NATURAL GAS SYSTEMS INC/NEW
Form 10QSB
February 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

|X| QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended December 31, 2005
or

|_| TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (D)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period ____________ to _____________

COMMISSION FILE NUMBER 000-27862

NATURAL GAS SYSTEMS, INC.
(Exact name of registrant as specified in charter)

NEVADA	41-1781991
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)

820 Gessner, Suite 1340, Houston, Texas 77024
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: (713) 935-0122

Check whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes: |X| No:|_|

Check whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act.). Yes: |_| No: |X|

The number of shares outstanding of Registrant's common stock, par value $0.001, as of February 1, 2006, was 24,948,364.

Transitional Small Business Disclosure Format (Check one): Yes: |_| No: |X|

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PART I - FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NATURAL GAS SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2005	June 30, 2005
	(Unaudited)	
Assets		
Current Assets:		
Cash	$ 433,465	$ 2,548,688
Accounts receivable, trade	316,162	300,761
Inventories (materials & supplies)	455,247	222,470
Prepaid expenses	132,788	84,304
Retainers and deposits	66,335	56,335
Total current assets	1,403,997	3,212,558
Oil & Gas properties - full cost	6,589,365	5,276,303
Oil & Gas properties - not amortized	44,844	61,887
Less: accumulated depletion	(502,739)	(313,391)

Net oil & gas properties	6,131,470	5,024,799
Furniture, fixtures, and equipment, at cost	14,684	12,113
Less: accumulated depreciation	(5,734)	(3,401)
Net furniture, fixtures, and equipment	8,950	8,712
Restricted deposits	868,263	863,089
Other assets	318,080	356,066
Total assets	$ 8,730,760	$ 9,465,224

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:		
Accounts payable	$ 400,161	$ 240,389
Accrued liabilities	261,225	276,470
Notes payable, current	0	6,754
Royalties payable	123,586	89,713
Total current liabilities	784,972	613,326
Long term Liabilities:		
Notes payable	4,000,000	4,000,000
Discount on notes payable	(1,023,776)	(1,093,452)
Asset retirement obligations	447,315	433,250
Total liabilities	4,208,511	3,953,124
Stockholders' Equity:		
Common Stock, par value $0.001 per share; 100,000,000 shares authorized, 24,788,364 and 24,774,606 shares issued and outstanding as of December 31, 2005 and June 30, 2005, respectively	24,788	24,774
Additional paid-in-capital	9,706,584	9,611,767
Deferred stock based compensation	(338,023)	(595,283)
Accumulated deficit	(4,871,100)	(3,529,158)
Total stockholders' equity	4,522,249	5,512,100
Total liabilities and stockholders' equity	$ 8,730,760	$ 9,465,224

See accompanying notes to condensed consolidated financial statements.

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NATURAL GAS SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended December 31, 2005	Three Months Ended December 31, 2004	Six Months Ended December 31, 2005	Six Months Ended December 31, 2004
Revenues:				
Oil sales	$ 557,439	$ 250,931	$ 1,043,834	$ 415,454
Gas sales	278,955	114,837	336,888	181,481
Price risk management activities	(5,458)	0	(6,902)	0
Total revenues	830,936	365,768	1,373,820	596,935
Expenses:				
Lease operating costs	398,686	193,469	862,876	331,217
Production taxes	21,536	12,470	36,020	28,494
Depreciation, depletion and amortization	114,431	53,986	191,681	101,092
General and administrative	662,106	540,569	1,246,384	851,704
Total operating expenses	1,196,759	800,494	2,336,961	1,312,507
Loss from operations	(365,823)	(434,726)	(963,141)	(715,572)
Other revenues and expenses:				
Interest income	14,955	2,621	33,892	6,097
Interest expense	(191,016)	(41,102)	(412,694)	(66,368)
Total other revenues and expenses	(176,061)	(38,481)	(378,802)	(60,271)
Net loss	$ (541,884)	$ (473,207)	$ (1,341,943)	$ (775,843)
Loss per common share, basic and diluted	$ (0.02)	$ (0.02)	$ (0.05)	$ (0.03)
Weighted average number of common shares, basic and diluted	24,780,405	23,357,807	24,778,730	23,334,443

See accompanying notes to condensed consolidated financial statements.

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NATURAL GAS SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

	Six months Ended December 31, 2005	Six months Ended December 31, 2004

Cash flow from operating activities:		
Net loss	$ (1,341,943)	$ (775,843)
Adjustments to reconcile net loss to net cash used by operating activities:		
Stock-based compensation	269,351	111,120
Depletion	189,348	101,092
Depreciation	2,333	772
Accretion of asset retirement obligation	14,065	6,581
Accretion of debt discount and non-cash interest	130,178	0
Other non-cash items	50,232	0
Changes in assets and liabilities:		
Accounts receivable	(15,401)	(64,741)
Inventories	(232,777)	(47,855)
Accounts payable	159,772	484,690
Royalties payable	33,873	0
Prepaid expenses	(48,484)	(12,772)
Accrued liabilities	(15,245)	128,501
Net cash used by operating activities	(804,698)	(68,455)
Cash flow from investing activities:		
Capital expenditures for oil and gas properties	(1,296,019)	(885,660)
Capital expenditures for furniture, fixtures and equipment	(2,571)	0
Restricted deposits and retainers	(15,174)	0
Other assets	9,993	(53,255)
Net cash used in investing activities	(1,303,771)	(938,915)
Cash flow from financing activities:		
Proceeds from notes payable	0	977,875
Payments on notes payable	(6,754)	(775,972)
Proceeds from issuance of common stock	0	529,199
Net cash provided by (used in) financing activities	(6,754)	731,102
Net decrease in cash	(2,115,223)	(276,268)
Cash and cash equivalents, beginning of period	2,548,688	367,831
Cash and cash equivalents, end of period	$ 433,465	$ 91,563
Supplemental disclosure of cash flow information:		
Interest paid	$ 282,516	$ 18,452

See accompanying notes to condensed consolidated financial statements.

NATURAL GAS SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization and Basis of Preparation

Headquartered in Houston, Texas, Natural Gas Systems, Inc. (the "Company", "NGS", "we" or "us") is a petroleum company incorporated under the laws of the State of Nevada, engaged primarily in the acquisition, exploitation and development of properties for the production of crude oil and natural gas from underground reservoirs. We acquire established oil and gas properties and exploit them through the application of conventional and specialized technology to increase production, ultimate recoveries, or both. At December 31, 2005, we conducted operations through the 100% working interests we own in our Delhi Field and Tullos Field Area, all located in Louisiana.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and, with the instructions to Form 10-QSB and Item 310(b) of Regulation S-B. All adjustments (consisting of normal recurring accruals) which are, in the opinion of management, necessary for a fair presentation of the results of operations for the interim periods have been included. All inter-company transactions are eliminated upon consolidation. The interim financial information and notes hereto should be read in conjunction with our 2005 Annual Report on Form 10-KSB and Form 10-KSB/A for the year ended June 30, 2005, as filed with the Securities and Exchange Commission. The results of operations for the three and six months ended December 31, 2005 are not necessarily indicative of results to be expected for the entire fiscal year.

2. Recent Accounting Pronouncements

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R "Shared Based Payment" ("SFAS 123R"). This statement is a revision of SFAS Statement No. 123 "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. SFAS 123R addresses all forms of shared based compensation ("SBP") awards, including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. Under SFAS 123R, SBP awards result in a cost that will be measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest and will be reflected as compensation cost in the historical financial statements. This statement is effective for public entities that file as small business issuers as of the beginning of the first interim or annual reporting period of the registrant's first fiscal year beginning after December 15, 2005. We are in the process of evaluating whether SFAS No. 123R will have a significant impact on our overall results of operations or financial position.

3. Asset Retirement Obligations

SFAS No. 143, "Accounting for Asset Retirement Obligations," ("SFAS 143") provides accounting requirements for retirement obligations associated with tangible long-lived assets, including: 1) the timing of liability recognition; 2) initial measurement of the liability; 3) allocation of asset retirement cost to expense; 4) subsequent measurement of the liability; and 5) financial statement disclosures. SFAS 143 requires that an asset retirement cost should be capitalized as part of the cost of the related long-lived asset and subsequently allocated to expense using a systematic and rational method.

The reconciliation of the beginning and ending asset retirement obligation for the period ending December 31, 2005 is as follows:

Asset retirement obligation at June 30, 2005	$ 433,250
Liabilities incurred	--
Liabilities settled	--
Accretion expense	14,065
Asset retirement obligation at December 31, 2005	$ 447,315

4. Loss per Share

Basic earnings per share is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share are determined on the assumption that outstanding stock options have been converted using the average price for the period. For purposes of computing earnings per share in a loss year, potential common shares have been excluded from the computation of weighted average common shares outstanding, because their effect is anti-dilutive.

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The following table sets forth the computation of basic and diluted earnings (loss) per share:

	Three months ended December 31	
	2005	2004
Numerator:		
Net loss applicable to common stockholders	$ (541,884)	$ (473,207)
Plus income impact of assumed conversions:		
Preferred stock dividends	N/A	N/A
Interest on convertible subordinated notes	N/A	N/A
Net loss applicable to common stockholders plus assumed conversions	$ (541,884)	$ (473,207)
Denominator:	24,780,405	23,357,807
Affect of potentially dilutive common shares:		
Warrants	N/A	N/A
Employee and director stock options	N/A	N/A
Convertible preferred stock	N/A	N/A
Convertible subordinated notes	N/A	N/A
Redeemable preferred stock	N/A	N/A
Denominator for dilutive earnings per share - weighted average shares	24,780,405	23,357,807
Loss per common share:		

Basic and diluted	$ (0.02)	$ (0.02)

	Six months ended December 31	
	2005	2004
Numerator:		
Net loss applicable to common stockholders	$ (1,341,943)	$ (775,843)
Plus income impact of assumed conversions:		
Preferred stock dividends	N/A	N/A
Interest on convertible subordinated notes	N/A	N/A
Net loss applicable to common stockholders plus assumed conversions	$ (1,341,943)	$ (775,843)
Denominator:	24,778,730	23,334,443
Affect of potentially dilutive common shares:		
Warrants	N/A	N/A
Employee and director stock options	N/A	N/A
Convertible preferred stock	N/A	N/A
Convertible subordinated notes	N/A	N/A
Redeemable preferred stock	N/A	N/A
Denominator for dilutive earnings per share - weighted average shares	24,778,730	23,334,443
Loss per common share:		
Basic and diluted	$ (0.05)	$ (0.03)

5. Long-term Debt

On February 3, 2005 we closed a financing agreement with Prospect Energy Corporation (the "Prospect Facility" or "Facility") and ultimately borrowed $4,000,000, secured by all of our assets. At December 31, 2005, our book balance was $2,976,224, net of the discount through such date. At maturity, or exclusive of any prepayment penalty on early prepayment, the total amount owed under the Facility will be $4,000,000.

