

Long-term contracting in semiconductor markets: Pause for thought

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Long-term, multiyear supply agreements are becoming increasingly prevalent across key semiconductor segments. This is particularly visible in AI-related supply chains, where constraints in high-bandwidth memory (HBM) supply and advanced packaging capacity have led to increased competition for secured long-term capacity. The commercial logic behind long-term contracting is to ensure security of supply in a world where, for many large customers (particularly hyperscalers and other AI infrastructure providers), price may be secondary. However, entering longer-term commitments in volatile markets, including for both differentiated leading-edge devices and more commoditised memory segments, requires careful evaluation of risk.

Understanding how the commercial dynamics translate into the drafting can turn a point of potential financial exposure into a driver of commercial value when considered over the life of a contract. This article looks at the backdrop to long-term contracting in the semiconductor market and explores some of the issues associated with four commonly drafted contractual provisions: volume flexibility options, allocation mechanisms, liquidated damages provisions and *force majeure*. In each case, there are tangible commercial benefits to be had from engaging with the underlying legal issues.

Key takeaways

- Volume, price or capacity reservation commitments may seem logical now, but should be tested against different market scenarios (even ones which feel implausible today).
- Understand the legal nuances of contractual allocation mechanisms, because it might be a source of commercial leverage.
- Imagine having to rely on the liquidated damages provisions in your contract in a range of scenarios and then ask if you are commercially protected.
- In an increasingly uncertain world, understanding what is (and is not) *force majeure* can pay dividends. Often it is not as straightforward as it seems, and boilerplate language that is copy and pasted from other agreements may not be suitable.

The backdrop: Long-term contracts and the surrounding market

In any market, a shift towards longer-term contractual terms changes the commercial dynamics of the arrangement, giving rise to distinct legal issues that parties need to be aware of.

The commercial benefits of a long-term contract will always be contingent on how it relates to the surrounding market over the whole term. That is the same for both buyers and sellers. This is especially pertinent in an industry that is (or has traditionally been) cyclical, volatile and susceptible to exogenous shocks.

By way of example, few observers would currently expect the supply of advanced memory chips to catch up to demand any time soon, primarily due to the time and upfront capital requirements of expanding leading-edge fab capacity and advanced packaging capability. But this is not a static state of affairs. Additional wafer capacity will eventually come online. Equally, the precise trajectory of demand (much of it AI-driven and dependent on accelerator deployment cycles) is potentially sensitive to external shocks or underlying investor sentiment. These dynamics have a direct impact on the commerciality of a long-term contract. For example, from a buyer's perspective, being locked into inflexible take-or-pay or capacity reservation commitments in a softening market carries financial risk. Conversely, sellers will want to avoid overcommitting capacity to a particular customer now and forgoing more lucrative opportunities further down the line. As such, it is important for parties to have a range of possible market scenarios in mind when negotiating the terms of an agreement they will be bound to over a sustained period.

A firm grasp of the key legal mechanics in long-term contracts is therefore indispensable from a risk management perspective. It can not only deliver commercial value, but also help navigate competing internal stakeholder priorities (for example balancing procurement interests with the financial exposure that accompanies longer-term commitments). A well-drafted long-term contract helps balance a business's operational priorities, as well as advancing them. And in an industry where key contractual terms are closely guarded and rarely made public, all participants need to be comfortable navigating the drafting issues and stress-testing key provisions themselves.

The topics below are examples of discrete contractual terms that may have a discernible impact on the commerciality of a long-term contract, particularly when considered against the backdrop of the semiconductor industry more broadly.

1) Flexibility is good (if you can get it)

Long-term supply agreements will generally impose some kind of take-or-pay or prepayment obligation on the buyer, requiring them to commit in advance to the purchase of a fixed volume of devices, or reserved wafer capacity. In the present supply-constrained environment, buyers and sellers may be perfectly comfortable with this. However, in the medium- to longer-term, these commitments can create risk for both a buyer (for example in the event that demand forecasts weaken, or secondary market prices fall below what the buyer has committed to pay) and seller (if the market price of the good goes above that which the seller has committed to make it available to the buyer at). Volume flexibility is a valuable tool in mitigating this risk.

While shortfalls in supply may be the norm at the moment, the three-to-five year contractual terms being widely reported may extend beyond the point that fab capacity starts to catch up. It is therefore not difficult to imagine a scenario where a long-term customer with a contractual flexibility option ends up in a better position than one who remains bound to the full extent of their purchasing or fixed capacity commitments.

Given their commercial value, flexibility options are often heavily negotiated. Caps or restrictions on the exercise of flexibility options, or corresponding obligations to "make up", or "make good" the relevant quantities in subsequent years, can dilute the commercial value of such an entitlement in ways that are not immediately obvious. Careful attention should therefore be paid to the terms themselves and how they might operate over time.

2) Allocation: Get what you're given?

As inventories continue to fall short of demand, allocation of limited wafer output among customers has latterly become a feature of many segments of the memory market (including HBM, DRAM and NAND). Frequently, it is hyperscalers, strategic customers, or even those buyers who maintained orders during recent downcycles that are benefiting from allocations. Understanding the scope of any allocation provisions in a long-term supply contract is an important tool in effectively mapping procurement needs.

