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FIVE ISSUES COMMONLY ENCOUNTERED IN COMMERCIAL BUILDING LEASES IN INDONESIA

By John A. Panggabean
(Senior Associate at Makarim & Taira S.)

I. INTRODUCTION

With an estimated economic growth of 5.1% – 5.2% for 2018[1], economic activities in Indonesia are expected to show a strong improvement. One of the indications of strong economic activities is the growing need for office space for businesses. It is expected that office space in Jakarta will increase by another 1.5 million square meters in 2018 – 2020[2] from 6 million square meters at the end of 2017[3].

Leasing an office space is an easy way for a business to acquire office space in a prime area, and to help the business to free up working capital. In this regard, a carefully prepared lease agreement is invaluable for the lessee and the lessor. A number of issues may be encountered when leasing a building for office space in Indonesia. This article highlights five of the most common ones.

In Indonesia, commercial lease agreements between lessees and lessors are not covered by any specific law, unlike in several other countries, where in some cases, standard format lease agreements are available (CMS, 2016). Agreements between lessees and lessors on leasing an object are generally regulated under the Indonesian Civil Code (the "ICC"). Under the ICC, a lease is an agreement under which a party binds itself to provide the enjoyment of an object to another party, for a certain period against a fixed price to be paid by the latter. This covers both movable and immovable goods. The obligations of the lessors under the ICC are to deliver the leased object to the lessee, maintain the object in a sufficiently good condition that it serves the purpose of the lease and to allow the lessee to have peaceful enjoyment during the term of the lease. On the other hand, under the ICC, the obligations of the lessee are to maintain the object of the lease as a good house-father and for the purpose stated in the lease agreement (or, without such a provision, according to the supposed purposes given the circumstances), and to pay the rent at the determined time.

Given the very generic scope of the provisions of the ICC, there are numerous type of lease agreement for office leases in Indonesia.

Makarim & Taira S.
Summitmas I, 16th & 17th Fls.
Jl. Jend. Sudirman Kav. 61-62
Jakarta 12190
Indonesia
P: (62-21) 5080 8300, 252 1272
F: (62-21) 252 2750, 252 2751
www.makarim.com

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1 https://ekonomi.kompas.com/read/2018/01/19/090000226/pertumbuhan-ekonomi-di-2018-akan-didorong-permintaan-domestik

2 https://bisnis.tempo.co/read/1021937/bisnis-online-menggeliat-sewa-ruang-kantor-meningkat

3 http://properti.bisnis.com/read/20180204/276/733976/ruang-kantor-sudirman-masih-menjadi-andalan

II. COMMON ISSUES IN COMMERCIAL BUILDING LEASES IN INDONESIA

A. Highlights of Some Provisions of a Lease Agreement in Indonesia

1. Key characteristics

Lease agreements for office/commercial space in Indonesia are often presented in a standard format prepared by the lessor/building owner (or in some cases, by the building management), which gives the lessee very little room to negotiate. However, this is not the case if the lessee is an anchor/major tenant in the property being leased.

As an anchor/major tenant, it is common for the lessor to grant naming rights or advertising rights. In addition, the lessor may accommodate a request from the lessee for a special access arrangement to the leased property, or an adjustment to the construction of the building/property to accommodate the lessee's specific requirements or special facilities brought in to the leased property.

2. Bankruptcy of the lessor, Sale of the property by the lessor

One of the concerns of the lessee is the bankruptcy of the lessor which is treated differently to the bankruptcy of the lessee, in which case, the lessor retains the right to terminate the lease.

Under Article 36 and Article 38 of Law No. 37 of 2004 on Bankruptcy and Debt Repayment, if the lessor is declared bankrupt and the court appoints a curator , the curator cannot immediately terminate the lease if the lessee is in compliance with all its obligations. If the rent has been paid in advance, the lease agreement cannot be terminated early. In a recent Supreme Court decision[4] the Supreme Court ruled that the curator could not terminate a lease agreement early if the lessee had paid the rent in full for the relevant term.

Another concern a lessee may have is the status of the lease agreement if the lessor decides to sell the leased property to a third party. In this case, the ICC protects the rights of the lessee under the ICC the sale of the object being leased does not terminate the lease, unless this has been agreed to.

3. Options for the settlement of disputes over lease agreements

Another aspect to be taken into consideration is the method to be used to settle a dispute. This needs to be considered carefully, especially if either party to the lease agreement is affiliated with a foreign corporation (eg a foreign investment company).