Among other restrictions and subject to certain exceptions, the Facility restricts us from creating liens, entering into certain types of mergers or consolidations, incurring additional indebtedness, changing the character of our business, or engaging in certain types of transactions. The Facility also requires us to maintain specified financial ratios, including a 1.5:1 ratio of borrowing base to debt and, a 2.0:1 ratio of operating cash flow to interest expense (exclusive of accretion expense).

Effective September 22, 2005, we entered into an amendment to the Facility, thereby obtaining covenant relief with respect to our obligation to maintain an

Earnings Before Interest (cash basis), Taxes, Depreciation and Amortization ("EBITDA") to interest payable coverage ratio of 2.0:1. The amendment changes our compliance date to begin not later than the three months ended January 31, 2006, as compared to October 31, 2005 under the original terms of the agreement. This amendment was effected in order to allow us to proceed with the delayed drilling program of proved undeveloped reserve locations in our Delhi Field, the results of which we are relying on to achieve the EBITDA coverage ratio required of us by the Prospect Facility. In consideration for the amendment, we issued to Prospect Energy Corporation (Prospect) revocable warrants to purchase 200,000 shares of our common stock, exercisable at $1.36 per share over five years. As a result, $32,509, representing the fair value of the warrants, as determined using the Black-Scholes option pricing model, was charged to interest expense during the three months ended September 30, 2005. The warrants will be automatically revoked in the event we achieve $200,000 in EBITDA, as defined, for any one month period through April 30, 2006. We also agreed to limit our acquisitions of additional oil and gas properties to a maximum of $100,000 (plus the amount of proceeds to us from financing transactions and positive cash flow from operations, if any, in each case subsequent to September 22, 2005) until we achieve a trailing three month EBITDA to interest coverage ratio of 2.0:1. The limitation does not include any evaluation costs, so that we may continue to review new projects.

6. Stock-Based Compensation

SFAS 123, "Accounting for Stock-Based Compensation," as amended by SFAS 148, "Accounting for Stock-Based Compensation--Transition and Disclosure," established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. We account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees" ("APB 25").

Options

In December 2005, we: (i) granted a non-qualified stock option to purchase 100,000 shares of common stock with an exercise price equal to the market price of the underlying common stock on the date of grant, with a ten year term and two year vesting schedule, to William E. Dozier, a newly elected independent member of our board of directors, (ii) made a direct stock grant of 10,000 shares of common stock (outside of the 2004 Stock Plan) to an outside consultant for services previously performed, resulting in $12,091 of stock compensation expense being recorded, (iii) accelerated the vesting of options granted to Messrs. Stoever and DiPaolo in 2004 of 100,000 shares each, resulting in the recording of $11,000 (six months) of additional stock compensation expense, and (iv) accelerated the vesting of a direct stock grant issued to Daryl Mazzanti in June 2005, resulting in $20,112 (six months) of additional stock compensation expense.

In August 2005, we granted options to purchase 28,000 shares of common stock with an exercise price equal to the market price of the underlying common stock, to each of two independent board members. The options have a ten year life and a one year vesting term. In addition, we granted 130,000 options to two employees with an exercise price equal to the market price of the underlying common stock as of the date of grant. They have a ten year life and a four year vesting term.

During the six months ended December 31, 2004, we granted options to purchase up to an aggregate total of 200,000 shares of common stock with an exercise price of $1.27 per share (in the money), to each of our two independent board members, Messrs. Gene Stoever and E. J. DiPaolo (or 100,000 shares each). The options have a ten year life and vest over a two year period beginning May 26, 2004, the date of the directors' election to the Board of directors.

Unless otherwise noted, all stock options mentioned above were granted under the

2004 Stock Plan.

The following tables illustrate the effect on net loss and loss per share for the three and six months ended December 31, 2005 and 2004, as if we had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation. Fair value was calculated using the Black-Scholes option pricing model.

	Three Months Ended December 31	
	2005	2004
Pro forma impact of Fair Value Method (SFAS 148):		
Net loss attributable to common stockholders, as reported	$ (541,884)	$ (473,207)
Plus compensation expense determined under Intrinsic Value Method (APB 25)	73,996	64,828
Less compensation expense determined under Fair Value Method	(372,074)	(126,306)
Pro forma net loss attributable to common stockholders	$ (839,962)	$ (534,685)
Loss per share (basic and diluted):		
As reported	$ (0.02)	$ (0.02)
Pro Forma	$ (0.03)	$ (0.02)

	Six Months Ended December 31	
	2005	2004
Pro forma impact of Fair Value Method (SFAS 148):		
Net loss attributable to common stockholders, as reported	$(1,341,943)	$ (775,843)
Plus compensation expense determined under Intrinsic Value Method (APB 25)	116,880	111,120
Less compensation expense determined under Fair Value Method	(628,431)	(157,298)
Pro forma net loss attributable to common stockholders	$(1,853,494)	$ (822,021)
Loss per share (basic and diluted):		
As reported	$ (0.05)	$ (0.03)
Pro Forma	$ (0.07)	$ (0.04)

Warrants
Pursuant to our amended agreement with Prospect, we issued revocable warrants to purchase 200,000 shares of our common stock, exercisable at $1.36 per share over five years. The warrants will be automatically revoked in the event we achieve

$200,000 in EBITDA, as defined, for any one month period through April 30, 2006. Using the Black-Scholes model to compute fair value, a non-recurring charge of $32,509 was recorded to interest expense for the three months ended September 30, 2005. The following assumptions were used in the calculation: term = 2.33 years, volatility = 140%, discount rate = 4.55%, and a 20% probability that the warrants will not be revoked.

The shares of common stock issuable upon exercise of the Prospect Warrants are subject to a registration rights agreement, pursuant to which we have granted the holder certain piggyback registration rights.

During the six months ended December 31, 2005, 7,000 warrants were exercised by two non-employees, resulting in the issuance of 3,758 shares of our common stock. The remaining 3,242 warrants were cancelled as part of a cashless exercise of the subject warrants.

Pursuant to a revocable warrant agreement we extended to our Vice President of Operations at the beginning of his employment requiring certain performance measures which were met as of December 12, 2005, thereby establishing a measurement and beginning vesting date for purposes of computing compensation expense for the pro forma tables provided in this Note 6 above.

During the six months ended December 31, 2004, no warrants were issued or granted.

7. Commodity Hedging and Price Risk Management Activities

Pursuant to the terms of the Prospect Facility, we entered into financial instruments covering approximately 50% of our expected oil and gas production from proved developed producing properties over the next two years. We used reserve report data prepared by W. D. Von Gonten & Co., our independent petroleum engineering firm, to estimate our future production for hedging purposes. As we may elect under FAS 133, Accounting for Derivative Instruments and Hedging Activities, we have designated our physical delivery contracts as normal delivery sale contracts. For the oil price floors (the "Puts") we purchased, we have not fulfilled the documentation requirements of FAS 133. As a result, the Put contracts are "marked-to-market", with the unrealized gain or loss reflected in our statement of operations. At December 31, 2005, we had the following financial instruments in place:

(i) 2,100 Bbls of oil to be delivered monthly from March 2005 through February 2006 to Plains Oil Marketing LLC, at $48.35 per barrel, plus or minus changes in basis between: (a) the arithmetic daily average of the prompt month "Light Sweet Crude Oil" contract reported by the New York Mercantile Exchange, and (b) Louisiana field posted price. This is accounted for as a normal delivery sales contract. This contract was extended for the months of March 2006 through May 2006 for 70 Bbls of oil per day at a fixed price of $52.55 per barrel of oil, and extended again for the months of June 2006 through August 2006 for 90 Bbls of oil per day at a fixed price $63.45 per barrel of oil.

(ii) 100 Mcfd of natural gas at a fixed price of $6.21, delivered through our Delhi Field sales tap into Gulf South's pipeline, for the account of Texla for deliveries from March 2005 to May 2006. This is accounted for as a normal delivery sales contract.

(iii) Purchase of a non-physical Put contract at $38 per barrel for 2,000 Bbls of crude oil production from March 2006 through February 2007. This is accounted for as a "mark-to-market" derivative investment. For the six months ended December 31, 2005, $6,902 was expensed to reflect the changes in the market value of the Put from June 30, 2005 to December 31, 2005.

For the six months ended December 31, 2004, there were no financial instruments in place.

8. Related Party Transactions

Laird Q. Cagan, Chairman of our Board, is a Managing Director and co-owner of Cagan McAfee Capital Partners, LLC ("CMCP"). CMCP performs financial advisory services to us pursuant to a written agreement, earning a monthly retainer of $15,000. In addition, Mr. Cagan, as a registered representative of Chadbourn Securities, Inc. ("Chadbourn"), has served as the Company's placement agent in private equity financings, typically earning cash fees equal to 8% of gross equity proceeds and warrants equal to 8% of the shares purchased, exercisable over seven years, net of any similar payments made to third parties.

In December 2005, we renegotiated our agreement with CMCP, and the monthly retainer fee has decreased from $15,000 per month to $5,000 per month effective December 1, 2005. The retainer includes payment for the services of Mr. Cagan as Chairman of our Board.

For the three months ended December 31, 2005, $30,000 was paid to CMCP, $20,000 was expensed and $10,000 was reclassified as a Prepaid Asset for future retainer fees (namely January and February 2006).

For the three months ended September 30, 2005, $45,000 was expensed and paid to CMCP.

During the three months ended December 31, 2004, $45,000 was expensed as monthly retainer fees to CMCP, and payment was made in May 2005. In addition, Mr. Cagan and Chadbourn earned $17,840 for the placement of 194,200 shares of our common stock. Furthermore, we issued warrants to purchase up to a total of 12,536 shares of common stock to Mr. Cagan and Chadbourn. These warrants have a $1.50 exercise price and a seven-year term. Mr. Cagan loaned us $445,000 as a partial bridge financing for our acquisition in the Tullos Field Area and for additional working capital purposes. This bridge loan was paid off in full, including interest, in February 2005.

