

GSE SYSTEMS INC  
Form S-3/A  
July 26, 2006

As filed with the Securities and Exchange Commission on July 25, 2006 Registration No. 333-

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SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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Amendment No. 1  
to  
FORM S-3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

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GSE SYSTEMS, INC.  
(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

52-1868008  
(I.R.S. Employer Identification Number)  
7133 Rutherford Road, Suite 200  
Baltimore, MD 21244  
(410) 277-3740

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

John V. Moran  
Chief Executive Officer  
GSE Systems, Inc.  
7133 Rutherford Road, Suite 200  
Baltimore, MD 21244  
Tel: (410) 277-3740  
Fax: (410) 277-5287

(Name and address, including zip code, and telephone number, including area code, of agent for service)

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Copy to:

James R. Hagerty, Esq.  
888 17<sup>th</sup> Street, N.W., Suite 1000  
Washington, DC 20006  
Tel: (202) 223-5600  
Fax: (202) 223-6625

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**Approximate date of commencement of proposed sale to the public:** As soon as practicable after the effective date of this Registration Statement.

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If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. ( )

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. (x )

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ( )

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ( )

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. ( )

If this form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the commission pursuant Rule 462(e) under the Securities Act, check the following box: ( )

If this form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box: ( )

## CALCULATION OF REGISTRATION FEE

Title of each class of securities to be registered	Amount to be Registered	Proposed maximum offering price per share	Proposed maximum aggregate offering price (5)	Amount of registration fee
Common stock, par value \$0.01 per share, issuable upon conversion of the Company's Series A 8% cumulative convertible preferred stock	2,401,133 (1)	\$1.77	\$4,250,000	\$455
Common stock, par value \$0.01 per share, issuable upon exercise of warrants	480,226 (1)	\$1.77	\$850,000	\$91
Common stock, par value \$0.01 per share, issuable upon exercise of warrants	150,000 (2)	\$1.77	\$265,500	\$29
Common stock, par value \$0.01 per share, issuable upon exercise of warrants	900,000 (3)	\$0.67	\$603,000	\$65
Common stock, par value \$0.01 per share, issuable upon exercise of warrants	367,647 (4)	\$0.01	\$3,676	\$0.40
				\$640.40

(1) Represents shares of our Common Stock issuable upon conversion of the Series A 8% Cumulative Convertible Preferred Stock or upon exercise of Warrants issued in connection with our private placement offering, which closed as of February 28, 2006. The securities being registered hereby do not consist of such indeterminate number of additional shares of common stock as may become issuable upon conversion of such convertible preferred stock or exercise of such warrants to prevent dilution resulting from stock splits, stock dividends or similar transactions, nor do they include such number of additional common stock that may be issued from time to time as a result of anti-dilution adjustments or missed dividend payments pursuant to the terms of the Convertible Preferred Stock and Warrants. The Company shall register such additional shares of Common Stock as necessary.

(2) Represents shares of our Common Stock issuable upon exercise of a warrant issued to Northeast Securities, Inc. as a placement agent fee in connection with the private placement offering, which closed as of February 28, 2006.

(3) Represents shares of our Common Stock issuable upon exercise of a warrant issued to Dolphin Direct Equity Partners, LP in connection with that certain Cancellation and Warrant Exchange Agreement, dated as of February 28, 2006.

(4) Represents shares of our Common Stock issuable upon exercise of a warrant issued to Laurus Master Fund, Ltd. in connection with the Company's new two-year revolving line of credit.

(5) Estimated solely for purposes of calculating the registration fee pursuant to Rule 457(c) of Regulation C under the Securities Act.

**THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933, AS AMENDED, OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE SECURITIES AND EXCHANGE COMMISSION ACTING PURSUANT TO SAID SECTION 8(A), MAY DETERMINE.**

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**The information in this Prospectus is not complete and may be changed. The selling shareholders may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

**SUBJECT TO COMPLETION, DATED JULY 25, 2006**

**PROSPECTUS**

**GSE SYSTEMS, INC.**

**Shares of Common Stock Issuable upon Conversion of Units Consisting of up to \$4,250,000 of  
8% Cumulative Convertible Preferred Stock and Warrants  
and  
Shares of Common Stock Issuable upon Exercise of Warrants**

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**Investing in our securities involves a significant degree of risk. You should carefully read this prospectus and consider the matters described in "Risk Factors" before you decide to invest in these securities.**

Our common stock is listed on the American Stock Exchange under the symbol "GVP." For a more detailed description of our securities, see "Description of Our Share Capital" section of this prospectus. On February 28, 2006, the closing sale price of the common stock on the American Stock Exchange was \$1.61. These securities have not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this Prospectus. Any representation to the contrary is a criminal offense.

This Prospectus does not constitute an offer to sell or the solicitation of an offer to buy any securities. Changes may occur after the date of this Prospectus and GSE Systems will not update the information contained herein except in the normal course of their respective public disclosures.

This prospectus relates to the disposition by the selling stockholders of up to 4,299,006 shares of our Common Stock issuable upon the conversion of Preferred Stock and the exercise of warrants issued for the account of the stockholders named in this prospectus.

The selling stockholders may sell the shares of common stock described in this prospectus in a number of different ways and at varying prices. We provide more information about how the selling stockholders may sell their shares of common stock in the section entitled "Plan of Distribution". We will not be paying any underwriting discounts or commissions in this offering.

Stockholders with inquiries related to the Offering should contact Jeff Hough at (410) 277-3740.

The information contained in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus.

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**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation**

**to the contrary is a criminal offense.**

The date of this prospectus is July \_\_\_\_\_, 2006.

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**TABLE OF CONTENTS**

	<b>Page</b>
PROSPECTUS SUMMARY	1
RISK FACTORS	6
FORWARD LOOKING STATEMENTS	10
GUIDE TO READING THIS PROSPECTUS	11
USE OF PROCEEDS	11
DIVIDEND POLICY	12
DESCRIPTION OF SHARE CAPITAL	12
DESCRIPTION OF SECURITIES TO BE REGISTERED	13
DETERMINATION OF OFFERING PRICE	16
SELLING SECURITY HOLDER	16
PLAN OF DISTRIBUTION	20
INTERESTS OF NAMED EXPERTS AND COUNSEL	22
WHERE YOU CAN FIND MORE INFORMATION	23
INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE	23

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## PROSPECTUS SUMMARY

**This section contains a general summary of the information contained in this prospectus and highlights selected information described in greater detail elsewhere or incorporated by reference in this prospectus. You should carefully read this entire prospectus, including the risk factors beginning on page 6, and the documents incorporated by reference in this prospectus to fully understand the offering and our business, results of operations and financial condition. The information in this prospectus is not complete and may be changed. The selling stockholders named in this prospectus may not sell these securities until the registration statement filed with the Securities and Exchange Commission becomes effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted. Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy and accuracy of this prospectus. Any representation to the contrary is a criminal offense.**

This prospectus relates to the sale by the selling stockholders of up to 4,299,006 shares of our Common Stock issuable upon the conversion of Preferred Stock and the exercise of warrants issued in three separate transactions (summarized below) for the account of the stockholders named in this prospectus. The selling stockholders may sell the Common Stock from time to time in the principal market on which the stock is traded at the prevailing market price or in negotiated transactions. We will pay the expense of registering these shares.