As the lease agreement most likely involves a real property in Indonesia, judicial resolution outside Indonesia should not be considered as an option as Indonesia is not a party to any bilateral or multilateral treaty regarding the reciprocal enforcement of rulings. Therefore, if a foreign ruling calls for the payment of monetary damages, in order to obtain recovery in Indonesia, the creditor must file a new suit against the debtor in the relevant District Court in Indonesia. This procedure effectively amounts to a retrial of the dispute, and while the foreign court decision can be used as evidence, the Indonesian court will not be bound by its findings.

Given the above, the most common dispute settlement methods provided for in Indonesian lease agreements are: (a) domestic litigation; (b) domestic arbitration; or (c) international arbitration in a country that is party to the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention").

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4 Supreme Court Decision Number 658 K/Pdt.Sus-Pailit/2014 of 23 December 2014

Domestic Litigation

The litigation process in Indonesia can simply be described as a very lengthy one. Depending on the complexity of the case, it can take from six months to approximately one year to obtain a District Court ruling, and the losing party can then file an appeal in the relevant High Court. Litigation at the High Court level can take another six months, and the losing party can file an appeal in the Supreme Court, which can take from one to five years before a final and binding ruling is handed down. All proceedings in Indonesian courts are conducted in Indonesian, so all foreign language documents to be submitted to the court must be translated into Indonesian .

Despite recent improvements in the Indonesian court system, many parties remain reluctant to turn to Indonesian courts except in situations in which interim relief enforceable in Indonesia is of paramount importance, or for matters involving Indonesian statutory rights or claims that may not otherwise be arbitrable, so the Indonesian court system may be the best and only viable option.

Domestic Arbitration

Under Law No. 30 of 1999, which governs arbitration in Indonesia (the "Arbitration Law"), all awards handed down by a tribunal or individual arbitrator within the jurisdiction of the Republic of Indonesia are treated as "domestic" awards, regardless of the international nature of the dispute or parties. Therefore, whenever parties choose the Arbitration Law as the *lex arbitri*, the resulting award is always treated as "domestic" under Indonesian law.

The following are several distinguishing features of the Arbitration Law:

- Only claims of a commercial nature, or involving rights within the full legal authority of the disputing parties, may be subject to arbitration.
- The language of the proceedings is Indonesian. Although the parties remain free to choose a different language, their choice is subject to the consent of the tribunal.
- The arbitration is usually decided on written documents. A hearing can be conducted only if both parties consent to it, or if deemed necessary by the tribunal.
- The involvement of the District Court in the arbitral process is strictly limited to rendering assistance with the appointment, withdrawal or recusal of arbitrators, as well as the enforcement of the award. Although arbitrators have the power to grant certain types of interim relief, it is doubtful whether the District Court would agree to enforce such orders in the event of non-compliance *pendente lite.*
- Once rendered, the award must be registered with the District Court within 30 days; otherwise, it will be deemed unenforceable.
- The District Court's decision to reject a request for the execution of a domestic award is final and binding. The only grounds for rejection are that there is no valid agreement to arbitrate, the dispute is not arbitrable or the award is contrary to decency or public order.
- The grounds for requesting the annulment of a domestic award are limited to matters involving fraud or intentional concealment, and do not include such things as lack of jurisdiction.

As in many other jurisdictions, domestic arbitral awards in Indonesia are not subject to appeal of any kind to the courts. And since arbitral proceedings are confidential and District Court opinions are not reported, very little information is available on the enforcement of domestic arbitration awards in Indonesia. The unusual features of the Arbitration Law (listed above) increase the risk that a domestic award may not be enforced based on formalistic or arbitrary grounds, or that an award made in excess of the tribunal's jurisdiction may not be subject to annulment by the losing party. What is more, the Arbitration Law offers no judicial assistance with the enforcement of interim measures imposed by arbitrators.

On the positive side, the costs of administered domestic arbitration in Indonesia are quite competitive, particularly for smaller claims. Therefore, for contractual matters involving straightforward factual and legal issues, and where interim relief is not a major concern, domestic arbitration may provide an efficient and cost-effective method of dispute resolution.