During the three months ended September 30, 2004, we expensed $45,000 in monthly retainers to CMCP and payment was made in May 2005. Also during this period, we charged $27,500 to stockholders' equity as a reduction of the proceeds from common stock sales placed by Mr. Cagan and Chadbourn, and issued warrants to purchase up to a total of 17,700 shares of common stock to Mr. Cagan and Chadbourn in connection with the placement of our common shares. These warrants were issued with a $1.50 exercise price and a seven-year term. Mr. Cagan loaned us $475,000 as a partial bridge financing for our first acquisition in the Tullos Field Area and for additional working capital purposes. This bridge loan was paid off in full, including interest, in February 2005.

Eric A. McAfee, a major shareholder of the Company and also a Managing Director of CMCP, has served as Vice Chairman of the Board of Verdisys, Inc., the provider of certain horizontal drilling services to the Company. Subsequently in 2004, Mr. McAfee resigned from the Board of Directors of Verdisys, but continues to hold shares in both companies. Mr. McAfee has represented to the Company that he is also a 50% owner of Berg McAfee Companies, LLC, which owns approximately 30% of Verdisys, Inc. NGS paid $25,960 to Verdisys (Blast Energy) during 2004 for horizontal drilling services.

John Pimentel, a former member of our Board of Directors, is a principal with CMCP.

9. Liquidity and Capital Resources

At December 31, 2005, we had $433,465 of unrestricted cash and positive working capital of $619,025, as compared to $2,548,688 of unrestricted cash and positive working capital of $2,599,232 at June 30, 2005, and $91,563 of unrestricted cash and negative working capital of $1,349,315 at December 31, 2004. In calendar 2005, our working capital was positively impacted by the $3,000,000 of gross proceeds we received from the sale of our common stock in May of 2005, and the re-financing of our short-term debt with long-term debt and equity under the Prospect Facility in February 2005.

An amendment to the Prospect Facility dated September 22, 2005 was effected in order to allow us to proceed with the delayed drilling program of proved undeveloped reserve locations in our Delhi Field, the results of which we are relying on to achieve the EBITDA coverage ratio required of us by Prospect. The timely drilling and production of our proved undeveloped reserves, based on the reserve report prepared by W.D. Von Gonten & Co dated July 1, 2005, will be necessary to provide sufficient additions to earnings to comply with Prospect's EBITDA coverage ratio and sufficient cash to maintain our operations for at least the next twelve months. Although the 2005 Delhi Development Drilling Program has been substantially completed, we can give no assurance that the assumptions in the reserve report will be achieved or that the wells will be completed and placed onto production in the timely manner necessary to comply with Prospect's EBITDA covenant coverage. If such a covenant breach occurs and is not waived by Prospect, the debt would become immediately due and payable. Since we do not have sufficient liquid assets to prepay our debt in full, we would be required to refinance all or a portion of our existing debt or obtain additional financing. If we were unable to refinance our debt or obtain additional financing, we would be required to curtail portions of our development program, sell assets, and/or reduce capital expenditures. Had we been subject to the interest coverage test at December 31, 2005, we would not have been in compliance.

10. Subsequent Events

On January 13, 2006, we entered into a Securities Purchase Agreement with Rubicon Master Funds ("Rubicon"), wherein we issued Rubicon 160,000 additional shares of our common stock as consideration for amending and restating our Registration Rights Agreement dated as of May 6, 2005. The amended terms removed our obligation to pay monetary damages for our failure to obtain and maintain an effective

registration statement including their shares, although we are still required to use our best commercial efforts to register for resale the 160,000 shares issued to Rubicon, along with the 1.2 million shares previously issued them.

On January 24, 2006 we filed Amendment No. 2 to our Form SB-2 originally filed with Securities and Exchange Commission ("SEC") on June 6, 2005, and amended on October 19, 2005. Amendment No. 2 was filed to include additional information in response to the SEC's comment letter to us dated November 18, 2005. The SEC is currently reviewing the amended registration statement and we can give no assurance that our registration statement will become or be maintained effective.

On January 27, 2006 we extended our crude oil hedging contracts with Plains Oil

Marketing, LLC for an additional six months, covering the periods September 2006 through February 2007. The contract requires us to deliver 2,700 Bbls of oil per month, in exchange for a fixed price of $69.30 per Bbl, plus or minus NYMEX to posted field price basis risk.

On January 31, 2006, we acquired an additional net revenue interest in one of our existing fields. Funding of the $1 million purchase price was provided by an additional $1 million advance under our Prospect Facility, thereby increasing the maturity value of our note due them at maturity to $5 million, and the issuance of an additional 150,000 of irrevocable warrants and 100,000 of revocable warrants, exercisable over five years at the 20 trading day average price immediately prior to January 31 2006. The revocable warrants can be revoked by the Company at any time that cash basis EBITDA reaches or exceeds $200,000 in any one month prior to June 1, 2006.

On February 13, 2006 we amended our existing agreements with Cagan McAfee Capital Partners, LLC and Chadbourn Securities, Inc.

Laird Q. Cagan, the Chairman of our Board of Directors, is a Managing Director of Cagan McAfee Capital Partners, LLC ("CMCP"). Under the revised terms of the agreement with CMCP (the "CMCP Agreement"), CMCP shall continue to perform management advisory services for us for an additional year, starting December 1, 2005, and receive a monthly retainer of $5,000, which includes the services of Mr. Cagan as Chairman of the Board.

In addition, Mr. Cagan is a registered representative of Chadbourn Securities, Inc. ("Chadbourn"), our non-exclusive placement agent for private financings. Under the revised terms of our agreement with Chadbourn (the "Chadbourn Agreement"), in connection with placement agent services Chadbourn shall earn cash fees of up to 8% (decreasing with private placements exceeding $1 million) and warrants equal to 4% of the number of shares sold in equity offerings at an exercise price equal to the offering price. In addition, Chadbourn shall receive a 2% placement fee for special purpose vehicle and/or debt financings. Finally, Chadbourn shall earn a merger & acquisition advisory fee equal to 1% of the consideration paid in a merger or acquisition transaction. This agreement has a one year term, starting December 1, 2005.

A copy of the CMCP Agreement and the Chadbourn Agreement are attached hereto as Exhibits 10.1 and 10.2, respectively, and are incorporated herein by reference. The foregoing summary does not purport to be complete and is qualified in its entirety by reference to the CMCP Agreement and the Chadbourn Agreement.

On November 17, 2005, a class action lawsuit was filed in the Fifth Judicial District Court, Richland Parish, Louisiana, against a number of defendants, including two of the Company's subsidiaries, Arkla Petroleum L.L.C. ("Arkla") and NG Sub Corporation (together with Arkla, the "Subsidiaries"). The Subsidiaries were not served with the lawsuit until February 2006. The plaintiffs claim to be landowners whose property (including the soil, surface water, and groundwater) has been contaminated by oil and gas exploration, and production and development activities conducted by the defendants on the plaintiffs' property and adjoining land, since the 1930s (including activities on the Delhi Field, which Arkla first began to operate in 2002 and which was acquired by the Company in 2003). The plaintiffs claim that the defendants knew of the alleged dangerous nature of the contamination and actively concealed it rather than remedy the problem.

The plaintiffs are seeking unspecified compensatory damages and punitive damages, as well as an order that the defendants restore the property and prevent further contamination. The Company's ultimate exposure related to this lawsuit is not currently determinable, but could, if adversely determined, have a material adverse effect on the Company's financial condition. The costs to the Company to defend this action could also have a material adverse effect on the

Company's financial condition.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Form 10-QSB and the information referenced herein contain forward-looking statements. The words "plan," "expect," "project," "estimate," "assume," "believe," "anticipate," "intend," "budget," "forecast," "predict" and other similar expressions are intended to identify forward-looking statements. These statements appear in a number of places and include statements regarding our plans, beliefs or current expectations, including the plans, beliefs and expectations of our officers and directors. We use the terms, "NGS," "Company," "we," "us" and "our" to refer to Natural Gas Systems, Inc. When considering any forward-looking statement, you should keep in mind the risk factors that could cause our actual results to differ materially from those contained in any forward-looking statement. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include the timing and extent of changes in commodity prices for oil and gas, operating risks and other risk factors as described in our 2005 Annual Report on Form 10-KSB and Form 10-KSB/A as filed with the Securities and Exchange Commission. Furthermore, the assumptions that support our forward-looking statements are based upon information that is currently available and is subject to change. We specifically disclaim all responsibility to publicly update any information contained in a forward-looking statement or any forward-looking statement in its entirety and therefore disclaim any resulting liability for potentially related damages. All forward-looking statements attributable to Natural Gas Systems, Inc. are expressly qualified in their entirety by this cautionary statement.

Overview

Natural Gas Systems, Inc. is a petroleum company engaged primarily in the acquisition, exploitation and development of properties for the production of crude oil and natural gas from underground reservoirs. We acquire established oil and gas properties and exploit them through the application of conventional and specialized technology to increase production, ultimate recoveries, or both. We conduct operations through our 100% working interests in the Delhi Field and Tullos Field Area, located in Louisiana.

Critical Accounting Policies

Our 2005 Annual Report on Form 10-KSB and Form 10-KSB/A describes the accounting policies that we believe are critical to the reporting of our financial position and operating results and that require management's most difficult, subjective or complex judgments.

This Quarterly Report on Form 10-QSB should be read in conjunction with the discussion contained in our 2005 Annual Report on Form 10-KSB and Form 10-KSB/A regarding these critical accounting policies.

Other Factors Affecting Our Business and Financial Results

In addition to the matters discussed above, our business, financial condition and results of operations are affected by a number of other factors.

This Quarterly Report on Form 10-QSB should be read in conjunction with the discussion in our 2005 Annual Report on Form 10-KSB and Form 10-KSB/A regarding these other risk factors.

Results of Operations

Summary

We have continued our growth in critical metrics of production and revenues while limiting our cash overhead costs. In the most recent three and six month periods, our sales volumes have increased by 93% or more, and our revenues have increased by 127% or more over the comparable periods of 2004. Key considerations in this growth are:

- The Tullos Area properties we purchased from Atkins as of September 1, 2004 only contributed production and revenues for four of the six months ended December 31, 2004, as compared to a six month contribution during the six months ended December 31, 2005;

- The Tullos Area properties we purchased from Chadco as of February 1, 2005 contributed no production or revenues during the six months ended December 31, 2004, as compared to a six month contribution during the six months ended December 31, 2005; and

- Only one of our five 2005 Delhi Development Drilling Program wells, the Delhi 92-2, was completed soon enough to make a meaningful revenue contribution in the three months ended December 31, 2005, and then for only the last half of the period.

