they may send internal documents (such as financial statements, balance sheets etc.), and the members of these organizations will analyze their current financial state in order to identify a potential financial decline. If identified, the directors will be notified, along with recommendations of both measures needed to be adopted and professionals which are able to advise them further. If the directors remain passive and insolvency is inevitable in a short amount of time, these organizations are able to notify the president

of the Commercial Court, which will summon the company’s directors and dispose the adoption of necessary measures. “It is, therefore, relationship of trust, based on the authority and competence of the magistrate, which the legislator who organized this alert procedure sought to establish in order to help the enterprise” (André Jacquemont, Thomas Mastrullo, Régis Vabres, 2017, p. 50.)

In Greece, the early warning mechanisms consist of assigning a professional which will analyze the company’s current state and shall suggest adequate measures to be adopted. This service is free of charge for the financially distressed company. Moreover, the professional will supervise the implementation of the proposed measures and will assist the debtor throughout the process. This approach on early warning mechanisms is by far one of the most efficient, since it has a double role: on one hand, the debtor will be more likely to surpass the financial difficulty by having the constant assistance of a professional, and on the other hand, it has an educative valence which will help the company to avoid or to identify in advance any other future difficulties. In the event of difficulties, the decisions adopted by entitled persons may be decisive for the continuation of the current activity and the prevention of insolvency, or they may condemn the enterprise to failure.

In Denmark, “The Early Warning mechanism has been operational (...) since 2007 and has assisted close to 6000 businesses in distress. It is a unique opportunity for business owners to get professional assistance at a time in their business’ life cycle when they are often unable to pay for-profit consultants to help them get back on track” (Morten Møller, Piya Mukherjee, 2019, p. 20). Denmark has created an organization called “Early Warning Denmark” (EWD), which is part of “Early Warning Europe” (EWE), the latter being a European organization consisting of a private-public partnership, whose members are professionals, bodies of European states’ Ministries, non-profit organizations, European states’ Chambers of Commerce / Trade etc.

However, even if the concept of early warning mechanisms are not new to few Member States, it is an innovation in the Romanian legal system. Therefore, there aren’t any private entities aiming at assisting financially distressed companies. The Romanian law states that private entities are allowed to develop and implement alert mechanisms that aim at assisting companies to identify financial distress in an early stage.

### **3. Research methodology**

Both the national and the European insolvency reform bring safeguarding procedures to the fore, with the aim of turning the application of formal insolvency procedures into the exception to the rule, aiming for them to be reserved exclusively for professionals who can no longer be saved from bankruptcy. All these arguments reveal the topicality and importance of the researched theme. In the context of the insolvency reforms, it was considered necessary to analyze the most relevant legal systems, applying for this purpose *the comparative research method*. *The theoretical research method* has also been used, since the Directive only states the objective of implementing early warning tools, while giving Member States the opportunity to design their own mechanisms. Since most Member States, including Romania, have only recently adopted early warning tools, we considered it useful to analyze the way that these mechanisms comply with the Directive’s requirements.

### **4. Findings**

As stated in the introduction, the Romanian early mechanisms have been introduced by the Law no. 216/2022, amending the Law no. 85/2014. Before proceeding to analyzing these mechanisms, a short review of the Directive’s requirements is imposed. According to Article 3 of the Directive, Member States need to make sure that they grant access to early warning tools “(...) which can detect circumstances that could give rise to a likelihood of insolvency and can signal to them (the debtors – n.n.) the need to act without delay.” As observed, the Directive does not oblige Member States to regulate a certain type of alert mechanisms, but it only provides their obligation to make such tools available to debtors. As an example, the Directive states that such mechanisms may include, but are not limited to the following: (1) alert mechanisms triggered by situations where the debtor hasn’t made certain types of payments; (2) assistance offered by public or private organizations; (3) incentives given to third parties having relevant information for notifying the debtor upon a negative development.

The Romanian legal system has implemented the first and the second recommendations, while remaining passive in adopting the third one. It is to be underlined that the Directive doesn't limitate Member States' options, and the above-stated recommendations are just an example given to Member States for a better understanding of the Directive's desideratum.