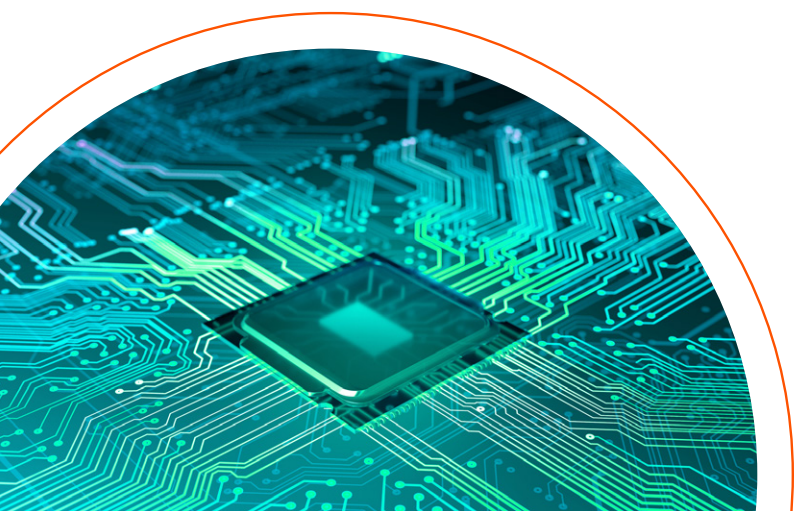
This too may involve careful analysis. If an allocation mechanism is specified in the long-term contract, has it been clearly expressed and thought through? If allocation is left at the discretion of the supplier, it is important to consider what the boundaries of such discretion are (if any). Under English law, for example, discretionary powers exercisable by one party may in certain circumstances be subject to implied constraints. Likewise, powers that are framed by reference to reasonable endeavours, or are to be exercised in good faith, may be different in substance to those that are phrased as being at the deciding party's sole or exclusive discretion. Again, much will turn on the precise wording of the contract. However, these are legal distinctions that parties may nevertheless derive clear value from being aware of when negotiating. Having a clear idea of what you are either entitled to as a buyer, or what constraints you are subject to as a seller, promotes operational clarity across the life of the contract and allows both parties to derive the full commercial value of what they have negotiated.

3) Liquidated damages: A moving target

Long-term contracts premised on security of supply will often contain provisions requiring the payment of a fixed amount of damages in the event of a failure to supply contracted volumes (or even to take delivery of reserved capacity). The primary benefit of liquidated damages provisions is that they provide the parties with certainty over their financial exposure in the event of a particular event of non-compliance.

It is important to consider carefully the level at which any liquidated damages provisions are set and ensure that any other restrictions (for example caps on the cumulative amounts that can be claimed) are drafted clearly. In a volatile or distressed environment, these provisions may become more frequently engaged. Parties should similarly evaluate how such provisions might affect their commercial operations across a range of market scenarios.

Here, it is sensible not to assume that these provisions will only be triggered sporadically, or in a market environment similar to that at the time of negotiation. Approaching provisions in this way may help guard against the adverse financial consequences that can flow from such clauses being applied to circumstances not directly anticipated when the contract was drafted.



4) Lessons from recent *force majeure* declarations

The war in the Gulf has provided a vivid reminder of the risks of chokepoints in international supply chains. The semiconductor industry's exposure to similar risks is well-understood.

It is therefore sensible to consider how the *force majeure* provisions in a long-term contract might operate in the event of disruption. The semiconductor industry has seen recent reports of some suppliers of critical inputs only being able to supply some of their buyers, but not all of them, because of the impact of the conflict. How does this kind of situation impact a manufacturer's ability to declare *force majeure*, given clauses will typically require the claiming party to have sought to continue performing their contract in some way? Does a supplier need to secure alternative supplies to continue performance, and, if so, how hard do they need to try? How does a party wishing to claim *force majeure* choose who to supply and who not to? And if a company's manufacturing output comes to a halt because one of its suppliers has declared *force majeure*, can they pass that declaration on to their customers as well?

The answers to these questions are often highly sensitive to both the prevailing facts, as well as the specific terms of the *force majeure* clause. This means that declarations of *force majeure* can often be contentious. Counterparties should therefore consider known or anticipated chokepoints or disruptions in the semiconductor supply chain and test the specific drafting of the *force majeure* provision against these when negotiating the contract. Parties should also be aware of any potentially relevant principles under the governing law of the contract. Those who cultivate an understanding of the interplay between these factors may find themselves in a better position in the event of external disruption than one who has merely presumed that a *force majeure* provision will avail them. This is obviously more pertinent to longer-term contracts, which are more likely to witness some period of disruption during the life of their terms.

Conclusion

Semiconductors have become one of the primary bottlenecks of the global economy, from data centres right down to consumer electronics. The transition of the market towards longer-term contracts is a reaction to this, and one that brings distinct legal issues. Many of these are more acute against the backdrop of a volatile market.

As the examples discussed in this piece illustrate, understanding these legal issues is important to negotiating the right contract. This in turn can help both buyer and seller maximise the commercial value of their agreement and, more importantly, avoid disputes and disruption.

Contact



Tim Flamank
Director, London
T +44 207 655 1062
M +44 754 511 0740
tim.flamank@squirepb.com