Our most significant development activity to date has been the implementation of our 2005 Delhi Development Drilling Program that was originally scheduled to begin in May 2005 and was delayed until the second week of October, 2005 by the drilling contractor. By December 31, 2005, three PUD wells in our 2005 Delhi Development Drilling Program had been completed and were producing. The fourth well had been drilled by year end, and was completed and put onto production in late January 2006. The fifth well, a PUD, had been drilled and completed, and was put onto production in early February, 2006.

Of particular significance, the fourth well drilled and completed, the Delhi 225-2, was an unproved location that we elected to drill ahead of other proved locations. The results of that well will add to our proved producing reserves and we believe should lead to one or more proved undeveloped locations in the same reservoir that could hold substantial reserves.

During the period ended December 31, 2005, only one of the five wells we drilled and completed, was producing mostly due to poor drilling practices by the drilling contractor, delays in drilling due to breakdowns in rig equipment, contractor crew turnover and resulting oil-water emulsions and paraffin blockages created in the reservoir. The oil-water emulsions and paraffin blockages have been alleviated, in part, through chemical treatments, and additional work is anticipated to further increase production. We believe that February 2006 will be the first month to include production from all five drilled and completed wells.

The sixth and seventh wells previously anticipated to be drilled in our 2005 Delhi Development Drilling Program have been rescheduled for later in 2006 due to unfavorable ground conditions resulting from heavy rains in early January in the area and the significant financial costs of putting the drilling rig on standby. Consequently, the drilling rig was released in early January 2006 as a cost saving measure. We are in negotiations with another contractor for a drilling rig to initiate our 2006 Delhi Development Drilling Program. The sixth and seventh wells from the 2005 program are expected to be included in our 2006 drilling program.

Going forward, our objectives for calendar year 2006 are to:

- Continue increasing our net property values (net present value in excess of our costs) through re-investments in infrastructure, work-overs, recompletions, water disposal capacity and new development drilling, at the potential cost of reduced near term cash flows and earnings; and

- Ultimately increase our margins, net cash flows and earnings by:
  - Increasing production and revenues
  - Controlling cash G&A expense to a growth rate slower than our revenue growth
  - Maintaining or reducing field operating expense per BOE
- Seek additional oil & gas property acquisitions.

Three months ended December 31, 2005 compared to three months ended December 31, 2004

The following table sets forth certain financial information with respect to our oil and gas operations.

	Three Months Ended December 31			
Net to NGS	2005	2004	Variance	% change
Sales Volumes:				
Oil (Bbl)	11,827	5,263	6,564	125%
Gas (Mcf)	24,109	15,860	8,249	52%
Oil and Gas (Boe)	15,845	7,906	7,940	100%
Revenue data (a):				
Oil revenue	$ 551,981	$ 250,931	$ 301,050	120%
Gas revenue	278,955	114,837	164,118	143%
Total oil and gas revenues	$ 830,936	$ 365,768	$ 465,168	127%
Average prices (a):				
Oil (per Bbl)	$ 46.67	$ 47.68	$ (1.01)	-2%
Gas (per Mcf)	11.57	7.24	4.33	60%
Oil and Gas (per Boe)	52.44	46.26	6.18	13%
Expenses (per BOE)				
Lease operating expenses and production taxes	$ 26.52	$ 26.05	$ 0.47	2%
DD&A expense on oil and gas properties	7.16	6.88	0.28	4%

(a) Includes the cash settlement of hedging contracts

Net loss. For the three months ended December 31, 2005, we reported a net loss of $541,884 or $0.02 loss per share on total revenues of $830,936, as compared with a net loss of $473,207 or $0.02 loss per share on total revenues of $365,768 for the three months ended December 31, 2004. The increase in losses is attributable to increases in lease operating and general and administrative expenses, high workover costs in October 2005 and losses on lender required price hedges, partially offset by increases in revenues due to higher sales volumes and sales prices. Excluding non-cash stock compensation expense of $156,277 and non-cash penalty expense of $114,239 for not obtaining an effective registration statement, our net loss for the three months ended December 31, 2005 was $271,368, or $0.01 loss per share. By comparison, after excluding non-cash stock compensation expense of $64,828 for the three months ended December 31, 2004, our net loss was $408,379, or $0.017 loss per share.

Sales Volumes. Oil sales volumes, net to our interest, for the three months ended December 31, 2005 increased 125% to 11,827 Bbls, compared to 5,263 Bbls for the three months ended December 31, 2004. The increase in sales volumes is primarily due to oil sales from the Chadco acquisition in the Tullos Field Area and the result of workovers and recompletions in our portfolio. The five wells we drilled and completed did not contribute materially to oil sales during the three months ended December 31, 2005.

Net natural gas volumes sold for the three months ended December 31, 2005 were 24,109 Mcfs, an increase of 52% from the three months ended December 31, 2004. Gas volumes increased primarily due to the Delhi 92-2 well which was drilled and completed in early November.

Production. Oil production varies from oil sales volumes by changes in crude oil inventories, which are not carried on the balance sheet. Net oil production for the three months ended December 31, 2005 increased 115% to 11,860 Bbls, compared to 5,524 Bbls for the three months ended December 31, 2004. This is primarily due to the acquisition of wells in the Tullos Field Area and general field development opportunities. The five wells we drilled and completed did not contribute materially to oil production during the three months ended December 31, 2005. Net natural gas production for the three months ended December 31, 2005 increased 38% to 29,203 Mcfs, compared to 21,161 Mcfs for the three months ended December 31, 2004. This increase was due to a new well drilled in November 2005, the Delhi 92-2.

Oil and Gas Revenues. Revenues presented in the table above and discussed herein represent revenue from sales of our oil and natural gas production volumes, net to our interest. Production sold under fixed price delivery contracts, which have been designated for the normal purchase and sale exemption under SFAS 133, are also included in these amounts. Realized prices may differ from market prices in effect during the periods, depending on when the fixed delivery contract was executed.

Oil and gas revenues increased 127% for the three month period ended December 31, 2005, compared to the same period in 2004, as a result of the 100% increase in sales volumes due to the Chadco acquisition of producing leases in the Tullos Field Area and additional natural gas sales from the 92-2 well which was completed and began production in November 2005. Another component of the increase was a 13% increase in the sales prices we received per BOE during the three months ended December 31, 2005 as compared to the three months ended December 31, 2004.

Lease Operating Expenses. Lease operating expenses for the three months ended December 31, 2005 increased $205,217 from the comparable 2004 period to $398,686. The increase in operating expenses in 2005 is primarily attributable to (1) an increase in the number of active wells due to the acquisition of properties in the Tullos Field Area, (2) substantial increases in overall industry service costs, and (3) high workover costs associated with our Delhi 87-2 and 197-2 wells, repairs to our salt water disposal system and repairs to two separate gas gathering line leaks.

General and Administrative Expenses. General and administrative expenses (exclusive of non-cash stock compensation expense of $156,277 and penalty expense of $114,239) was $391,590 for the three months ended December 31, 2005, a decrease of $84,151 from $475,741 (exclusive of non-cash stock compensation expense of $64,828), for the three months ended December 2004. Overall general and administrative expenses were higher in the prior year due to significant start up expenses associated with a being a public registrant, including expenses for audited financial statements, SEC counsel, outside engineering estimates, D&O insurance, outside director fees and other related costs.

Depletion and Amortization Expense. Depletion and amortization expense increased $59,457 for the three months ended December 31, 2005 to $113,443 from $53,986 for the same period in 2004. The increase is primarily due to a 100% increase in sales volumes and a 4% increase in the average depletion rate, period over period.

Interest Expense. Interest expense for the three months ended December 31, 2005 increased $149,914 to $191,016 (of which $141,151 was cash expense) compared to $41,102 (of which $6,370 was cash expense) for the three months ended December 31, 2004. The increase in interest expense was primarily due to interest expense associated with the Prospect Facility, which was not outstanding in the 2004. The non-cash portion of interest expense is associated with amortization of the discount we assigned to the Prospect note, based on the fair value we attributed to the granting of the warrants to Prospect.

Six months ended December 31, 2005 compared to six months ended December 31, 2004

	Six Months Ended December 31			
Net to NGS	2005	2004	Variance	% change
Sales Volumes:				
Oil (Bbl)	20,781	9,202	11,579	126%
Gas (Mcf)	33,959	27,117	6,842	25%
Oil and Gas (Boe)	26,441	13,722	12,720	93%
Revenue data (a):				
Oil revenue	$1,036,932	415,454	$ 621,478	150%
Gas revenue	336,888	181,481	155,407	86%
Total oil and gas revenues	$1,373,820	$ 596,935	$ 776,885	130%
Average prices (a):				
Oil (per Bbl)	$ 49.90	$ 45.15	$ 4.75	11%

Gas (per Mcf)	9.92	6.69	3.23	48%
Oil and Gas (per Boe)	51.96	43.50	8.45	19%
Expenses (per Boe)				
Lease operating expenses and production taxes	$ 34.00	$ 26.22	$ 7.78	30%
DD&A expense on oil and gas properties	7.16	6.88	0.28	4%

(a) Includes the cash settlement of hedging contracts

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Net Loss. For the six months ended December 31, 2005, we reported a net loss of $1,341,943 or $0.05 loss per share on total revenues of $1,373,820, as compared with a net loss of $775,843 or $0.03 loss per share on total revenues of $596,935 for the six months ended December 31, 2004. The increase in losses are attributable to overall increases in lease operating and general and administrative expenses, partially offset by increases in revenues due to higher sales volumes and sales prices. Excluding non-cash stock compensation expense of $269,351 and non-cash penalty expense of $114,239 for not having obtained an effective registration statement, our net loss for the six months ended December 31, 2005 was $958,353, or $0.04 loss per share. By comparison, excluding non-cash stock compensation expense of $111,121 for the six months ended December 31, 2004, our net loss was $664,722, or $0.03 loss per share.

Sales Volumes. Oil sales volumes, net to our interest, for the six months ended December 31, 2005 increased 126% to 20,781 Bbls, compared to 9,202 Bbls for the six months ended December 31, 2004. The increase in sales volumes is primarily due to oil sales from the Chadco acquisition in the Tullos Field Area and the result of workovers and recompletions in our portfolio.

