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CLIENT ALERT

Float Like A *Butterfly*: Second Circuit Resolves "Issue Of First Impression" That Effective Contractual "Blockers" Shield Investors From Short-Swing Profit Liability Under Section 16(b) Of The Securities Exchange Act

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EXECUTIVE SUMMARY

On July 7, 2026, the Second Circuit issued a precedential decision in *20230930-DK-Butterfly-1, Inc., f/k/a Bed Bath & Beyond Inc. v. HBC Investments LLC, et al.*, No. 25-2728, affirming dismissal of 20230930-DK-Butterfly-1, Inc.'s ("Butterfly") complaint against investment manager Hudson Bay Capital Management LP and affiliated fund HBC Investments LLC (together, "Hudson Bay"). Butterfly alleged that Hudson Bay's trading of Bed Bath & Beyond Inc. ("BBBY") stock violated Section 16(b) of the Securities Exchange Act (the "Exchange Act") because Hudson Bay had the right to acquire more than 10% of BBBY stock, and sought disgorgement of Hudson Bay's short-swing profits. The Second Circuit held as "an issue of first impression in this Circuit" that contractual "blockers" that

prevent investors from owning 10% of a company's stock at any one time shield investors from liability under Section 16(b), so long as such blockers are not "illusory" or a "sham." Importantly, the Second Circuit adopted a three-factor test to assess whether a blocker is a sham or illusory, which provides a clear roadmap to investors on how to structure contractual blockers to protect them from potential Section 16(b) liability.

BACKGROUND ON SECTION 16(B) AND "BLOCKERS"

Section 16(b) of the Exchange Act is a "blunt instrument" that "imposes strict liability on corporate insiders who have profited from buying and selling securities within a six-month period," and requires "disgorgement of short-term profits."[1] Section 16(b) applies to "a public company's directors and officers," and "beneficial owners of more than ten percent of a public company's stock – including those who have the *right* to acquire such ownership."[2] Sophisticated investors who invest in options, warrants, preferred stock, convertible debt, or other complex instruments can unintentionally cross the 10% beneficial ownership threshold and therefore risk disgorgement of short-term trading profits under Section 16(b).

To protect against this potential liability, investors have included "blockers" or "conversion caps" in their contractual agreements. These provisions cap investors' right to acquire a public company's stock at below 10% at any one time and block any transactions that bring investors' stockholdings up to 10% or more. Thus, such blockers seek to protect investors from Section 16(b) liability by ensuring that they never become 10% beneficial owners.

The Second Circuit has long recognized the viability of contractual blockers and conversion caps as a shield against Section 16(b) liability. More than two decades ago, the Second Circuit held that "where a binding conversion cap denies an investor the right to acquire more than 10% of the underlying equity securities of an issuer, at any one time, the investor is not, by virtue of his or her ownership of convertible securities, the beneficial owner of more than 10% of those equity securities."[3] Courts across the country have adopted the Second Circuit's view that blockers can shield investors from liability.[4]

However, the Second Circuit also held that blockers and conversion caps are not enforceable if they "are discovered to be illusory or a sham."[5] Before the Second Circuit's *Butterfly* decision, there was a "dearth of caselaw" on "the issue of sham or illusory blockers," so investors lacked guidance about how to structure blockers to ensure that they were enforceable.[6]

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1 *20230930-Dk-Butterfly-1, Inc. v. HBC Invs. LLC*, --- F.4th ----, 2026 WL 1954771, at *1, *3 (2d Cir. July 7, 2026) (*Butterfly II*) (cleaned up).

2 *Id.* (emphasis in original).

3 *Levy ex rel. ImmunoGen Inc. v. Southbrook Int'l Invs., Ltd.*, 263 F.3d 10, 12 (2d Cir. 2001) (cleaned up).

4 *See Decker v. Advantage Fund Ltd.*, 362 F.3d 593, 597 (9th Cir. 2004) ("conversation cap that would bar conversation once the owner reached a threshold of 4.9% ownership" "protected them from section 16(b) liability") (citing *Levy*, 263 F.3d at 15); *ION Geophysical Corp. v. Fletcher Int'l, Ltd.*, 2010 WL 4378400 (Del. Ch. Nov. 5, 2010); *Klawonn v. YA Global Invs., L.P.*, 2010 WL 5094423 (D.N.J. Dec. 6, 2010).