The three transactions are summarized here and are more fully explained in separate sections below:

1. On February 28, 2006, we sold units consisting of up to \$4,250,000 of Series A 8% Cumulative Convertible Preferred Stock (the "Preferred Stock") and Warrants (the "Warrants") in a private offering exempt from registration under the Securities Act of 1933. Northeast Securities, Inc. ("Northeast Securities") acted as placement agent for this offering. We entered into a registration rights agreement with the individual investors and with the placement agent in the offering in which we agreed, for the benefit of the holders of the Preferred Stock and Warrants, to file a registration statement with the U.S. Securities and Exchange Commission (the "SEC"), with respect to the resale of the Common Stock issuable upon conversion of the Preferred Stock and upon exercise of the Warrants. The exercise price for the Preferred Stock and Warrants is \$1.77 per share.
2. On February 28, 2006, we entered into a Cancellation and Warrant Exchange Agreement with Dolphin Direct Equity Partners, LP (the "Cancellation Agreement"). Pursuant to that Cancellation Agreement, we issued Dolphin a warrant to purchase 900,000 shares of our Common Stock at an exercise price equal to \$0.67 per share. See page 13, "The Preferred Stock".
3. On March 7, 2006, we entered into a new two-year revolving credit facility with Laurus Master Fund, Ltd. ("LMF"), a limited liability company organized under the laws of the Cayman Islands, in an amount up to \$5.0 million (the "New Facility"). The exact amount of the New Facility that the Company is permitted to draw will be based on the Company's accounts receivable at an advance rate equal to 90% of eligible billed receivables and 40% of unbilled receivables (subject to a cap of \$1.0 million on unbilled receivables) at the time of such draw. In consideration of the New Facility, we issued LMF a warrant to purchase 367,647 shares of our Common Stock at an exercise price of \$0.01 per share.

### The Company

#### General



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GSE Systems, Inc. (the “Company,” “GSE” or “GSE Systems” or “we” or “us”) is organized under the laws of the State of Delaware and is a leader in real-time, high fidelity simulation. The Company provides simulation solutions and services to the nuclear and fossil electric utility industry, the chemical and petrochemical industries and to the U.S. Military Complex. In addition, the Company provides plant monitoring and signal analysis monitoring and optimization software primarily to the power industry. GSE Systems, Inc.’s executive offices are located at 7133 Rutherford Road, Suite 200, Baltimore, Maryland 21244. The Company’s telephone number is (410) 277-3740 and its facsimile number is (410) 277-5287. GSE maintains a Web site at <http://www.gses.com>. Nothing contained in such Web site should be deemed a part of this Memorandum.

## Recent Developments

In 2005, the Company incurred a net loss of \$4.8 million. The Company's revenue and profitability were impacted by the low volume of orders logged in 2004 and 2005 and the Company's backlog decreased from \$19.6 million at December 31, 2004 to \$12.3 million at December 31, 2005. In addition, the Company continued to spend heavily on business development activities in order to expand the Company's simulation business into new sectors, such as integrating its simulation capabilities with broader training and educational programs. Accordingly, the Company's cash position weakened during the year, with total cash used in operating activities of \$1.9 million.

The Company received \$2.0 million through the sale of a Senior Subordinated Secured Convertible Note ("Dolphin Note") to Dolphin Direct Equity Partners, LP ("Dolphin") in May 2005, and the Company utilized \$1.2 million of its \$1.5 million credit facility in 2005.

In May 2005, the Company's lease for the Baltimore facility was amended to release the Company from its rental obligation for 14,000 sq.ft. of the total 34,000 sq. ft. being leased effective October 1, 2005. In October 2005, the Company relocated its Maryland operations from its facility in Columbia to the Baltimore facility.

Also in October 2005, the Company signed an "Assignment of Lease and Amendment to Lease" that assigns and transfers to another tenant (the "assignee") the Company's rights, title and interest in its Columbia, Maryland facility lease. The assignee's obligation to pay rent under the lease began on February 1, 2006. The Company remains fully liable for the payment of all rent and for the performance of all obligations under the lease through the scheduled expiration of the lease, May 31, 2008, should the assignee default on its obligations.

Finally, the Company took actions that will reduce its operating expenses in 2006, including the termination of a number of employees and the restructuring of the two facility leases discussed above.

## Description of the February 27, 2006 Offering

The Company offered Units consisting of up to \$4.25 million of shares of Preferred Stock and Warrants. The minimum investment was \$50,000 and the price per share of Preferred Stock was \$100 (or 500 shares per the minimum investment). The Preferred Stock is convertible at any time into a total of 2,401,133 shares of GSE Common Stock at a conversion price of \$1.77 per share. The conversion price was equal to 110% of the closing price of the Company's Common Stock on February 28, 2006, the date the sale of the Convertible Preferred Stock was completed. In addition to Preferred Stock, each investor received a five-year Warrant to purchase GSE Common Stock equal to 20% of the shares they would receive from the conversion of the Convertible Preferred Stock, at an exercise price of \$1.77. In aggregate, the Company issued Warrants to purchase a total of 480,226 shares of GSE Common Stock.

The Preferred Stock holders are entitled to an 8% cumulative dividend, payable on a semiannual basis every June 30 and December 30. If the Company does not make two consecutive dividend payments on the dates such payments are due, there will be an additional 30% warrant coverage of five-year warrants at a conversion price of \$1.77 per share. At any time after March 1, 2007, the Company has the right to convert the Preferred Stock into shares of GSE common stock when the average of the current stock price during the twenty trading days immediately prior to the date of such conversion exceeds 200% of the Series A Conversion Price. The holders of the Preferred Stock are entitled to vote on all matters submitted to the stockholders for a vote, together with the holders of the voting common stock, all voting together as a single class. The holders of the Convertible Preferred Stock are entitled to the number of votes equal to the number of GSE Common Stock that they would receive upon conversion of their Preferred Stock.

The Company paid the placement agent 6% of the gross proceeds received by the Company from the offering (\$255,000) plus five-year warrants to purchase 150,000 shares of the Company's Common Stock at an exercise price of \$1.77 per share (the "NESC Warrant"). On March 5, 2006, counsel for the placement agent notified the Company that the placement agent had assigned a portion of the NESC Warrant to certain of the selling stockholders identified in the "Selling Security Holders" section of this Prospectus (See also Footnote 18).

This offering was made on an "any and all" basis. That is, funds tendered for payment of the subscription purchase price were not maintained in an escrow or other account until a minimum number of units had been sold. Rather, as acceptable subscriptions were received by the Company, they were accepted in whatever order the Company determined. Upon acceptance of each subscription, the accompanying payment became the property of the Company and may have been applied by the Company to any of its business purposes and uses. Subscriptions were submitted and received on an irrevocable basis.