Net natural gas volumes sold for the six months ended December 31, 2005 were 33,959 Mcfs, an increase of 25% from the six months ended December 31, 2004. Gas volumes increased primarily due to the Delhi 92-2 well which was drilled in October and completed in early November.

Production. Oil production varies from oil sales volumes by changes in crude oil inventories, which are not carried on the balance sheet. Net oil production for the six months ended December 31, 2005 increased 140% to 22,500 Bbls, compared to 9,375 Bbls for the six months ended December 31, 2004. This is primarily due to the acquisition of wells in the Tullos Field Area and general field development opportunities.

Our net oil stock ending inventory increased approximately 80% at December 31, 2005 to approximately 4,300 Bbls, as compared to approximately 2,400 Bbls at December 31, 2004. Increases in oil inventory were attributable to additional producing wells (and tank batteries) acquired in the Chadco acquisition and approximately 1,600 barrels of oil that were not picked up by our crude oil purchaser for sale by December 31, 2005. Since many of these leases do not make a full truckload within one month (one truckload equals ~ 160 Bbls), the Tullos Field Area tends to maintain higher levels of inventory compared to production, and can cause erratic oil runs due to the preference of our oil purchaser to gather a full truckload from a single tank battery.

Net natural gas production for the six months ended December 31, 2005 increased 16% to 43,570 Mcfs, compared to 37,521 Mcfs for the six months ended December 31, 2004. This increase was due to a new well drilled in November 2005, the Delhi 92-2, offset by well downtime caused by mechanical problems on the Delhi 184-2 well, shut-in of our gas gathering line to repair line leaks and normal production declines.

Oil and Gas Revenues. Revenues presented in the table above and discussed herein represent revenue from sales of our oil and natural gas production volumes, net to our interest. Production sold under fixed price delivery contracts, which have been designated for the normal purchase and sale exemption under SFAS 133, are also included in these amounts. Realized prices may differ from market prices in effect during the periods, depending on when the fixed delivery contract was executed.

Oil and gas revenues increased 130% for the six month period ended December 31, 2005, compared to the same period in 2004, as a result of a 93% increase in production volumes due to the Chadco and Atkins acquisitions of producing leases in the Tullos Field Area and increases in production from our Delhi Field, including the gas production from our recently drilled Delhi 92-2 well. Another component of the increase was a 19% increase in the average sales prices we received per BOE during the six months ended December 31, 2005 as compared to the six months ended December 31, 2004.

Lease Operating Expenses. Lease operating expenses for the six months ended December 31, 2005 increased $531,659 from the comparable 2004 period to $862,876. The increase in operating expenses in 2005 is primarily attributable to (1) an increase in the number of active wells due to the acquisition of properties in the Tullos Field Area, (2) substantial increases in overall industry service costs, and (3) high workover costs associated with our Delhi 87-2 and 197-2 wells, repairs to our salt water disposal system and repairs to two separate gas gathering line leaks.

On a BOE basis, lease operating expense and production taxes totaling $34.00 per BOE did not meet our expectations for the six months ended December 31, 2005, as compared to 2004's comparable period of $26.22. The unfavorable variance in the current period was predominately due to the previously mentioned workover costs associated with an unusually large number of our Delhi wells, combined with the loss of production from well downtime while working over the wells. Over half of this unfavorable variance was attributable to workover expenses incurred to maintain production on our Delhi 87-2 well, which currently accounts for the majority of our production from our Delhi Field. As previously reported, our Delhi 87-2 well is over 50 years old. Following its recompletion last year into a new reservoir with an initial flowing production rate of 90 bopd, it suffered a casing collapse, causing us to engage in numerous expensive workovers that eventually enabled us to produce the well at a constrained rate of 30+ bopd.

General and Administrative Expenses. General and administrative expenses (exclusive of non-cash stock compensation expense of $269,351 and penalty expense of $114,239) was $862,794 for the six months ended December 31, 2005, an increase of $122,211 as compared to $740,583 (exclusive of non-cash stock compensation expense of $111,121) for the comparable 2004 period. The increase is primarily due to an increase in employees from two to five and implementation of an outsourced property accounting service with Petroleum Financial Incorporated. Overall general and administrative expenses are high due to expenses associated with a being a public registrant, including expenses for audited financial statements, SEC counsel, outside engineering estimates, D&O insurance, outside director fees and other related costs.

Depletion and Amortization Expense. Depletion and amortization expense increased $88,256 for the six months ended December 31, 2005 to $189,348 from $101,092 for the same period in 2004. The increase is primarily due to a 93% increase in sales volumes and a 4% increase in the average depletion rate, period over period.

Interest Expense. Interest expense for the six months ended December 31, 2005 increased $346,326 to 412,694 (of which $282,516 was cash expense) compared to $66,368 (of which $18,452 was cash expense) for the six months ended December 31, 2004. The increase in interest expense was primarily due to interest expense associated with the Prospect Facility, which was not outstanding in the comparable period in 2004. In addition, $32,509 was recorded as a non-recurring charge to interest expense, representing the fair value of 200,000 revocable warrants issued in consideration to amend the Prospect Facility on September 22, 2005.

Hurricane Update. On August 29, 2005, Hurricane Katrina, came onshore just east of New Orleans, LA. None of our oil and gas properties suffered casualty losses from this storm. On September 24, 2005, Hurricane Rita came onshore near the Texas/Louisiana border and headed north near our oil and gas operations in Northern Louisiana. None of our oil and gas properties suffered casualty losses from this storm, except we experienced approximately two days of deferred production at our Tullos Field, due to sporadic electricity outages.

Liquidity and Capital Resources

At December 31, 2005, we had $433,465 of unrestricted cash and positive working capital of $619,025, as compared to $2,548,688 of unrestricted cash and positive working capital of $2,599,232 at June 30, 2005, and $91,563 of unrestricted cash and negative working capital of $1,349,315 at December 31, 2004. In 2005, our working capital was positively impacted by the $3,000,000 of gross proceeds we received from the sale of our common stock in May of 2005, and the re-financing of our short-term debt with long-term debt and equity under the Prospect Facility in February 2005.

Effective September 22, 2005, we entered into an amendment to the Prospect Facility, thereby obtaining covenant relief with respect to our obligation to maintain an EBITDA to interest payable coverage ratio of 2.0:1. The amendment changes our compliance date to begin not later than the three months ended January 31, 2006, as compared to October 31, 2005 under the original terms of the agreement. In consideration for the amendment, we have issued to Prospect revocable warrants to purchase 200,000 shares of our common stock, exercisable at $1.36 per share over five years. As a result, a non-recurring charge of $32,509 was recorded to interest expense during the three months ended September 30, 2005. The warrants will be automatically revoked in the event we achieve $200,000 in EBITDA, as defined, for any one month period through April 30, 2006. We also agreed to limit our acquisitions of additional oil and gas properties to a maximum of $100,000 plus any new funds raised, until we achieve a trailing three month EBITDA to interest coverage ratio of 2.0:1. The limitation does not include any evaluation costs, so that we may continue to review new projects.

The amendment to the Prospect Facility was effected in order to allow us to proceed with the delayed drilling program of proved undeveloped reserve locations in our Delhi Field, the results of which we are relying on to achieve the EBITDA coverage ratio required of us by Prospect. The timely drilling and production of our proved undeveloped reserves, based on the reserve report prepared by W.D. Von Gonten & Co dated July 1, 2005, will be necessary to provide sufficient additions to earnings to comply with Prospect's EBITDA coverage ratio, and will provide sufficient cash to maintain our operations for at least the next twelve months. Although the 2005 Delhi Development Drilling Program has been substantially completed, we can give no assurance that the assumptions in the reserve report will be achieved or that the wells will be completed and placed onto production in the timely manner necessary to comply with Prospect's EBITDA covenant coverage. If such a covenant breach occurs and is not waived by Prospect, the debt would become immediately due and payable. Since we do not have sufficient liquid assets to prepay our debt in full, we would be required to refinance all or a portion of our existing debt or obtain additional financing. If we were unable to refinance our debt or obtain additional financing, we would be required to curtail portions of our development program, sell assets, and/or reduce capital expenditures. Had we been subject to the interest coverage test at December 31, 2005, we would not have been in compliance.

We have historically financed our development activities through proceeds from debt and equity proceeds. In the short term we intend to finance our current development drilling program through our existing working capital resources. As operator of all of our projects in development, we have the ability to significantly control the timing of most of our capital expenditures. We believe the cash flows from operating activities, combined with our ability to control the timing of substantially all of our future development and acquisition requirements, will provide us with the flexibility and liquidity to meet our future planned capital requirements through the next twelve months.

Cash used in operating activities for the six months ended December 31, 2005 was $804,698 and cash used in operations for the comparative period in 2004 was $68,455. In 2005, the increase in cash used in operating activities was primarily due to higher operating expenses, partially offset by higher revenues.

Cash used in investing activities in the six months ended December 31, 2005 and 2004 was $1,303,771 and $938,915, respectively. In 2005, the majority of the development capital expenditures were spent on the 2005 Delhi Development Drilling Program. For the six months ended December 2004, we expended approximately $725,000 in capital acquisition costs for the purchase of producing properties in our Tullos Field Area, and approximately $215,000 was used for development capital in our existing portfolio.

Cash used in financing activities for the six months ended December 31, 2005 was $6,754, which was used to pay off the remaining note for property insurance. Comparatively, $731,102 was used in the 2004 period which consisted of $977,875 in net proceeds from loans and $529,199 of gross cash proceeds from the private sale of 369,200 shares of our common stock, before commissions, less $775,972 used for loan repayments.

Budgeted Capital Expenditures. Our 2005 Delhi Development Drilling Program began in early October, 2005. As of January 26, 2006 we had drilled and completed four wells and drilled and logged one other well. We estimate that capital expenditures approximating $1.3 million, provided from our working capital, will be necessary for the drilling and completion of these five wells. The two option wells we originally planned for the 2005 program (wells six and seven) were postponed due to heavy rains at Delhi during January 2006. We anticipate that these wells will be combined with other locations to comprise our 2006 Delhi Development Drilling Program, to commence later in calendar year 2006. Budgeting for our 2006 plan is in progress.