Early warning tools in the Romanian legal system are regulated by articles 5<sup>1</sup> – 5<sup>6</sup> of the Law no. 85/2014. The Romanian legislator took into consideration recital (22) of the Directive, which states that “(...) Early warning tools which take the form of alert mechanisms that indicate when the debtor has not made certain types of payments could be triggered by, for example, non-payment of taxes or social security contributions. Such tools could be developed either by Member States or by private entities, provided that the objective is met (...)” Therefore, the main early warning tool recently introduced in the national legislation consists of the obligation of the fiscal body to notify the debtor regarding the non-execution of certain obligations. The notification shall also include free of charge information regarding the recovery solutions provided for by law through a website. “The enterprises are alerted by means of an alert notification sent automatically through the electronic communication system by electronic means of remote transmission developed by the Ministry of Finance/National Fiscal Administration Agency (A.N.A.F.) in related to non-execution of obligations to the state budget, to the state social insurance budget or to the unemployment insurance budget” (article 5<sup>2</sup> alin. 1 of the Law no. 85/2014). It is to be noted that, even if the Directive refers to alert mechanisms for the lack of “certain payments”, the Romanian legislator has chosen to apply the alert mechanisms only for the lack of payment of *fiscal and budgetary claims*.

One might ask if the Ministry of Finance is able to detect when the debtor was not able to pay obligations of other nature. The answer is yes, since the Ministry of Finance already disposes of the infrastructure necessary to fulfill such a purpose, because, by Law no. 30/2019 for the approval of the Ordinance no. 25/2018 (published in the Romanian Official Journal no. 44 / 17.01.2019), the Fiscal Procedure Code has been amended in the sense of assigning taxpayers to 3 tax risk classes. According to art. 7 para. (7) of the Fiscal Procedure Code, the general criteria according to which the tax risk class / subclass is established are: (a) criteria regarding tax registration; (b) criteria regarding the submission of tax returns; (c) criteria regarding the level of declaration, and (d) *criteria regarding the fulfillment of payment obligations to the general consolidated budget and to other creditors*. Based on these reasons, we appreciate that it is necessary for the fiscal body to have the duty of early warning also regarding claims of a nature other than budgetary, because, in our opinion, only in this form would the purpose of early warning be fulfilled.

Therefore, *de lege ferenda*, the establishment of a special commission within A.N.A.F., which would have the authority to identify and warn professionals about the existence of difficulties, based on the financial indicators resulting from the submitted tax returns, motivated by the fact that this institution has of all the information necessary for this purpose, is needed. Analyzing the French regulatory model of warning mechanisms, we identify a new argument that comes in support of this proposal, namely the fact that early warning could be carried out free of charge and would include all professionals facing the risk of insolvency.

The Romanian legislator has attributed to the Ministry of Entrepreneurship and Tourism the duty of publishing on its website relevant information regarding guidance in the field of early warning. Such information include the following: (a) the role of early warning consisting in the debtor's need to act without delay, in matters of adopting adequate measures in order to limit the negative impact of its financial distress; (b) economic and financial indicators for a general assessment of the financial situation, in order to diagnose the state of difficulty or insolvency, using available diagnostic programs; (c) systematized information regarding recovery solution, including early restructuring and insolvency proceedings; (d) a list of insolvency practitioners, authorities and organisms that are able to assist and supervise the enterprise's current state; (e) information regarding programs and facilities which may be accessed and which, in our opinion, consist of fiscal measures both permanently regulated or limited in time.

In addition to information which shall soon be made available online, the debtor receiving a notification from the Ministry of Finance may also access specialized assistance from this body, free of charge. Assistance is available either by telephone, or by online correspondence.

From the financially distressed debtor's point of view, the first step is receiving the notification from the Ministry of Finance, regarding the fact that there are increased chances of a financial

decline, and it is necessary for the debtor to intervene and to adopt adequate measures or decisions in order to recover and to avoid a potential state of insolvency. The early warning tools have been introduced in the Romanian legal framework on the 17<sup>th</sup> of July 2022, therefore, by the date of this paper, it is not known if this mechanism is already being used. However, if or when this mechanism is shall apply, the debtor would need to react and to identify what measures would be the most adequate for limiting the risk of insolvency. This is the second step of the early warning mechanism. If the debtor does not identify solutions by itself, the Ministry of Finance is available for free-of-charge assistance, by telephone. The debtor also has a chance of accessing a fiscal mediation proceeding. This proceeding is regulated by article 230<sup>1</sup> alin. (1) of the Code of Fiscal Procedure (Law no. 207/2015 regarding the Code of Fiscal Procedure, published in the Romanian Official Journal no. 547 / 23.07.2015), and by Order of the National Agency for Fiscal Administration no. 1757/2019 (published in the Romanian Official Journal no. 549 / 04.07.2019) and it consists of one of the next objectives: (1) a) clarification of the scope of the fiscal obligation entered in the summons, if the respective debtor has objections regarding it; b) the analysis by the fiscal body together with the debtor of the economic and financial situation of the debtor in order to identify optimal solutions for the settlement of fiscal obligations, including the possibility of benefiting from the payment facilities provided by law.