This offering was made only to "accredited investors," as that term is used in rules and regulations of the SEC.

The proceeds of the private placement offering were used to pay off the Dolphin Note and the Company's line of credit balance and for other working capital purposes.

### **Description of the Cancellation and Warrant Exchange Agreement**

On February 28, 2006 the Company and Dolphin Direct Equity Partners, LP, a Delaware limited partnership ("Dolphin"), entered into a Cancellation and Warrant Exchange Agreement (the "Cancellation Agreement"). Pursuant to the terms of the Cancellation Agreement, Dolphin agreed to cancel its senior subordinated secured convertible promissory note issued by the Company to Dolphin on May 26, 2005 in the aggregate principal amount of \$2,000,000 (the "Note"), all as further provided for in the Senior Subordinated Secured Convertible Note and Warrant Purchase Agreement dated as of May 26, 2005 (the "Purchase Agreement") wherein the Company agreed to issue to Dolphin a warrant to purchase an aggregate of 380,952 shares of common stock, par value \$0.01 per share (the "Exchange Warrant") in addition to the Note.

In exchange for Dolphin's agreement to enter into the Cancellation Agreement and for the participation of Dolphin Offshore Partners, L.P. in the private placement offering, the Company paid off the Note and exchanged the warrant issued pursuant to the Purchase Agreement for the Exchange Warrant. Upon exercise of the Exchange Warrant, Dolphin will acquire 900,000 shares of the Company's common stock at a price per share (the "Exercise Price") equal to \$0.67 cents. Dolphin must exercise the Exchange Warrant promptly after the Company certifies to Dolphin on or after May 30, 2006 (the "Mandatory Exercise Date") that (i) the Company has filed a registration statement with respect to the resale of the Common Stock issuable upon exercise of the Exchange Warrant and such registration statement shall have been declared effective by the Commission, (ii) the Common Stock has been listed on the American Stock Exchange and the Company has not received any communication from such exchange regarding the Company's failure to meet listing qualifications or the institution of any delisting proceeding at any time up to and including the Mandatory Exercise Date, (iii) the Current Stock Price shall not be less than \$1.25 on the Mandatory Exercise Date and (iv) the average of the Current Stock Prices for each trading day of the 30 calendar day period up to and including the Mandatory Exercise Date shall not be less than \$1.25. The Company also agreed to use its best efforts to file a registration statement with respect to the resale of the Common Stock issuable upon exercise of the Exchange Warrant with the Commission within 30 days after the original issuance of the Preferred Stock and Warrants as set forth in the Registration Rights Agreement.

The Company also agreed to pay to Dolphin Advisors, L.L.C. a transaction fee in the amount of \$3,000 in respect of services it rendered to Dolphin related to the Cancellation Agreement transaction. Furthermore, Dolphin Offshore Partners, L.P., an affiliate of Dolphin, agreed to invest in the Company's private placement offering.

### **Description of the New Two-Year Revolving Credit Facility**

On March 7, 2006, GSE entered into the New Facility with LMF in an amount up to \$5.0 million (all as further described in the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein). The exact amount of the New Facility that the Company is permitted to draw will be based on the Company's accounts receivable at an advance rate equal to 90% of eligible billed receivables and 40% of unbilled receivables (subject to a cap of \$1.0 million on unbilled receivables) at the time of such draw. The interest rate on the New Facility is the Prime Rate (as reported in the *Wall Street Journal*) plus 2.0%, provided that the minimum interest rate is 8.0%.

The New Facility is secured by a first lien on certain assets and receivables of the Company as set out more fully in that certain Security Agreement dated as of March 7, 2006 (attached as an Exhibit to the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein), including but not limited to: (i) a security interest in the patents and trademarks of the Company and GSE Power Systems, Inc. ("GSE Power"), a Delaware corporation and wholly owned subsidiary of GSE Systems, Inc.; (ii) a security interest in favor of LMF in all of the right, title and interest of the Company in and to any and all equity interests (including, without limitation, limited liability company interests and membership interests) from time to time issued by GSE Services, LLC ("GSE Services"), a Delaware limited liability company owned and controlled by the Company; and (iii) a security interest in certain defined collateral of (a) MSHI, Inc. ("MSHI"), a Virginia corporation and wholly owned subsidiary of the Company, (b) GSE Power, (c) GSE Erudite Software, Inc. ("GSE Erudite"), a Delaware corporation and wholly owned subsidiary of the Company, (d) GSE Process Solutions, Inc. ("GSE Process"), a Delaware corporation and wholly owned subsidiary of the Company, and (e) GSE Government & Military Simulation Systems, Inc. ("GSE Military" and together with MSHI, GSE Power, GSE Erudite, GSE Process, GSE Military and GSE Services, the "Subsidiaries"), a Delaware corporation and wholly owned subsidiary of the Company.

In connection with entering into the New Facility, the Company also issued to LMF a Warrant to purchase up to 367,647 shares of the Company's Common Stock, at a price per share equal to \$0.01 (the "LMF Warrant"). The Company paid LMF \$15,000 in due diligence fees and \$30,000 in structuring fees associated with the New Facility.

The Company agreed that it would use its best efforts to prepare and file a registration statement with the Securities and Exchange Commission (the "Commission") and the American Stock Exchange within 60 days of LMF funding the New Facility and use reasonable best efforts to have such Registration Statement declared effective within 120 days thereafter.

The key agreements underlying the New Facility are more fully described below and were attached as exhibits to the Form 8-K filed with the SEC on March 13, 2006:

*Subsidiary Guaranty:* In consideration of the Company and LMF entering into the New Facility, the Subsidiaries unconditionally guaranteed all present and future obligations and liabilities of any and all kinds of each Company to LMF. The Guaranty is a guaranty of payment and not of collection. LMF has no obligation to take any action against any company, person or entity liable with respect to any of the obligations or resort to any collateral security held by it to secure any of the obligations as a condition precedent to the Subsidiaries being obligated to perform. Each Subsidiary waived any and all statutory or common law rights which would require LMF to seek redress first from any liable person or entity before seeking redress from the Subsidiary. LMF is also under no obligation to marshal any assets in favor of Subsidiaries, or against or in payment of any or all of the obligations. Each of the Subsidiaries also waived all suretyship defenses and any rights to interpose any defense, counterclaim or offset of any nature and description which any company may assert on the underlying debt. A complete copy of the Subsidiary Guaranty is contained in the Form 8-K filed with the Commission on March 13, 2006 and is incorporated by reference herein.



*Security Agreements and Interests:* Capitalized terms used herein have the same meaning as indicated in the Security Agreement, a complete copy of which is attached hereto as an Exhibit to the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein.