ITEM 3. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the

Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to this company's management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of the Company's management, including our Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that the information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

There has been no change in our internal control over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEMS 2, 3 AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED

ITEM 1. Litigation

On November 17, 2005, a class action lawsuit was filed in the Fifth Judicial District Court, Richland Parish, Louisiana, against 26 defendants, including two of our subsidiaries, Arkla Petroleum L.L.C. ("Arkla") and NGS Sub. Corp. (together with Arkla, the "Subsidiaries"). We were not served with the lawsuit until February 2006.

The plaintiffs claim to be landowners whose property (including the soil, surface water, and groundwater) has been contaminated by oil and gas exploration, production and development activities conducted by the defendants on the plaintiffs' property and adjoining land, since the 1930s (including activities by Arkla as operator of the Delhi Field subsequent to Arkla's formation in 2002 and our acquisition of Arkla in 2003, and activities since NGS Sub. Corp.'s acquisition of a 100% working interest in the Delhi Field in 2003.). The plaintiffs claim that the defendants knew of the alleged dangerous nature of the contamination and actively concealed it rather than remedy the problem.

The plaintiffs are seeking unspecified compensatory damages and punitive damages, as well as an order that the defendants restore the property and prevent further contamination. Our ultimate exposure related to this lawsuit is not currently determinable, but could, if adversely determined, have a material adverse effect on our financial condition. Our costs to defend this action could also have a material adverse effect on our financial condition.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The following matters were submitted to a vote of security holders during Natural Gas System's Annual Meeting of Stockholders held on December 1, 2005:

1. Election of Directors - The following nominees were elected to serve as Directors of Natural Gas Systems, Inc. until the 2006 Annual Meeting of Stockholders:

	Votes Cast for	Votes Withheld
Laird Q. Cagan	18,748,691	25,405
E. J. DiPaolo	18,749,591	24,505
William E. Dozier	13,374,000	0
Robert S. Herlin	18,749,491	24,605
Gene S. Stoever	18,749,591	24,505

2. Ratification of the appointment of Hein & Associates LLP, as independent accountants:

For	Against	Abstain
18,769,091	5,005	0

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

A. Exhibits

10.1 Agreement with Chadbourn Securities, Inc., dated February 13, 2006.

10.2 Agreement with Cagan McAfee Capital Partners, LLC, dated February 13, 2006.

31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended.

31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended.

32.1 Certification of Chief Executive Officer pursuant Rule 13a-14(b) or Rule 15d-14(b) under the Securities Exchange Act of 1934, as amended and 18 U.S.C. Section 1350.

32.2 Certification of Chief Financial Officer pursuant Rule 13a-14(b) or Rule 15d-14(b) under the Securities Exchange Act of 1934, as amended and 18 U.S.C. Section 1350.

B. Reports on Form 8-K

Current Report on Form 8-K filed on October 7, 2005, pursuant to Item 1.01, announcing the entry into a material definitive agreement.

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SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NATURAL GAS SYSTEMS, INC.
(Registrant)

Date: February 14, 2006

By: /s/ STERLING H. MCDONALD

Sterling H. McDonald
Chief Financial Officer
Principal Financial and Accounting Officer

="font-size: 10pt"> Our ability to achieve revenue growth depends on our continuing ability to improve and reduce the cost of our technologies and to introduce these technologies to the marketplace in a timely manner. If our development efforts are not successful or are significantly delayed, companies may not incorporate our technologies into their products and our revenue growth may be impaired.

IF WE FAIL TO DEVELOP NEW OR ENHANCED TECHNOLOGIES FOR NEW APPLICATIONS AND PLATFORMS, WE MAY NOT BE ABLE TO CREATE A MARKET FOR OUR TECHNOLOGIES OR OUR TECHNOLOGIES MAY BECOME OBSOLETE AND OUR ABILITY TO GROW AND OUR RESULTS OF OPERATIONS MIGHT BE HARMED.

Our initiatives to develop new and enhanced technologies and to commercialize these technologies for new applications and new platforms may not be successful. Any new or enhanced technologies may not be favorably received by consumers and could damage our reputation or our brand. Expanding our technologies could also require significant additional expenses and strain our management, financial, and operational resources. Moreover, technology products generally have relatively short product life cycles and our current products may become obsolete in the future. Our ability to generate revenues will be harmed if:

we fail to develop new technologies or products;

the technologies we develop infringe on existing non-Immersion patents;

our new technologies fail to gain market acceptance; or

our current products become obsolete.

WE DEPEND ON A SINGLE SUPPLIER TO PRODUCE SOME OF OUR MEDICAL SIMULATORS AND MAY LOSE CUSTOMERS IF THIS SUPPLIER DOES NOT MEET OUR REQUIREMENTS.

We have one supplier for some of our custom medical simulators. Any disruption in the manufacturing process from our sole supplier could adversely affect our ability to deliver our products and ensure quality workmanship and could result in a reduction of our product sales. Additionally, the single supplier could increase prices and thereby erode our margins before we are able to find an alternative source.

MEDICAL LICENSING AND CERTIFICATION AUTHORITIES MAY NOT RECOMMEND OR REQUIRE USE

OF OUR TECHNOLOGIES FOR TRAINING AND/OR TESTING PURPOSES, SIGNIFICANTLY SLOWING OR INHIBITING THE MARKET PENETRATION OF OUR MEDICAL SIMULATION TECHNOLOGIES.

Several key medical certification bodies, including the American Board of Internal Medicine (ABIM), and the American College of Cardiology (ACC), have great influence in recommending particular medical methodologies, including medical training and testing methodologies, for use by medical professionals. In the event that the ABIM and the ACC, as well as other, similar bodies, do not endorse medical simulation products as a training and/or testing vehicle, market penetration for our products could be significantly and adversely affected.

AUTOMOBILES INCORPORATING OUR TOUCH-ENABLING TECHNOLOGIES ARE SUBJECT TO LENGTHY PRODUCT DEVELOPMENT PERIODS, MAKING IT DIFFICULT TO PREDICT WHEN AND WHETHER WE WILL RECEIVE PER UNIT AUTOMOTIVE ROYALTIES.

The product development process for automobiles is very lengthy, sometimes longer than four years. We do not earn per unit royalty revenue on our automotive technologies unless and until automobiles featuring our technologies are shipped to customers, which may not occur until several years after we enter into an agreement with an automobile manufacturer or a supplier to an automobile manufacturer. Throughout the product development process, we face the risk that an automobile manufacturer or supplier may delay the incorporation of, or choose not to incorporate, our technologies into its automobiles, making it difficult for us to predict the per unit automotive royalties we may receive, if any. After the product launches, our royalties still depend on market acceptance of the vehicle or the option packages if our technology is an option (e.g. a navigation unit), which is likely to be determined by many factors beyond our control.

WE MIGHT BE UNABLE TO RETAIN OR RECRUIT NECESSARY PERSONNEL, WHICH COULD SLOW THE DEVELOPMENT AND DEPLOYMENT OF OUR TECHNOLOGIES.

Our ability to develop and deploy our technologies and to sustain our revenue growth depends upon the continued service of our management and other key personnel, many of whom would be difficult to replace. Management and other key employees may voluntarily terminate their employment with us at any time upon short notice. The loss of management or key personnel could delay product development cycles or otherwise harm our business.

We believe that our future success will also depend largely on our ability to attract, integrate, and retain sales, support, marketing, and research and development personnel. Competition for such personnel is intense, and we may not be successful in attracting, integrating, and retaining such personnel. Given the protracted nature of if, how, and when we collect royalties on new design contracts, it may be difficult to craft compensation plans that will attract and retain the level of salesmanship needed to secure these contracts. Some of our executive officers and key employees hold stock options with exercise prices considerably above the current market price of our common stock. Each of these factors may impair our ability to retain the services of our executive officers and key employees. Our technologies are complex and we rely upon the continued service of our existing engineering personnel to support licensees, enhance existing technologies, and develop new technologies.

OUR MAJOR STOCKHOLDERS RETAIN SIGNIFICANT CONTROL OVER US, WHICH MAY LEAD TO CONFLICTS WITH OTHER STOCKHOLDERS OVER CORPORATE GOVERNANCE MATTERS AND COULD ALSO AFFECT THE VOLATILITY OF OUR STOCK PRICE.

We currently have, have had in the past, and may have in the future, stockholders who retain greater than 10%, or in some cases greater than 20%, of our outstanding stock. Acting together, these stockholders would be able to exercise significant influence over matters that our stockholders vote upon, including the election of directors and mergers or other business combinations, which could have the effect of delaying or preventing a third party from acquiring control over or merging with us. Further, if any individuals in this group elect to sell a significant portion or all of their holdings of our common stock, the trading price of our common stock could experience volatility.

BECAUSE PERSONAL COMPUTER PERIPHERAL PRODUCTS THAT INCORPORATE OUR TOUCH-ENABLING TECHNOLOGIES CURRENTLY MUST WORK WITH MICROSOFT S OPERATING SYSTEM SOFTWARE, OUR COSTS COULD INCREASE AND OUR REVENUES COULD DECLINE IF MICROSOFT MODIFIES ITS OPERATING SYSTEM SOFTWARE.

Our hardware and software technologies for personal computer peripheral products that incorporate our touch-enabling technologies is currently compatible with Microsoft s Windows 2000, Windows Me,

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and Windows XP operating systems, including DirectX, Microsoft s entertainment applications programming interface. If Microsoft modifies its operating system, including DirectX, we may need to modify our technologies and this could cause delays in the release of products by our licensees. If Microsoft modifies its software products in ways that limit the use of our other licensees products, our costs could increase and our revenues could decline.

LEGISLATIVE ACTIONS, HIGHER INSURANCE COST, AND POTENTIAL NEW ACCOUNTING PRONOUNCEMENTS ARE LIKELY TO IMPACT OUR FUTURE FINANCIAL POSITION AND RESULTS OF OPERATIONS.

There have been regulatory changes, including the Sarbanes-Oxley Act of 2002, and there may potentially be new accounting pronouncements or additional regulatory rulings that will have an impact on our future financial position and results of operations. These changes and other legal changes, as well as proposed legislative initiatives following the Enron bankruptcy, are likely to increase general and administrative costs. In addition, insurers are likely to increase premiums as a result of high claims rates over the past year, which we expect will increase our premiums for our various insurance policies. Further, the Financial Accounting Standards Board (FASB) recently enacted Statement of Financial Accounting Standard (SFAS) No. 123R which will require us to adopt a different method of determining the compensation expense of our employee stock options. SFAS No. 123R may have a significant adverse effect on our reported financial conditions and may impact the way we conduct our business. These and other potential changes could materially increase the expenses we report under generally accepted accounting principles, and adversely affect our operating results.