International Arbitration

For foreign investors, international arbitration offers at least one important distinct advantage over both domestic arbitration and domestic courts: forum neutrality. In addition, in well-established regional venues such as Singapore and Hong Kong, arbitration enjoys the full support of a strong *lex arbitri*, backed by a reliable and independent court system.

However, parties should always bear in mind, that there are inherent limits to the usefulness of even the best *lex arbitri.* Therefore, in cases where provisional relief is urgently needed with respect to assets or persons located in Indonesia, the interim orders of a foreign court or arbitrator are not enforceable in Indonesia, and Indonesian courts may decline to exercise jurisdiction if the underlying dispute is subject to a binding arbitration agreement.

Once a final award has been entered, however, its recognition and enforcement in Indonesia should generally be (but in practice is not always) simple and straightforward. Under the Arbitration Law, any award handed down by a tribunal or individual arbitrator outside of Indonesia's jurisdiction is treated as "international" for the purposes of recognition and enforcement under the New York Convention. At the same time, when Indonesia ratified the convention, it entered a reservation declaring that it would limit its application to disputes arising out of legal relationships that are considered "commercial" under Indonesian law. Therefore, Article 5 of the Arbitration Law (which states that only claims of a commercial nature or involving rights within the full legal authority of the disputing parties may be subject to arbitration) applies equally to domestic and to international awards. This means that if enforcement in Indonesia is anticipated, care must be taken at the outset to ensure that the subject matter of the dispute will be deemed arbitrable under both the *lex arbitri* and Indonesian law.

Other conditions for the recognition and enforceability of an international award in Indonesia are that it must be rendered by a tribunal in a country that is also a party to the New York Convention; the order must not violate public order, and the order must be registered with – and a writ of execution must be obtained from – the Chairman of the District Court of Central Jakarta. As a practical matter, it is important to include in the appointment of the tribunal an undertaking that the arbitrators will register the award with the local court for enforcement, if requested by the winning party.

Unlike domestic awards, international awards are not subject to strict time limits for recognition and enforcement. Furthermore, while a decision of the Chairman of the District Court of Central Jakarta granting exequatur of an international award is not subject to appeal, a decision refusing exequatur can be appealed to the Supreme Court, which should resolve the matter within 90 days.

B. Service Charges

In Indonesia, the service charge in lease agreements usually includes:

- a charge for the electricity needed for lighting public areas, AC and elevators;
- charges for water, security services and the operation and maintenance of public areas (such as public restrooms);
- a charge for operating and maintaining (including repairing) the building and equipment, machinery and building facilities (such as water disposal and treatment, elevators, fire suppression equipment;
- a charge for cleaning public areas;
- a charge to cover employee salaries (security personnel, engineers/technicians/office staff), and building management;

- a charge for general administration matters (such as permits and licenses, tax);
- a charge for building insurance.

Depending on the lessor, the agreement regarding service charges may vary, including when payment is due (e.g. quarterly, semi-annually, etc.) and who charges the service tax. Normally, the lessee pays the service charge together with the rent to the lessor as part of the payment of the rent. However, in some cases, under the lease agreement, the lessee may pay the service charge separately from the rent to the lessor, or in some cases, to the building management engaged by the lessor. These arrangements can have two different consequences from the tax point of view. In the first case, the withholding tax is paid at the rate which applies to rent including the service charge. In the second case, the tax due on the rent is paid at the rate which applies to the rent, while the tax due on the service charge is paid at the rate which applies to management services charge. It is therefore common for the lessee to engage a qualified Indonesian tax consultant to review or finalize the arrangement regarding the rent and service charge, to make sure that the tax regulations are not infringed.

One of the most hotly debated items in a lease agreement between a lessee and the lessor is the amount service charge the lessor must pay. Previously, lessees would accept the service charge without question, but it now has become customary for the lessee and the lessor to determine the service charge after comparing the average service charge in several similar buildings in the same location. This is a fairer way to decide on the service charge for both the lessee and the lessor.

C. Gross-up Payment for the Rent

Law Number 7 of 1983 on Income Tax (as amended several times) obliges the lessee to withhold the income tax due on the rent paid to the lessor. This means that the lessor receives less than the amount stated in the lease agreement, and in some cases (particularly in the case of the lease of a building owned by an individual owner or a more traditional lessor/ building owner) the lessor insists on being paid the full amount of the rent stated in the lease agreement. Although it has become common in Indonesia for lease agreements to contain a clause under which each party accepts responsibility for its respective tax obligations, some lessors still insist that the lessee grosses-up the rent payment.