Pursuant to a Security Agreement by and among the Company, GSE Power and LMF dated as of March 7, 2006, the Company and GSE Power are jointly and severally liable for payment of interest at the Contract Rate (all as further defined in the Security Agreement filed as an Exhibit to the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein) on the unpaid principal balance of each Loan made by LMF under the Security Agreement with interest and payments being computed on the basis of actual days elapsed in a year of 360 days, with interest chargeable to the Company or GSE Power's accounts at LMF's option. Upon the occurrence or continuation of any Event of Default, the Contract Rate shall automatically be increased and all outstanding Obligations, including unpaid interest, shall continue to accrue interest from the date of such Event of Default at the Default Rate applicable to such Obligations. In the event any Company fails to deliver to LMF financial information required by the Security Agreement as specified therein, all Companies shall jointly and severally pay LMF an aggregate fee in the amount of \$250.00 per week (or portion thereof) for each such failure until such failure is cured or waived in writing by Laurus.

In addition, upon execution of the Security Agreement, the Company agreed to pay Laurus Capital Management, LLC ("LCM") a closing payment in an amount equal to three and three-fifths (3.60%) of the Capital Availability Amount which would be deemed fully earned on the Closing Date and not be subject to rebate or pro-ration. In the event the Loans exceed the Formula Amount (each such event, an "Overadvance"), all such Overadvances shall bear additional interest at a rate equal to one and one half percent (1.5%) per month of the amount of such Overadvances. All amounts Overadvances incurred are due and payable by the Companies monthly, in arrears, on the first business day of each calendar month and upon expiration of the Term. All amounts that are incurred are due and payable by the Company monthly, in arrears, on the first business of each calendar month and upon expiration of the Term. Furthermore, the Company paid LMF \$15,000 in due diligence fees and \$30,000 in structuring fees associated with the New Facility.

Pursuant to the terms of that certain Grant of Security Interest in Patents and Trademarks by and among GSE Systems, GSE Power and LMF dated March 7, 2006 (attached hereto as an Exhibit to the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein), LMF was granted a security interest that extends to all right, title and interest in and to the Trademarks and Patents, and all proceeds thereof, together with the business as well as the goodwill of the business symbolized by, or related or pertaining to, the Trademarks, and the customer lists and records related to the Trademarks and Patents and all causes of action which may exist by reason of infringement of any of the Trademarks and Patents (collectively, the "T&P Collateral").

*Stock Pledge Agreement:* Pursuant to a Stock Pledge Agreement by and among GSE Services, MSHI, GSE Power and GSE Process and LMF dated as of March 7, 2006, each of which pledged and granted a security interest to LMF in certain collateral (the "Collateral") to include certain shares of stock together with (i) any additional shares of stock or other equity interests acquired by any Pledgor, the "Pledged Stock"; (ii) the certificates representing the Pledged Stock and all dividends, cash, instruments and other property or proceeds from time to time received, receivable or otherwise distributed in respect of or in exchange for any or all of the Pledged Stock; (iii) all additional shares of stock of any issuer (each, an "Issuer") of the Pledged Stock acquired by any Pledgor in any manner, including stock dividends or a distribution (in connection with any increase or reduction of capital, reclassification, merger, consolidation, sale of assets, combination of shares, stock split, spin-off or split-off); (iv) the certificates representing such additional shares, and (v) all dividends, cash, instruments and other property or proceeds received, receivable or otherwise distributed in respect of or in exchange for any or all of such shares; (vi) and all options and rights to any shares of any Pledged Stock and all dividends, cash, instruments and other property or proceeds received, receivable or otherwise distributed in respect of or in exchange for any or all such options and rights.

### **Registration Rights**

In connection with each of the above described transactions, the Company agreed that it would use its best efforts to prepare and file a registration statement with the Securities and Exchange Commission (the "Commission") and the American Stock Exchange within 60 days of the completion of the foregoing transactions to cover resales of the Common Stock underlying the securities.

### **Other Information**

Our common stock trades on the American Stock Exchange under the symbol "GVP."

Our principal executive offices are located at 7133 Rutherford Road, Suite 200, Baltimore, Maryland 21244. Our telephone number is (410) 277-3740.

Our website address is [www.gses.com](http://www.gses.com). Except for any documents that are incorporated by reference into this prospectus that may be accessed from our website, the information available on or through our website is not part of this prospectus.

### **RISK FACTORS**

You should carefully consider the risks described below before making an investment decision. The risks and uncertainties described below may not be the only ones we will face. Additional risks and uncertainties not presently known to us or that we currently deem not material may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In such case, the trading price of our common stock could decline, and you may lose all or part of your investment.

**The Company has limited cash resources. If the Company is unable to generate adequate cash flow from operations, it will need additional capital to fund its operations.**

In 2005, the Company incurred a net loss of \$4.8 million. The Company's revenue and profitability were impacted by the low volume of orders logged in 2004 and 2005 and the Company's backlog decreased from \$19.6 million at December 31, 2004 to \$12.3 million at December 31, 2005. In addition, the Company continued to spend heavily on business development activities in order to expand the Company's simulation business into new sectors, such as integrating its simulation capabilities with broader training and educational programs. Accordingly, the Company's cash position weakened during the year, with total cash used in operating activities of \$1.9 million. Although the Company took actions that will reduce its operating expenses in 2006, including the termination of a number of employees and by restructuring two facility leases, our ability to meet our debt obligations and to reduce our debt level depends on our future performance which is affected by general economic conditions and financial, business and other factors, and there can be no assurance the Company will continue to be able to reduce its operating expenses.

Although the Company believes that, as a result of the transactions described in this prospectus, it has sufficient liquidity and working capital for its operations in 2006, the Company may be required to look for additional capital to fund its operations if the Company is unable to operate profitably and generate sufficient cash from operations. There can be no assurance that the Company would be successful in raising such additional funds.

**The Company's expense levels are based upon its expectations as to future revenues, so it may be unable to adjust spending to compensate for a revenue shortfall. Accordingly, any revenue shortfall would likely have a disproportionate effect on the Company's operating results.**

The Company's revenue was \$22.0 million, \$29.5 million and \$25.0 million for the years ended December 31, 2005, 2004 and 2003, respectively. The Company's operating income (loss) was (\$4.7 million), \$2,000 and (\$1.0 million) in 2005, 2004 and 2003, respectively. The Company's operating results have fluctuated in the past and may fluctuate significantly in the future as a result of a variety of factors, including purchasing patterns, timing of new products and enhancements by the Company and its competitors, and fluctuating foreign economic conditions. Since the Company's expense levels are based in part on its expectations as to future revenues and includes certain fixed costs, the Company may be unable to adjust spending in a timely manner to compensate for any revenue shortfall and such revenue shortfalls would likely have a disproportionate adverse effect on operating results. The Company believes that these factors may cause the market price for its common stock to fluctuate, perhaps significantly. In addition, in recent years the stock market in general, and the shares of technology companies in particular, have experienced extreme price fluctuations. The Company's common stock has also experienced a relatively low trading volume, making it further susceptible to extreme price fluctuations.