FAILURE TO ACHIEVE AND MAINTAIN EFFECTIVE INTERNAL CONTROLS IN ACCORDANCE WITH SECTION 404 OF THE SARBANES-OXLEY ACT COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS AND STOCK PRICE.

During the course of the evaluation and attestation process required by Section 404, we may identify deficiencies which we may not be able to remediate in time to meet the deadline imposed by the Sarbanes-Oxley Act for compliance with the requirements of Section 404. In addition, if we fail to maintain the adequacy of our internal controls, as such standards are modified, supplemented, or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Failure to achieve and maintain an effective internal control environment could have a material adverse effect on our business and stock price.

IF OUR FACILITIES WERE TO EXPERIENCE CATASTROPHIC LOSS, OUR OPERATIONS WOULD BE SERIOUSLY HARMED.

Our facilities could be subject to a catastrophic loss such as fire, flood, earthquake, power outage, or terrorist activity. California has experienced problems with its power supply in recent years. As a result, we have experienced utility cost increases and may experience unexpected interruptions in our power supply that could have a material adverse effect on our sales, results of operations, and financial condition. In addition, a substantial portion of our research and development activities, manufacturing, our corporate headquarters, and other critical business operations are located near major earthquake faults in San Jose, California, an area with a history of seismic events. Any such loss at our facilities could disrupt our operations, delay production, shipments, and revenue, and result in large expenses to repair and replace the facility. While we believe that we maintain insurance sufficient to cover most long-term potential losses at our facilities, our existing insurance may not be adequate for all possible losses.

WE HAVE EXPERIENCED SIGNIFICANT CHANGE IN OUR BUSINESS, AND OUR FAILURE TO MANAGE THE COMPLEXITIES ASSOCIATED WITH THE CHANGING ECONOMIC ENVIRONMENT AND TECHNOLOGY LANDSCAPE COULD HARM OUR BUSINESS.

Any future periods of rapid change may place significant strains on our managerial, financial, engineering, and other resources. Further economic weakness, in combination with our complex technologies, may demand an unusually high level of managerial effectiveness in anticipating, planning, coordinating, and meeting our operational needs as well as the needs of our licensees.

WE MAY ENGAGE IN ACQUISITIONS THAT COULD DILUTE STOCKHOLDERS INTERESTS, DIVERT MANAGEMENT ATTENTION, OR CAUSE INTEGRATION PROBLEMS.

As part of our business strategy, we have in the past and may in the future, acquire businesses or intellectual property that we feel could complement our business, enhance our technical capabilities, or increase our intellectual property portfolio. If we consummate acquisitions through cash and/or an exchange of our securities, our stockholders could suffer significant dilution. Acquisitions could also create risks for us, including:

- unanticipated costs associated with the acquisitions;
- use of substantial portions of our available cash to consummate the acquisitions;
- diversion of management s attention from other business concerns;
- difficulties in assimilation of acquired personnel or operations; and
- potential intellectual property infringement claims related to newly acquired product lines.

Any acquisitions, even if successfully completed, might not generate significant additional revenue or provide any benefit to our business.

OUR CURRENT CLASS ACTION LAWSUIT COULD BE EXPENSIVE, DISRUPTIVE, AND TIME CONSUMING TO DEFEND AGAINST, AND IF WE ARE NOT SUCCESSFUL, COULD ADVERSELY AFFECT OUR BUSINESS.

We are involved in legal proceedings relating to a class action lawsuit filed on November 9, 2001, In re Immersion Corporation Initial Public Offering Securities Litigation, No. Civ. 01-9975 (S.D.N.Y.), related to In re Initial Public Offering Securities Litigation, No. 21 MC 92 (S.D.N.Y.). The named defendants are us and three of our current or former officers or directors (the Immersion Defendants), and certain underwriters of our November 12, 1999 initial public offering (IPO). Subsequently, two of the individual defendants stipulated to a dismissal without prejudice.

The operative amended complaint is brought on purported behalf of all persons who purchased the common stock of Immersion from the date of the IPO through December 6, 2000. It alleges liability under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, on the grounds that the registration statement for the IPO did not disclose that: (1) the underwriters agreed to allow certain customers to purchase shares in the IPO in exchange for excess commissions to be paid to the underwriters; and (2) the underwriters arranged for certain customers to purchase additional shares in the aftermarket at predetermined prices. The complaint also appears to allege that false or misleading analyst reports were issued. The complaint does not claim any specific amount of damages.

Similar allegations were made in other lawsuits challenging over 300 other initial public offerings and follow-on offerings conducted in 1999 and 2000. The cases were consolidated for pretrial purposes. On February 19, 2003, the Court ruled on all defendants motions to dismiss. The motion was denied as to claims under the Securities Act of 1933 in the case involving Immersion, as well as in all other cases (except for 10 cases). The motion was denied as to the claim under Section 10(b) as to Immersion, on the basis that the complaint alleged that Immersion had made acquisition(s) following the IPO. The motion was granted as to the claim under Section 10(b), but denied as to the claim under Section 20(a), as to the remaining individual defendant.

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We and most of the issuer defendants have settled with the plaintiffs. In this settlement, plaintiffs have dismissed and released all claims against the Immersion Defendants, in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the IPO cases, and for the assignment or surrender of certain claims we may have against the underwriters. The Immersion Defendants will not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement exceeds the amount of the insurance coverage, a circumstance which we believe is remote. The settlement will require approval of the Court, which cannot be assured, after class members are given the opportunity to object to the settlement or opt out of the settlement.

IF WE FAIL TO COMPLY WITH NASDAQ S MAINTENANCE CRITERIA FOR CONTINUED LISTING ON THE NASDAQ NATIONAL MARKET, OUR COMMON STOCK COULD BE DELISTED.

To maintain the listing of our common stock on the Nasdaq National Market, we are required to comply with one of two sets of maintenance criteria for continued listing. Under the first set of criteria, among other things, we must maintain stockholders equity of at least $10 million, the market value of our publicly held common stock (excluding shares held by our affiliates) must be at least $5 million, and the minimum bid price for our common stock must be at least $1.00 per share. Under the second set of criteria, among other things, the market value of our common stock must be at least $50 million or we must have both $50 million in assets and $50 million in revenues, the market value of our publicly held shares must be at least $15 million, and the minimum bid price for our common stock must be at least $1.00 per share. As of December 31, 2004, our most recent balance sheet date, we had a deficit in stockholders equity, and therefore would not have been in compliance with the first set of listing criteria as of that date. Although we were in compliance with the second set of criteria, should the price of our common stock decline to the point where the aggregate value of our outstanding common stock falls below $50 million, the value of our publicly held shares falls below $15 million, or the bid price of our common stock falls below $1.00 per share, our shares could be delisted from the Nasdaq National Market. If we are unable to comply with the applicable criteria and our common stock is delisted from the Nasdaq National Market, it would likely be more difficult to effect trades and to determine the market price of our common stock. In addition, delisting of our common stock could materially affect the market price and liquidity of our common stock and our future ability to raise necessary capital.

OUR STOCK PRICE MAY FLUCTUATE REGARDLESS OF OUR PERFORMANCE.

The stock market has experienced extreme volatility that often has been unrelated or disproportionate to the performance of particular companies. These market fluctuations may cause our stock price to decline regardless of our performance. The market price of our common stock has been, and in the future could be, significantly affected by factors such as: actual or anticipated fluctuations in operating results; announcements of technical innovations; announcements regarding litigation in which we are involved; new products or new contracts; sales or the perception in the market of possible sales of large number of shares of Immersion common stock by insiders or others; changes in securities analysts recommendations; changing circumstances regarding competitors or their customers; governmental regulatory action; developments with respect to patents or proprietary rights; inclusion in or exclusion from various stock indices; and general market conditions. In the past, following periods of volatility in the market price of a company s securities, securities class action litigation has been initiated against that company, such as the suit currently filed against us.

PROVISIONS IN OUR CHARTER DOCUMENTS AND DELAWARE LAW COULD PREVENT OR DELAY A CHANGE IN CONTROL, WHICH COULD REDUCE THE MARKET PRICE OF OUR COMMON STOCK.

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. In addition, certain provisions of Delaware law may discourage, delay, or prevent someone from acquiring or merging with us. These provisions could limit the price that investors might be willing to pay in the future for shares.

ISSUANCE OF THE SHARES OF COMMON STOCK UPON CONVERSION OF DEBENTURES AND EXERCISE OF WARRANTS WILL DILUTE THE OWNERSHIP INTEREST OF EXISTING STOCKHOLDERS AND COULD ADVERSELY AFFECT THE MARKET PRICE OF OUR COMMON STOCK.

The issuance of shares of common stock in the following circumstances will dilute the ownership interest of existing stockholders: (i) upon conversion of some or all of the convertible debentures and (ii) upon exercise of some or all of the warrants. Any sales in the public market of the common stock issuable upon such conversion or upon such exercise, respectively, could adversely affect prevailing market prices of our common stock. In addition, the existence of these convertible debentures and warrants may encourage short selling by market participants.

OUR CONVERTIBLE DEBENTURES PROVIDE FOR VARIOUS EVENTS OF DEFAULT AND CHANGE OF CONTROL TRANSACTIONS THAT WOULD ENTITLE THE SELLING STOCKHOLDERS TO REQUIRE US TO REPAY THE ENTIRE AMOUNT OWED IN CASH. IF AN EVENT OF DEFAULT OR CHANGE OF CONTROL OCCURS, WE MAY BE UNABLE TO IMMEDIATELY REPAY THE AMOUNT OWED, AND ANY REPAYMENT MAY LEAVE US WITH LITTLE OR NO WORKING CAPITAL IN OUR BUSINESS.

Our convertible debentures provide for various events of default, such as the termination of trading of our common stock on the Nasdaq Stock Market, and specified change of control transactions. If an event of default or change of control occurs prior to maturity, we may be required to redeem all or part of the convertible debentures, including payment of applicable interest and penalties. Some of the events of default include matters over which we may have some, little, or no control. Many other events of default are described in the agreements we executed when we issued the convertible debentures. If an event of default or a change of control occurs, we may be required to repay the entire amount, plus liquidated damages, in cash. Any such repayment could leave us with little or no working capital for our business. We have not established a sinking fund for payment of our outstanding convertible debentures, nor do we anticipate doing so.