5 *20230930-Dk-Butterfly-1, Inc. v. HBC Invs. LLC*, 2025 WL 2782334, at *9 (S.D.N.Y. Sept. 30, 2025) (*Butterfly I)* (quoting *Levy*, 263 F.3d at 17 n.5), *aff'd*, 2026 WL 1954771 (2d Cir. July 7, 2026).

6 *Butterfly II*, 2026 WL 1954771, at *3 (cleaned up).

The Second Circuit's *Butterfly* Decision

In 2023, Hudson Bay purchased certain derivative securities from then-publicly traded BBBY that gave Hudson Bay "the right to buy heavily discounted, tradable BBBY common stock that they could sell to public investors at market price for a profit."[7] In connection with these derivative transactions, the parties "added contractual provisions known as 'blockers,'" which "prohibited Hudson Bay from ever 'beneficially owning in excess of 9.99%' of BBBY's common stock."[8] The blockers provided that any exercise of the derivatives "would 'be null and void and treated as if never made' if it brought Hudson Bay over the 9.99% threshold."[9] "Hudson Bay was also required to certify" each time it sought to exercise the derivatives that "it would not 'have beneficial ownership of a number of shares of BBBY Common Stock that exceeded' 9.99%."[10] "Hudson Bay and BBBY supplemented these contracts with a letter agreement (the 'Side Letter')," which "neither superseded nor in any way altered the public-offering documents" containing the blockers.[11] Hudson Bay exercised the derivatives to "acquir[e] newly issued BBBY stock at a discount and then resell[] it at market value" obtaining "profits of over $300 million."[12]

In 2024, Butterfly (as BBBY is now known post-bankruptcy) sued Hudson Bay alleging that its sales of BBBY stock violated Section 16(b) of the Exchange Act because the blocker provisions were sham or illusory, so Hudson Bay had the right to acquire more than 10% of BBBY's common stock.[13] The District Court dismissed the case, holding that "Butterfly did not sufficiently plead that 'the block provisions were illusory or a sham,'" and Butterfly appealed.[14]

The Second Circuit affirmed dismissal, holding that "a comprehensive and legally binding blocker *should* generally insulate a defendant from section 16(b) liability."[15] Importantly, the Second Circuit set forth "three relevant (and commonsense) factors to be considered in assessing" whether a blocker is viable or is illusory: "whether (i) the acquiring party may waive the blocker 'in its sole discretion,' (ii) the blocker lacks 'a means of ensuring compliance,' and (iii) as a practical reality, the investor has 'ever exceeded the conversion cap.'"[16] Notably, the Second Circuit declined to adopt the SEC's proposed test for "whether a block qualifies as illusory," while acknowledging that the Second Circuit's three factors "largely overlap with three of the SEC's proposed factors."[17]

Applying its own three-factor test, the Second Circuit concluded that "[a]ll three factors indicate that the blockers at issue here are not illusory":[18]

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7 *Butterfly I*, 2025 WL 2782334, at *2; *see also Butterfly II*, 2026 WL 1954771, at *1.
8 *Butterfly II*, 2026 WL 1954771, at *2 (cleaned up).
9 *Id.*
10 *Id.* (cleaned up).
11 *Id.*
12 *Id.* (cleaned up).
13 *Id.*
14 *Id.* (quoting *Butterfly I*, 2025 WL 2782334, at *17).
15 *Id.* at *5 (emphasis in original).
16 *Id.* at *3 (quoting *Levy*, 263 F.3d at 12, 17–18).
17 *Id.* at *3 n.1.
18 *Id.* at *4.