### **Risk of International Sales and Operations**

Sales of products and the provision of services to end users outside the United States accounted for approximately 65% of the Company's consolidated revenue in 2004 and 63% of the Company's consolidated revenue in 2005. As a result, the Company may be subject to certain risks, including risks associated with the application and imposition of protective legislation and regulations relating to import or export (including export of high technology products) or otherwise resulting from trade or foreign policy and risks associated with exchange rate fluctuations. Additional risks include potentially adverse tax consequences, tariffs, quotas and other barriers, potential difficulties involving the Company's strategic alliances and managing foreign sales agents or representatives and potential difficulties in accounts receivable collection. The Company currently sells products and provides services to customers in emerging market economies such as Russia, Ukraine, Bulgaria, and the Czech Republic. Although end users in the Ukraine accounted for 18%, 21%, and 29% of the Company's consolidated revenue in 2005, 2004, and 2003, respectively, GSE's customer for these projects was Battelle's Pacific Northwest National Laboratory, which is the purchasing agent for the U.S. Department of Energy ("DOE"). The DOE provides funding for various projects in Eastern and Central Europe. Accordingly, the Company is not subject to the political and financial risks that are normally faced when doing business in the Ukraine. The Company has taken steps designed to reduce the additional risks associated with doing business in these countries, but the Company believes that such risks may still exist and include, among others, general political and economic instability, lack of currency convertibility, as well as uncertainty with respect to the efficacy of applicable legal systems. There can be no assurance that these and other factors will not have a material adverse effect on the Company's business, financial condition or results of operations.

**The Company relies on one customer for a substantial portion of its revenue. The loss of this customer could have a material adverse effect upon the Company's revenues and results of operations.**

For the years ended December 31, 2005, 2004, and 2003, one customer (Battelle's Pacific Northwest National Laboratory) accounted for approximately 25%, 24%, and 29%, respectively, of the Company's consolidated revenue. The Pacific Northwest National Laboratory is the purchasing agent for the DOE and the numerous projects the Company performs in Eastern and Central Europe. If the Company lost this customer, the Company's revenue and results of operations would be materially and adversely affected.

**The Company's business is substantially dependent on sales to the nuclear power industry. Any disruption in this industry would have a material adverse effect upon the Company's revenue.**





In 2005, 83% of GSE's revenue was from customers in the nuclear power industry. The Company will continue to derive a significant portion of its revenue from customers in the nuclear power industry for the foreseeable future. The Company's ability to supply nuclear power plant simulators and related products and services is dependent on the continued operation of nuclear power plants and, to a lesser extent, on the construction of new nuclear power plants. A wide range of factors affect the continued operation and construction of nuclear power plants, including the political and regulatory environment, the availability and cost of alternative means of power generation, the occurrence of future nuclear incidents, and general economic conditions.

**The Company's new line of credit agreement with Laurus Master Fund Ltd. imposes significant operating and financial restrictions, which may prevent it from capitalizing on business opportunities.**

GSE's new line of credit agreement imposes significant operating and financial restrictions. These restrictions affect, and in certain cases limit, among other things, the Company's ability to:

- incur additional indebtedness and liens;
- make capital expenditures;
- make investments and acquisitions and sell assets;
- consolidate, merge or sell all or substantially all of its assets.

There can be no assurance that these restrictions will not adversely affect the Company's ability to finance its future operations or capital needs or to engage in other business activities that may be in the interest of stockholders.

**The Company is dependent on product innovation and research and development, which costs are incurred prior to revenues for new products and improvements.**

The Company believes that its success will depend in large part on its ability to maintain and enhance its current product line, develop new products, maintain technological competitiveness and meet an expanding range of customer needs. The Company's product development activities are aimed at the development and expansion of its library of software modeling tools, the improvement of its display systems and workstation technologies, and the advancement and upgrading of its simulation technology. The life cycles for software modeling tools, graphical user interfaces, and simulation technology are variable and largely determined by competitive pressures. Consequently, the Company will need to continue to make significant investments in research and development to enhance and expand its capabilities in these areas and to maintain its competitive advantage.

**The Company relies upon its intellectual property rights for the success of its business; however, the steps it has taken to protect its intellectual property may be inadequate.**

Although the Company believes that factors such as the technological and creative skills of its personnel, new product developments, frequent product enhancements and reliable product maintenance are important to establishing and maintaining a technological leadership position, the Company's business depends, in part, on its intellectual property rights in its proprietary technology and information. The Company relies upon a combination of trade secret, copyright, patent and trademark law, contractual arrangements and technical means to protect its intellectual property rights. The Company enters into confidentiality agreements with its employees, consultants, joint venture and alliance partners, customers and other third parties that are granted access to its proprietary information, and limits access to and distribution of its proprietary information. There can be no assurance, however, that the Company has protected or will be able to protect its proprietary technology and information adequately, that the unauthorized disclosure or use of the Company's proprietary information will be prevented, that others have not or will not develop similar technology or information independently, or, to the extent the Company owns patents, that others have not or will not

be able to design around those patents. Furthermore, the laws of certain countries in which the Company's products are sold do not protect the Company's products and intellectual property rights to the same extent as the laws of the United States.

**The industries in which GSE operates are highly competitive. This competition may prevent the Company from raising prices at the same pace as its costs increase.**

The Company's businesses operate in highly competitive environments with both domestic and foreign competitors, many of whom have substantially greater financial, marketing and other resources than the Company. The principal factors affecting competition include price, technological proficiency, ease of system configuration, product reliability, applications expertise, engineering support, local presence and financial stability. The Company believes that competition in the simulation fields may further intensify in the future as a result of advances in technology, consolidations and/or strategic alliances among competitors, increased costs required to develop new technology and the increasing importance of software content in systems and products. As the Company's business has a significant international component, changes in the value of the dollar could adversely affect the Company's ability to compete internationally.

**The nuclear power industry, the Company's largest customer group, is associated with a number of hazards which could create significant liabilities for the Company.**

The Company's business could expose it to third party claims with respect to product, environmental and other similar liabilities. Although the Company has sought to protect itself from these potential liabilities through a variety of legal and contractual provisions as well as through liability insurance, the effectiveness of such protections has not been fully tested. Certain of the Company's products and services are used by the nuclear power industry primarily in operator training. Although the Company's contracts for such products and services typically contain provisions designed to protect the Company from potential liabilities associated with such use, there can be no assurance that the Company would not be materially adversely affected by claims or actions which may potentially arise.

**The Common Stock issuable upon conversion of the Convertible Preferred Stock may be diluted.**

The number of shares of our Common Stock issuable upon conversion is subject to adjustment only for stock splits and combinations, stock dividends and specified other transactions. The number of shares of our common stock issuable upon conversion is not subject to adjustment for other events, such as employee stock option grants, offerings of our common stock, or in connection with acquisitions or other transactions which may adversely affect the price of our Common Stock. The terms of our Convertible Preferred Stock do not restrict our ability to offer Common Stock in the future or to engage in other transactions that could dilute our Common Stock. We have no particular obligation to consider the interests of the holders of our Convertible Preferred Stock in engaging in any such offering or transaction.