However, as Indonesian tax regulations require the lessee to withhold income tax from the rent paid to the lessor, the lessee should not pay the lessor the full amount of the rent stated in the lease agreement as the tax authority will decide that the lessee is not complying with its obligation to withhold income tax from the rent paid to the lessor. Therefore, the lessee and the lessor should come to an agreement that the rent stated in the lease agreement includes an additional amount corresponding to the withholding tax to be withheld, so that the lessor receives the "full amount" of the rent as originally intended. It is also common for the lease to be paid 3 months in advance.

D. Repair Work

Under the ICC, the lessor is required to maintain the leased object and may ask for repairs to be made to the leased object except for repairs for which the lessor is responsible. The lessor should also be responsible for all defects in the leased object that prevent its use. On the other hand, the lessee should be responsible for damage caused to the leased object during the lease term (unless it can be established that the damage was not caused by the lessee). This should include any damage to the leased object or loss to the lessor caused by the lessee's roommates or transferee, and the lessee should be required to take down and remove everything installed or constructed within the premises (at the lessee's own cost) without damaging the leased object.

However, in Indonesia, it has become common practice for commercial office/building leases to state that any repair and maintenance work will be undertaken by the lessor (or, in some cases, by the building manager engaged by the lessor), especially if the lessor is also the owner of the building. This is because the lessor usually understands the construction of the property much better than the lessee or the contractors engaged by the lessee, and this way, any maintenance or repair work necessary can be performed without threatening the integrity of the construction of the building.

To this end, it is common for lease agreements in Indonesia to contain clauses under which the lessor (or the building management engaged by it) undertakes the maintenance and repair work and usually includes the lessor's response time following receipt of a request from the lessee, a time limit for completing the repair and maintenance work, who pays the cost of the repair and maintenance work and the compensation available to the lessee if the maintenance and repair work disrupts the lessee's activities.

E. Sinking Fund

Sometimes, a heated debate ensues over the proposal to establish a sinking fund during the negotiations over the lease agreement between the lessee and the lessor. Unfortunately, there is no specific regulation on office/building/property leases, which defines or regulates sinking funds. Usually, the sinking fund is established to cover repairs and maintain the property, which are the basic obligations of the lessor. However, in some cases, the lessor will try to include a contribution to the sinking fund in the service charge which is not refundable, thereby making the lessee also responsible to a certain degree, for the maintenance and repair of the property. However, the lessor can be persuaded (and it is quite common) to make the contribution to the sinking fund charged the lessee (often as part of the service charge) refundable upon the expiry of the term of the lease, but no interest is usually payable on the accumulated contributions as if they were a deposit.

In strata title buildings, the sinking fund paid to the tenants' association is not refundable, as the association uses it for the maintenance and repair of the strata title building. However, this is not the case in commercial building leases. As there is no specific regulation on this matter, it is unclear which practice is the most appropriate and so whether the sinking fund contributions are refundable to the lessee upon the expiry of the lease depends on the negotiations between the lessee and the lessor.

If the lessor insists on charging the lessee a non-refundable contribution to the sinking fund, the contribution should constitute additional income for the lessee under Law Number 7 of 1983 on Income Tax (as amended several times). Consequently, the contribution paid is subject to withholding tax at the prevailing rate, and the lessee must withhold the tax due on the contribution paid to the sinking fund. Lessees should consider this aspect when negotiating with a lessor.

On the other hand, if the contribution to the sinking fund will be refunded upon the expiry of the lease, it does not constitute additional income for the lessor and therefore the lessee does not need to withhold any income tax on it. Meanwhile, it is common practice in Indonesia for any deposit the lessee pays to the lessor during the term of the lease to be refunded without any interest, and this applies to the contribution to the sinking.

III. CLOSING REMARKS

Given the various issues discussed above, in Indonesia, both the lessee and the lessor should prepare the lease agreement carefully to avoid any potential dispute arising during the term of the lease. In some cases, the lessee does not negotiate the lease agreement diligently and so may well accept lease provisions that would be unacceptable to other lessees, while at the other end of the spectrum, sometimes the lessee and the lessor get in involved in multiple lengthy, page-turning sessions when negotiating the lease agreement.

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Contacts:

Rahayu N. Hoed rahayu.hoed@makarim.com

John A. Panggabean john.panggabean@makarim.com