1. **Discretion To Waive**. The Second Circuit held that "the blockers at issue here are solid contractual provisions, not phantom clauses that Hudson Bay could quietly waive without BBBY's consent."[19] The fact that both parties could together "theoretically amend a contractual clause" is true of "every clause of every contract" and does not make the blocker "a sham."[20]

2. **Means Of Ensuring Compliance**. The Second Circuit set a low bar for this factor, holding that it requires only that "the contract at issue include[] mechanisms that would prevent the investor from acquiring more than ten percent of the company's stock," and the investor have the "'ability to revoke a requested conversion to the extent that full exercise would exceed the cap.'"[21] The Second Circuit specifically rejected Butterfly's arguments that this factor is not satisfied by an investor's "self-policing" and requires that a public company have the "ability to monitor . . . compliance with the blockers."[22] Instead, the Second Circuit held that the blockers at issue satisfy this factor because "they automatically nullify any above-the-threshold acquisition," and "every time that Hudson Bay attempted to exercise" a derivative, "it certified that it was not amassing more than 9.99% of BBBY's common stock."[23]

3. **Exceeding The Conversion Cap**. The Second Circuit calculated whether "Hudson Bay ever actually exceeded the ten-percent cap" for beneficial ownership based on "Hudson Bay's end-of-day beneficial ownership" for each relevant day.[24] The Second Circuit also excluded "shares that Hudson Bay had already agreed to sell" that "were still briefly transiting through its account," holding that Hudson Bay did not beneficially own already sold shares "just sitting in its brokerage account."[25] Applying this methodology, the Second Circuit held that Hudson Bay never exceeded the 10% cap.[26]

The Second Circuit also rejected Butterfly's arguments that Hudson Bay used the blockers as "'plans or schemes to evade'" reporting requirements in violation of SEC Rule 13d–3(b), and "should thus be deemed the beneficial owner of BBBY's common stock."[27] The Second Circuit held that this Rule prohibits only conduct that "*conceal[s]* a defendant's effective ownership"; it does not prohibit fully disclosed "contractual provisions that *prevent* an investor from owning a security in the first place."[28] The Second Circuit similarly rejected Butterfly's argument that "the Side Letter secretly" gave "Hudson Bay the unlimited right to acquire as much stock as it wanted – despite the blockers' ten-percent cap" – because the Side Letter "was clearly subject to BBBY's and Hudson Bay's other agreements," including the blockers.[29]

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19 *Id.*

20 *Id.*

21 *Id.* (quoting *Levy*, 263 F.3d at 18).

22 *Id.* (cleaned up).

23 *Id.*

24 *Id.*

25 *Id.* at *4–5 (citing 17 C.F.R. §§ 240.14d–3(a)(2), 240.16a–1(a)(1)) (cleaned up).

26 *Id.*

27 *Id.* at *5 (quoting 17 C.F.R § 240.13d–3(b)) (cleaned up).

28 *Id.* at *6 (citing *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 6545 F.3d 276, 304–05 (2d Cir. 2011) (Winter, J., concurring)) (emphasis in original).

29 *Id.* (cleaned up).

The *Butterfly* Roadmap: How Investors Can Protect Themselves From Potential Section 16(b) Liability

In *Butterfly*, the Second Circuit again "blessed the use of effective blockers" to protect investors against potential short-swing profit liability under Section 16(b).[30] For the first time, the Second Circuit provided a clear roadmap to investors for how to structure blockers to make them effective. In particular, investors negotiating contracts with the option to purchase stock in public companies should ensure that:

- Blockers are in place and disclosed to the public company *before* investors risk becoming 10% beneficial owners;
- They do not have discretion to unilaterally waive or amend blockers without the public company's consent;
- Blockers provide that any stock purchases or derivative exercises will be "null and void and treated as if never made" if they bring an investor up to or above the 10% beneficial ownership threshold;
- Blockers require investors to certify that they would not acquire beneficial ownership up to or above the 10% threshold every time they purchase stock or exercise derivatives;
- They monitor their beneficial ownership on a daily basis to ensure that they do not exceed the 10% beneficial ownership threshold; and
- Any additional agreements or "side letters" are subject to and continue to preserve any blockers.

By following this roadmap, investors will best position themselves to guard against Section 16(b) liability risk, and will maintain strong arguments that any potential Section 16(b) claim should be dismissed at the pleading stage.

[30] *Id*. (citing *Levy*, 263 F.3d at 12).

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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