**Our Convertible Preferred Stock may be diluted upon the issuance of a new series of preferred stock on parity with the shares sold in this offering.**

While the terms of our Convertible Preferred Stock restrict our ability to offer a new series of preferred stock that would rank senior to our Convertible Preferred Stock, they do not restrict our ability to offer a new series of preferred stock that is on parity with our Convertible Preferred Stock in the future or engage in other transactions that could dilute our Convertible Preferred Stock. We have no particular obligation to consider the interests of the holder of our Convertible Preferred Stock in engaging in any such offering or transaction.

**Our Convertible Preferred Stock will rank behind our current debt obligations.**

Until such time as our current debt obligations are satisfied, our Convertible Preferred Stock will rank junior to our outstanding debt obligations as to payment of dividends and distribution of assets upon dissolution, liquidation or winding up of the Company.



**You should consider the tax considerations relating to investing in the Convertible Preferred Stock and Warrants.**

Investors in this offering may face adverse federal, state and local tax consequences by virtue of their purchase, ownership and holdings of Convertible Preferred Stock and Warrants. Prospective investors should consult their own tax advisors regarding these and other possible tax consequences to them of an investment in this offering.

**FORWARD-LOOKING STATEMENTS**

This prospectus and the documents incorporated by reference herein contain “forward-looking” statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act that are based on management’s assumptions, expectations and projections about us, and the industry within which we operate, that have been made pursuant to the Private Securities Litigation Reform Act of 1995 which reflect our expectations regarding our future growth, results of operations, performance and business prospects and opportunities. Wherever possible, words such as “anticipate,” “believe,” “continue,” “estimate”, “intend”, “may,” “plan”, “potential”, “predict”, “expect”, “should”, “expressions, or the negative of these terms or other comparable terminology, have been used to identify these forward-looking statements. These forward-looking statements may also use different phrases. These statements regarding our expectations reflect our current beliefs and are based on information currently available to us. Accordingly, these statements by their nature are subject to risks and uncertainties, including those listed under “Risk Factors,” which could cause our actual growth, results, performance and business prospects and opportunities to differ from those expressed in, or implied by, these statements. Discussions containing these forward-looking statements may be found, among other places, in “Business” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” incorporated by reference from our most recent annual report on Form 10-K and in our most recent quarterly report on Form 10-Q subsequent to the filing of our most recent annual report on Form 10-K with the SEC, as well as any amendments thereto reflected in subsequent filings with the SEC. We may not actually achieve the plans, intentions or expectations disclosed in our forward-looking statements and you should not place undue reliance on our forward-looking statements. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements we make. Except as otherwise required by federal securities law, we are not obligated to update or revise these forward-looking statements to reflect new events or circumstances. We caution you that a variety of factors, including but not limited to the factors described below under the heading “Risk Factors” and the following, could cause our business conditions and results to differ materially from what is contained in forward looking statements:

- changes in the rate of economic growth in the United States and other major international economies;
- changes in investment by the nuclear and fossil electric utility industry, the chemical and petrochemical industries and the U.S. military-industrial complex;
- changes in the financial condition of our customers;
- changes in regulatory environment;
- changes in project design or schedules;
- contract cancellations;
- changes in our estimates of costs to complete projects;
- changes in trade, monetary and fiscal policies worldwide;
- currency fluctuations;
- war and/or terrorist attacks on facilities either owned or where equipment or services are or may be provided;
- outcomes of future litigation;
- protection and validity of our patents and other intellectual property rights;
- increasing competition by foreign and domestic companies;
- compliance with our debt covenants;
- recoverability of claims against our customers and others; and
- changes in estimates used in our critical accounting policies.



Other factors and assumptions not identified above were also involved in the formation of these forward looking statements and the failure of such other assumptions to be realized, as well as other factors, may also cause actual results to differ materially from those projected. Most of these factors are difficult to predict accurately and are generally beyond our control. You should consider the areas of risk described above in connection with any forward looking statements that may be made by us. You should not place undue reliance on any forward-looking statements. New factors emerge from time to time, and it is not possible for us to predict which factors will arise.

We undertake no obligation to publicly update any forward looking statements, whether as a result of new information, future events or otherwise. You are advised, however, to consult any additional disclosures we make in proxy statements, quarterly reports on Form 10-Q, annual reports on Form 10-K and current reports on Form 8-K filed with the SEC.

### **GUIDE TO READING THIS PROSPECTUS**

We urge you to read the entire prospectus, including “Risk Factors,” and the information contained in the public documents that we have filed with the Securities and Exchange Commission (the “Commission”). You should read this prospectus together with additional information described under the headings “Where You Can Find More Information” and “Incorporation of Documents by Reference.”

Certain of the information contained in this prospectus was obtained from other sources. This prospectus also incorporates by reference important business and financial information about us that is not included in or delivered with this prospectus.

You should rely only on the information contained in this prospectus or any supplement and any information incorporated by reference in this prospectus or any supplement. We have not authorized anyone to provide you with any information that is different from such information. If you receive any unauthorized information, you should not rely on it. You should disregard anything we said in an earlier document that is inconsistent with what is included or incorporated by reference in this prospectus or any supplement.

You should not assume that the information in this prospectus or any supplement is current as of any date other than the date on the front page of this prospectus or on the date of any supplement as to information contained in it. This prospectus is not an offer to sell nor is it seeking an offer to buy these securities in any state or jurisdiction where the offer or sale is not permitted.

We include cross references to captions in this prospectus where you can find further related discussions. The above table of contents tells you where to find these captions.

Throughout this prospectus, we refer to ourselves, GSE Systems, Inc. as the “Company,” “GSE” or “GSE Systems”, “we” or “us”.

### **USE OF PROCEEDS**

The Company will not receive any of the proceeds from the sale of the resale shares by the selling security holders. All proceeds from the resale of shares will be for the accounts of the selling security holders named in this prospectus, any supplement to this prospectus or in any amendment to the registration statement of which this prospectus forms a part. We will, in the ordinary course of business, receive proceeds from the issuance of shares upon exercise of the warrants described in this prospectus, which we will use for general corporate purposes.

The Company used the net proceeds of the private placement offering, in combination with currently available funds, to refinance existing senior debt obligations, fund its ongoing business operations and other general corporate



purposes, including development of new training simulators, pursuance of new contracts, marketing, and other working capital requirements.

The Company intends to draw down the New Facility for working capital and to fund its ongoing business operations and for other general corporate purposes.

### **DIVIDEND POLICY**

The holders of convertible preferred stock are entitled to receive cumulative dividends on a semiannual basis every June 30 and December 30, commencing on June 30, 2006. If the Company does not make two consecutive dividend payments on the dates such payments are due, the Company will issue to holders of Convertible Preferred Stock additional warrants to purchase such number of shares of Common Stock equal to 30% of the dollar amount invested in Convertible Preferred Stock divided by \$1.77. Should the Company miss its dividend payments and issue the additional warrants as described above, the Company will undertake to register with the SEC and with AMEX such number of additional shares of Common Stock as necessary to cover the issuance of the warrants.

