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Preservation of Arbitration Rights in Kentucky When Litigation Is Filed

Despite the presence of an arbitration provision in a loan agreement or other document, a lender may be required to file suit to bring certain claims against individuals or property. For instance, a lender may be forced to file suit either to foreclose on a mortgage, or to obtain a court order to recover, liquidate, and clear title to collateral. If the borrower asserts counterclaims against the lender in response to the suit, the lender may want to compel arbitration with respect to those counterclaims. However, because filing a complaint can constitute a waiver of a party's right to compel arbitration, lenders must be **extremely careful** both in filing suit and in responding to counterclaims to prevent a waiver of their arbitration rights. A recent case from the Kentucky Court of Appeals, *Kathleen Imhoff v. Lexington Public Library Board of Trustees*, 2016 WL 192017, shows just how careful a litigant in Kentucky must be to avoid waiving his or her right to arbitration.

In *Imhoff* the Kentucky Court of Appeals held that the former director of the Library had waived her right to arbitrate her claims related to her termination when she had (i) prepared a draft complaint and sent it to the library's board of directors in advance of pre-suit mediation, (ii) filed a claim with the Equal Employment Opportunity Commission ("EEOC"), and (iii) actually filed suit against the Library and demanded a jury trial. After six weeks had passed since the suit was filed, and after the Library filed a motion to dismiss the complaint on sovereign immunity grounds, Ms. Imhoff sought to stay the litigation and arbitrate the dispute. The trial court did order arbitration and ultimately confirmed portions of the arbitrators' award. Both parties appealed this decision to the Court of Appeals with Ms. Imhoff seeking confirmation of the entire arbitration award with the Library asserting its sovereign immunity defenses with respect to the award and that Ms. Imhoff had waived her right to arbitration.^[1]

To resolve this appeal, the Kentucky Court of Appeals had to reconcile the somewhat conflicting holdings of *Jackson v. Mackin*,

277 S.W.3d 626 (Ky. App. 2009) and *American General Home Equity, Inc. v. Kestel*, 253 S.W.3d 543 (Ky. 2008). In the *Jackson* decision, the Court of Appeals held that a plaintiff waived its right to arbitrate a dispute over misrepresentations in a real estate purchase contract when it filed suit and failed to request arbitration. In *American General*, the Supreme Court held that a lender who filed a foreclosure suit could assert that the borrower's counterclaims were subject to arbitration because the filing of the foreclosure suit was mandatory. And in the recent *Imhoff* holding, the Court of Appeals concluded that Ms. Imhoff evidenced her waiver of her right to arbitration by obtaining a right-to-sue letter from the EEOC, delivering a draft complaint to the board of the Library, and suing the Library without mentioning arbitration. Ms. Imhoff argued that she had to file suit before the statute of limitations expired; however, the Court of Appeals rejected this argument noting that her complaint failed to mention arbitration and that she did not move the court to order mediation pursuant to KRS 417.060 until the Library's motion to dismiss was filed. While only six weeks elapsed between the filing of Ms. Imhoff's complaint and her motion to stay litigation pending arbitration, the Court of Appeals held that this was sufficient to constitute a waiver of her arbitration rights.

Taking these three cases together, it is likely that Kentucky courts will construe most actions parties pursue in litigation as constituting a waiver of a contractual arbitration right. Accordingly, a lender who has filed suit to pursue foreclosure or recover collateral must carefully retain its contractual right to compel arbitration whenever the borrower or guarantor's responsive pleading includes a counterclaim. In order to preserve its right to compel arbitration over a counterclaim, a lender is normally best served by responsively pleading a motion to dismiss any borrower-filed counterclaim, in lieu of arbitration, pursuant to KRS 417.060. To the extent the Court denies the motion to dismiss or an answer is otherwise required, the answer should clearly prominently assert the affirmative defense of the arbitration clause and should seek to preserve all rights thereunder, in addition to pleading all other available lender affirmative defenses. If a lender is deciding whether or not to file suit based on a contract that contains an arbitration

provision, it must be certain that civil litigation is permitted by the parties' contract and then strategically limit the pleaded causes of action and the demanded relief, such as a foreclosure on real estate or to recover and/or declaration of rights respecting in collateral. Failing to proceed correctly may result in the lender unintentionally waiving the arbitrable characteristics of all other disputes which may subsequently arise under the lending documents.

For questions about this post or how to evaluate pursuit of state law remedies while protecting arbitration rights in a particular situation, please contact Tyler Powell at (859) 244-3254 or tpowell@fbtlaw.com.

[1] The Court of Appeals noted that only an order denying arbitration is immediately appealable by interlocutory action while an order compelling arbitration can only be appealed after the entry of a final judgment on the merits by the court.

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