Starting with the 17<sup>th</sup> of July 2023, when article 5<sup>4</sup> alin. (1) from the Law no. 85/2014 will enter into force, companies facing difficulties in their activity will be able to benefit from a telephone line for guidance and assistance in the field of early warning, for a general assessment of the business in order to access recovery solutions. This assistance shall be offered by the Ministry of Entrepreneurship and Tourism. However, the law offers the Ministry the possibility of settling a network of consultants from both the private and public sector, including representatives of non-governmental organizations of the business environment, in order to establish mentorship programs in the field of early warning. We believe that such mentorship programs, which would be available free of charge, would greatly help financially distressed companies to understanding the risk they're facing and to identify optimal steps needed to be taken in order to limit such risks. This objective is important not only for the debtor itself, but also for the state and for the debtor's creditors, thus having both microeconomic and macroeconomic benefits.

To summarize what is stated above, we can observe the fact that a notified debtor has the possibility of asking for assistance to both the Ministry of Finance and the Ministry of Entrepreneurship and Tourism. While it may appear confusing for the debtor, the legislator wanted – in our opinion – to offer debtors the possibility of discussing with representatives of Ministry of Finance issues related to the lack of payment of *budgetary claims*, while also giving them the possibility of discussing with representatives of the Ministry of Entrepreneurship and Tourism issues related to the lack of payment of *claims of other nature than budgetary*. This is because budgetary claims may be restructured through fiscal mechanisms, while claims of other nature need to be previously negotiated with creditors in order to be restructured.

Lastly, it is to be underlined the fact that the Romanian legislator followed the French model in the field of early warning tools, regulating that even private entities could develop early warning tools. Such private entities could also include non-governmental associations, private companies etc. One of the most beneficial effect of this regulation is the fact that public-private partnerships could be established, and therefore the objective of early warning tools – making debtors aware of the problems they're facing and the effects that they could encounter if they remain passive – could be fulfilled. An interesting, yet concrete idea of developing early warning tools could be an application, or better yet a digital program based on Altman's model for SMEs, which has been known to have a high degree of financial distress identification. Such programs may be offered to SMEs free of charge by public institutions, or for a small monthly fee by private or public-private institutions.

## 5. Conclusions

As a result of the transposition of the Directive (EU) 2019/1023 in the Romanian legal system, early warning tools have been introduced for the first time in our national legislation. These mechanisms have two objectives: (1) to make the debtor aware of a potential risk of insolvency, so that adequate measures would be implemented in order to limit such risks, and (2) to educate debtors

upon the need to constantly analyze their current financial state in order to identify risks as soon as possible. As the French doctrine stated, it is not enough for the management bodies to ensure the fulfillment of the legal provisions in terms of accounting, but it is necessary for them to be able to analyze them in order to identify potential difficulties (Alain Lienhard, 2020 – 2021, p. 27.)

Early warning tools in Romania have been regulated only in the field of banking and insurance systems (Vasile Nemeş, Gabriela Fierbinţeanu, 21.05.2021, p. 212 and following), but SMEs did not dispose of such mechanisms before the entry into force of the Law no. 216/2022. In the banking sector, early warning tools are regulated by Title III of the Law no. 312/2015 regarding the recovery and resolution of credit institutions and investment firms, as well as for the modification and completion of some normative acts in the financial field (Published in the Romanian Official Journal no. 920 / 11.12.2015), while early warning tools in the insurance sector are regulated by Chapter III of Title I of the Law no. 246/2015 regarding the recovery and resolution of insurers (Published in the Romanian Official Journal no. 813 / 02.11.2015).

The regulation of early warning tools in both the banking and insurance systems reveal the importance of insolvency risk limitation. Now, SMEs have access to their own mechanisms, which is expected to decrease insolvency cases. “Economic prospects are modest. Because of an economic slowdown at the end 2021, aggravated by the invasion of Ukraine by Russia in 2022, it is expected that Real GDP will grow by just over 2% in 2022 and 2023 (...), being supported mainly by investments from several EU funds, including from the Mechanism recovery and resilience (MRR)” [European Commission, SWD (2022) 624 final, Bruxelles, 23.5.2022, p. 2]. According to the quoted report, the Romanian economy is still recovering from the effects of the COVID-19 pandemic shocks. Corroborated with a high level of inflation, fiscal instability (See the Government’s Ordinance no. 16/2022 for the amendment and completion of Law no. 227/2015 regarding the Fiscal Code, the repeal of some normative acts and other financial-fiscal measures, published in the Romanian Official Journal no. 716 / 15.07.2022) and also uncontrollable rising prices, we predict a high number of insolvencies in the following 2-3 years. Thus, early warning tools have been introduced into our national legislation with perfect timing and we believe that these mechanisms will contribute to a decrease of insolvency cases.

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