Except as described above, the Company intends to retain its future earnings, if any, to finance the further development and expansion of our business and do not intend to pay dividends for the foreseeable future. Any future determination to pay dividends will be at the discretion of our board of directors and will depend on our financial condition, results of operations, capital requirements, restrictions contained in our current and future financing instruments and other factors our board of directors deems relevant.

### **DESCRIPTION OF OUR SHARE CAPITAL**

*The following description of the Company's share capital summarizes certain provisions of the Company's certificate of incorporation and by-laws and a certificate of designation in respect of the preferred shares and of applicable U.S. law. Such summaries are not complete and are subject to, and are qualified in their entirety by reference to, all of the provisions of the Company's certificate of incorporation and by-laws, and the certificate of designation in respect of the preferred shares, copies of which have been filed as exhibits to the registration statement of which this prospectus forms a part. Prospective investors are urged to read those exhibits carefully.*

#### **Authorized Capital Stock**

As of the date of this prospectus, we are authorized to issue 20,000,000 shares of common stock, par value \$0.01, of which 18,000,000 shares shall be common stock and 2,000,000 shares shall be preferred stock.

As of the date of this prospectus, the Company had 8,999,706 shares of common stock outstanding, and had reserved an additional (1) 2,401,133 shares of common stock for issuance upon conversion of the Preferred Stock, (2) 480,226 shares of common stock for issuance upon exercise of the Warrants, (3) 150,000 shares of common stock for issuance upon exercise of the NESW Warrant, (4) 900,000 shares of common stock for issuance upon exercise of the Exchange Warrant, and (5) 367,647 shares of common stock for issuance upon exercise of the LMF Warrant.

#### **Common Stock**

*Generally.* The Company's common shares, into which the Series A convertible preferred shares are convertible, are quoted on the American Stock Exchange under the symbol "GVP". Holders of common shares have no pre-emptive, redemption, conversion or sinking fund rights. The Company's by-laws provide that any variation of the rights attached to the common shares, whether by the amendment, alteration or repeal of the terms of the Company's certificate of association and by-laws relating to the common shares or resulting from any merger, amalgamation or similar business combination, or otherwise would require the approval of holders of at least three fourths of the issued and outstanding common shares, voting as a separate class. This approval can be evidenced either by a unanimous consent in writing or by a resolution passed by the requisite majority at a meeting of the holders of the common shares

at which a quorum consisting of at least two persons holding or representing one-third of the issued and outstanding common shares is present.

12

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*Liquidation.* In the event of the liquidation, dissolution or winding up of the Company, the holders of common shares are entitled to share equally and ratably (with the holders of other shares of the Company entitling the holders to liquidation rights pro rata with the common shares, including holders of preferred shares) in the assets, if any, remaining after the payment of all of the Company's debts and liabilities, subject to any liquidation preference on any outstanding preferred shares.

*Voting Rights.* Holders of common shares are entitled to one vote per share on all matters submitted to a vote of holders of common shares. Unless a different majority is required by law or by the Company's by-laws, resolutions to be approved by holders of common shares require approval by an affirmative majority of the votes cast at a meeting at which a quorum is present. The common shares and, prior to their becoming convertible, the preferred shares will vote together as a single class except in the case of circumstances which constitute a variation of the rights of the common shares or the preferred shares, as described below or as required by applicable law, when holders of common shares and preferred shares will each vote as a separate class.

*Dividend Rights.* The Company's board of directors may declare and pay dividends on the common shares or the preferred shares or make distributions out of contributed surplus from time to time unless there are reasonable grounds for believing the Company is or would, after the payment, be unable to pay its liabilities as they become due or that the realizable value of its assets would thereby be less than the aggregate of its liabilities and issued share capital and share premium accounts. The board of directors may declare that any dividend be paid wholly or partly by the distribution of shares of the Company.

## DESCRIPTION OF SECURITIES TO BE REGISTERED

### **The Preferred Stock**

Prior to the date of this Prospectus, convertible preferred shares were issued by the Company pursuant to the terms of the offering of units consisting of up to \$4.25 million of preferred shares and warrants. However, no such shares were listed on the American Stock Exchange or on any market.

*Terms of the Series A Convertible Preferred Shares.* A total of 42,500 preferred shares were designated as "Series A Convertible Preferred Shares" pursuant to a certificate of designation adopted by resolution of the board of directors of the Company. The Company began accepting subscription agreements on February 27, 2006 and the Company closed the offering on February 28, 2006. As of March 31, 2006, 42,500 such shares were issued and outstanding and no preferred shares had been converted into common shares. The material terms of the preferred shares are described below.

Holders of preferred shares have no pre-emptive, redemption, or sinking fund rights. The holders of the Series A preferred stock shall be entitled to notice of all stockholder meetings in accordance with the Company's bylaws. Except as otherwise required by applicable law, the holders of the Convertible Preferred Stock shall be entitled to vote on all matters submitted to the stockholders for a vote, together with the holders of the voting Common Stock all voting together as a single class. The holders of Preferred Stock shall be entitled to such number of votes as shall be equal to the whole number of shares of Common Stock into which holder's aggregate number of shares of Preferred Stock are convertible immediately after the close of business on the record date fixed for such meeting where the votes will be cast or the effective date of any written consent.

So long as the Preferred Stock represent ten percent (10%) or more of the outstanding voting stock of the Company (calculated as if each Preferred Stock was converted at the then-current Conversion Price), without the affirmative

vote of the holders of a majority of the outstanding Convertible Preferred Stock, all voting together as a single class, the Company shall not:

13

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(i) issue any additional equity securities or other equity securities convertible into equity securities of the Company or effect a reclassification of any of the outstanding capital stock of the Company in each case that is senior to or *pari passu* with the Preferred Stock; or

(ii) amend the Certificate of Incorporation or By-Laws of the Company in a manner that would materially adversely affect or impair the rights or preferences of the Preferred Stock.

*Dividends.* The holders of the Series A preferred stock shall be entitled to receive cumulative dividends on a semiannual basis every June 30 and December 30, commencing on June 30, 2006. Dividends on each Series A preferred share shall accrue on a daily basis from and including the date of issuance at the rate of 8% per annum of the Liquidation Value (the "Dividend Rate" as that term is defined in the Certificate of Designation, previously filed as an Exhibit to the Company's March 6, 2006 Form 8-K). The dividends shall accrue whether or not they have been declared and whether or not there are profits, surplus or other funds of the Company legally available for the payment of dividends. If the Company does not make two consecutive dividend payments on the dates such payments are due, the Company will issue to holders of Preferred Stock additional Warrants to purchase such number of shares of Common Stock equal to 30% of the dollar amount invested in Preferred Stock divided by \$1.77. Such warrants shall have other terms substantially similar to the terms of the other warrants issued to investors in the Preferred Stock.

All holders of Preferred Stock shall be *pari passu* with respect to their entitlement to receive dividends. After payment of all dividends on Preferred Stock, the holders of Preferred Stock shall be entitled to participate with the outstanding Common Stock as to any dividends payable on the Common Stock.

*Conversion of the Preferred Stock.* The certificate of designation provides that each preferred share is convertible at the holder's option into common shares at a conversion price of \$1.77. In order to effect a conversion of preferred shares, a holder must deliver a notice of conversion to the Company. Once the Company receives a notice of conversion, the holder's preferred shares will immediately cease to have the rights and restrictions of a preferred share, and the holder will simultaneously receive common shares in accordance with the terms outlined above. We will also deliver a copy of such notice at any time at the request of a holder of preferred shares. Upon such a conversion of the preferred shares, the number of authorized preferred shares will decrease and the number of authorized, issued and outstanding common shares will increase by a proportionate amount.

### **The Warrants, NESC Warrant, Exchange Warrant and LMF Warrant**

*Reservation of Shares.* We have reserved a sufficient number of common shares for issuance upon exercise of the warrants, and such common shares, when issued in accordance with the terms of the warrants, will be fully paid and non assessable.

*Dilution Protections.* The terms and conditions of the warrants protect against dilution resulting from the sale of additional common shares at a price less than the exercise price of the warrants.

*Voting and Dividends.* The holders of the warrants as such are not entitled to vote, to receive dividends or to exercise any of the rights of holders of shares of common shares for any purpose until such warrants shall have been duly exercised and payment of the exercise price shall have been made. There is no market for the warrants and there is no assurance that any such market will ever develop.

### **Market Price Information**

The following table sets forth, for the periods indicated, the high and low sale prices for the Company's common stock reported by the American Stock Exchange:



**2006**

<b><u>Quarter</u></b>		<b>High</b>		<b>Low</b>
<b>First</b>	\$	<b>1.90</b>	\$	<b>1.30</b>

**2005**

<b><u>Quarter</u></b>		<b>High</b>		<b>Low</b>
<b>First</b>	\$	<b>2.76</b>	\$	<b>1.75</b>
<b>Second</b>	\$	<b>2.20</b>	\$	<b>1.70</b>
<b>Third</b>	\$	<b>1.80</b>	\$	<b>1.25</b>
<b>Fourth</b>	\$	<b>1.58</b>	\$	<b>1.06</b>

**2004**

<b><u>Quarter</u></b>		<b>High</b>		<b>Low</b>
<b>First</b>	\$	<b>2.33</b>	\$	<b>1.72</b>
<b>Second</b>	\$	<b>2.70</b>	\$	<b>1.45</b>
<b>Third</b>	\$	<b>2.78</b>	\$	<b>2.35</b>
<b>Fourth</b>	\$	<b>2.70</b>	\$	<b>1.95</b>

The following table sets forth the equity compensation plan information as of March 31, 2006:

Plan category	Number of Securities to be issued upon exercise of outstanding options, warrants and rights	Weighted average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plan approved by security holders	2,239,634	\$3.09	46,566
Equity compensation plan not approved by security holders	--	\$ --	--
<b>Total</b>	<b>2,239,634</b>	<b>\$3.09</b>	<b>46,566</b>

There were approximately 72 holders of record of the common stock as of March 31, 2006. The Company has never declared or paid a cash dividend on its common stock. The Company currently intends to retain future earnings to finance the growth and development of its business and, therefore, does not anticipate paying any cash dividends in the foreseeable future on its common stock. In December 2001, the Company issued to ManTech International Corp. ("ManTech") 39,000 shares of convertible preferred stock which accrued dividends at an annual rate of 6% payable quarterly. ManTech elected to convert the preferred stock to common stock in October 2003. At the date of the



conversion, the Company's credit facility restricted the Company from paying any dividends on the preferred stock. At December 31, 2005, the Company had accrued dividends payable to ManTech of \$366,000. The unpaid dividends accrue interest at 6% per annum. At December 31, 2005, the Company had an accrual for interest payable of \$60,000.

The Company believes factors such as quarterly fluctuations in results of operations and announcements of new products by the Company or by its competitors may cause the market price of the common stock to fluctuate, perhaps significantly. In addition, in recent years the stock market in general, and the shares of technology companies in particular, have experienced extreme price fluctuations. The Company's common stock has also experienced a relatively low trading volume, making it further susceptible to extreme price fluctuations. These factors may adversely affect the market price of the Company's common stock.

### **DETERMINATION OF OFFERING PRICE**

The Company determined the offering price of the Preferred Stock and Warrants, the NESC Warrant, the Exchange Warrant and the LMF Warrant as a result of arms-length negotiations between the Company and the respective parties.

### **SELLING SECURITY HOLDERS**

We initially issued the preferred stock and warrants to the selling security holders, as initial purchasers in transactions exempt from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"). To the best of our knowledge and after due inquiry, with the exception of Dolphin (see "Description of the Cancellation and Warrant Exchange Agreement"), none of the selling security holders owned any of the Company's securities prior to the transactions described in the sections captioned "Prospectus Summary" and "Recent Developments."

The selling security holders, including their transferees, pledges, donees or other successors, may from time to time offer and sell pursuant to this prospectus any and all of the common stock issuable upon conversion of the preferred stock or exercise of the warrants. Any selling security holder may also elect not to sell any common stock issuable upon conversion of the preferred stock or exercise of the warrants.

To sell common stock issuable upon exercise of the Series A preferred stock or warrants pursuant to the registration statement, each investor will be required to, among other things, be named as a selling security holder in the prospectus. We are registering the shares of preferred stock and warrants in order to permit the stockholders to offer the shares for resale from time to time. None of the selling security holders has, or had, any position, office or other material relationship with us or any of our affiliates beyond their investment in or receipt of our securities, except for Dolphin Offshore Equity Partners, L.P., and Northeast Securities, Inc. (the placement agent for the private placement).

The following table is prepared based on information supplied to us by the selling security holders. Although we have assumed for purposes of the table below that the selling security holders will sell all of the shares offered by this prospectus, because the selling security holders may offer from time to time all of their shares covered under this prospectus, or in another permitted manner, no assurances can be given as to the actual number of shares that will be resold by the selling security holders or that will be held by the selling security holders after completion of the resales.

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Certain of the selling shareholders and/or their affiliates provide or from time to time have provided or in the future may provide certain investment banking and other services to us and/or our affiliates and subsidiaries, for which they receive or have received customary fees and commissions or for which we expect them to receive customary fees and commissions. In addition, affiliates of certain of the selling shareholders from time to time have acted or in the future may act as agents and lenders to us and/or our affiliates and subsidiaries under our credit facility, for which services they have received or expect to receive customary compensation.

Name of Beneficial Owner	Total Number of Shares of Common Stock	Percent of Common Stock	Total Number of Series A Preferred Stock Beneficially	Percent of Series A Preferred Stock	Percent of Total Voting