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USE OF PROCEEDS

We will not receive any proceeds from the disposition by the selling stockholders of the common stock covered hereby or interests therein. The selling stockholders will receive all of the proceeds. However, upon any exercise of the warrants by payment of cash, we will receive the exercise price of the warrants. We will use any such cash proceeds for general corporate purposes.

DIVIDEND POLICY

We have never paid cash dividends on our common stock. We currently intend to retain earnings for use in our business and do not anticipate paying any cash dividend on our common stock in the foreseeable future. Any future declaration and payment of dividends on our common stock will be subject to the discretion of our board of directors, will be subject to applicable law and will depend on our results of operations, earnings, financial condition, contractual limitations, cash requirements, future prospects and other factors deemed relevant by our Board of Directors.

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DESCRIPTION OF CAPITAL STOCK

Our authorized capital stock consists of 100,000,000 shares of common stock, $0.001 par value per share, and 5,000,000 shares of preferred stock, $0.001 par value per share. Of the 5,000,000 authorized shares of preferred stock, 2,814,208 shares remain available for issuance.

The following is a summary of the material terms of our common stock and preferred stock. Please see our certificate of incorporation for more detailed information.

Common Stock

The holders of our common stock are entitled to one vote for each share held of record on all matters submitted to a vote of stockholders. Holders of a majority of the shares of common stock entitled to vote in any election of directors may elect all of the directors standing for election. Subject to preferences applicable to any outstanding preferred stock, holders of common stock are entitled to receive ratably any dividends declared by the Board of Directors out of funds legally available therefor. See Dividend Policy. In the event of a liquidation, dissolution or winding up of Immersion, holders of common stock are entitled to share ratably in the assets remaining after payment of liabilities and the liquidation preferences of any outstanding preferred stock. Holders of our common stock have no preemptive, conversion or redemption rights.

Preferred Stock

Our Board of Directors has the authority, without further action by our stockholders, to issue preferred stock in one or more series. In addition, the Board of Directors may fix the rights, preferences and privileges of any preferred stock it determines to issue. Any or all of these rights may be superior to the rights of the common stock with terms calculated to delay or prevent a change in control of Immersion or to make removal of management more difficult. Additionally, the issuance of preferred stock may decrease the market price of our common stock.

Registration Rights

Under our agreements with the selling stockholders, we agreed to file, at our expense, with the Securities and Exchange Commission, or the SEC, a shelf registration statement on Form S-3 covering the resale of shares of Immersion common stock issued to the selling stockholders upon conversion of the convertible debentures and the common stock issuable upon the exercise of the warrants. Terms of our agreement with respect to the registration of the shares are set forth under the caption Plan of Distribution below.

Antitakeover Provisions

Delaware Law

Immersion is subject to Section 203 of the Delaware General Corporation Law regulating corporate takeovers, which prohibits a Delaware corporation from engaging in any business combination with an interested stockholder, unless:

- prior to the date of the transaction, the Board of Directors of the corporation approved either the business combination or the transaction which resulted in the stockholder becoming an interested stockholder;

- the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced, excluding for purposes of determining the number of shares outstanding (a) shares owned by persons who are directors and also officers, and (b) shares owned by employee stock plans in which employee participants do not have the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer; or

on or subsequent to the date of the transaction, the business combination is approved by the board and authorized at an annual or special meeting of stockholders, and not by written consent, by the affirmative vote of at least 66 2/3% of the outstanding voting stock which is not owned by the interested stockholder.

Except as otherwise specified in Section 203, an interested stockholder is defined to include (a) any person that is the owner of 15% or more of the outstanding voting securities of the corporation, or is an affiliate or associate of the corporation and was the owner of 15% or more of the outstanding voting stock of the corporation at any time within three years immediately prior to the date of determination and (b) the affiliates and associates of any such person.

Certificate of Incorporation and Bylaw Provisions

Our Certificate of Incorporation provides that the Board of Directors will be divided into three classes of directors serving staggered three-year terms. Each class of directors need not be of equal number, with the size to be fixed exclusively by the Board. As a result, only one of the three classes of the Board will be elected each year. The directors are removable only for cause upon the affirmative vote of the holders of at least a majority of the voting power of all outstanding shares of voting stock, voting together as a single class. The Board has the exclusive right to set the authorized number of directors and to fill vacancies on the Board. Our Certificate of Incorporation requires that any action required or permitted to be taken by stockholders of Immersion must be effected at a duly called annual or special meeting of the stockholders and may not be effected by a consent in writing. In addition, special meetings of the stockholders of Immersion may be called only by the Board or the holders of not less than ten percent of the shares entitled to vote at such a meeting. Advance notice is required for stockholder proposals or director nominations by stockholders.

In addition, pursuant to our Certificate of Incorporation, the Board has authority to issue up to 2,814,208 shares of preferred stock and to fix the rights, preferences, privileges and restrictions, including voting rights, of these shares without any further vote or action by the stockholders. The rights of the holders of the common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of the outstanding voting stock of the company, thereby delaying, deferring or preventing a change in control of the company. Furthermore, such preferred stock may have other rights, including economic rights, senior to the common stock, and as a result, the issuance of such preferred stock could have a material adverse effect on the market price of the common stock.

These provisions could discourage potential acquisition proposals and could delay or prevent a change in control of the company. Such provisions could diminish the opportunities for a stockholder to participate in tender offers, including tender offers at a price above the then current market price of the common stock. Such provisions also may inhibit fluctuations in the market price of the common stock that could result from takeover attempts.

Transfer Agent and Registrar

The transfer agent and registrar for our common stock is Equiserve, Inc.

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DESCRIPTION OF DEBENTURES

Our convertible debentures were issued on December 23, 2004. The following description summarizes the material provisions of the convertible debentures. It does not purport to be complete and is subject to, and qualified in its entirety by, the provisions of the convertible debentures, including the definitions of certain capitalized terms used in this section, but that are not defined in this section. A copy of the form of convertible debenture is attached as Exhibit A to the Purchase Agreement, which is an exhibit to the registration statement of which this prospectus forms a part.

General

On December 23, 2004, we issued an aggregate principal amount of $20 million of convertible debentures. Our convertible debentures will mature on December 22, 2009, the Maturity Date. The amount payable at maturity of each convertible debenture is the initial principal plus all accrued but unpaid interest thereon, to the extent such principal amount and interest has not been converted into common shares or previously paid in cash. We cannot prepay the convertible debentures except as described below in Mandatory Conversion and Mandatory Redemption of Convertible Debentures at Our Option.

Interest

Commencing on the date the convertible debenture was issued, interest accrues daily on the principal amount of the convertible debenture at a rate of 5.00% per year. Interest is payable on the last day of each calendar quarter, commencing on March 31, 2005.

Interest will cease to accrue on that portion of the convertible debenture that is converted or paid, including pursuant to conversion right or redemption. We may not reissue a convertible debenture that has matured or been converted, redeemed or otherwise cancelled, except for registration of transfer, exchange or replacement of such convertible debenture.

Ranking of Convertible Debentures

Our convertible debentures are subordinate to all Senior Debt, whether outstanding on the date of issue of our convertible debentures or thereafter created, incurred, assumed or guaranteed. Senior Debt includes all indebtedness that ranks on a parity with or senior to the convertible debentures in right of payment. Our convertible debentures are unsecured.

Conversion Rights

The holder of a convertible debenture has the right to convert the outstanding principal amount and accrued and unpaid interest in whole or in part into our common shares at a price of $7.0265 per common share, the Conversion Price, as may be adjusted under the convertible debenture, by delivering to us a conversion notice.

Mandatory Conversion and Mandatory Redemption of Convertible Debentures at Our Option

Commencing on December 23, 2005, the Mandatory Conversion Eligibility Date, if the daily volume-weighted average price of our common shares has been at or above 200% of the Conversion Price for at least 20 consecutive trading days and certain other conditions are met, we have the right to (i) require the holder of a convertible debenture to convert the convertible debenture in whole, including interest, into shares of our common stock at a price of $7.0265 per common share, as may be adjusted under the debenture, as set forth and subject to the conditions in the convertible debenture, or (ii) redeem the convertible debenture. If we make either of the foregoing elections with respect to any convertible debenture, we must make the same election with respect to all convertible debentures.

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Redemption Upon a Change of Control

In the event of a Change of Control, a holder may require us to redeem all or a portion of their convertible debenture. The redeemed portion shall be redeemed at a price equal to the redeemed amount multiplied by (a) 110% of the principal amount of the convertible debenture if the Change of Control occurs on or prior to December 23, 2005, (b) 105% of the principal amount of the convertible debenture if the Change of Control occurs after December 23, 2005 and on or prior to December 23, 2006, or (c) 100% of the principal amount of the convertible debenture if the Change of Control occurs after December 23, 2006.

Conversion Price Adjustments

The Conversion Price will be reduced in certain instances where shares of common stock are sold or deemed to be sold at a price less than the applicable Conversion Price, including the issuance of certain options, the issuance of convertible securities, or the change in exercise price or rate of conversion for options or convertible securities. The Conversion Price will be proportionately adjusted if we subdivide (by stock split, stock dividend, recapitalization or otherwise) or combine (by combination, reverse stock split or otherwise) one or more classes of our common stock.

Certain Covenants

So long as any convertible debentures are outstanding, we will not, nor will we permit any of our subsidiaries to, directly or indirectly, incur or guarantee, assume or suffer to exist any Indebtedness other than Permitted Indebtedness.

Issuance Limitations

We will not be obligated to issue any shares of our common stock upon conversion of the convertible debentures if the issuance would exceed the aggregate number of shares of our common stock that we may issue upon conversion and exercise of the convertible debentures and warrants without breaching the Nasdaq rules. However, in such event, we will be required to obtain stockholder approval under applicable Nasdaq rules to permit the full conversion of the convertible debentures.

Default and Related Matters

If an Event of Default occurs, and is continuing with respect to any of our convertible debentures, the holder may, at its option, require us to redeem all or a portion of the convertible debenture.

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DESCRIPTION OF WARRANTS

The warrants were issued on December 23, 2004. The following description summarizes the material provisions of the warrants. It does not purport to be complete and is subject to, and qualified in its entirety by, the provisions of the warrants, including the definitions of certain capitalized terms used in this section, but that are not defined in this section. A copy of the form of warrant is attached as Exhibit B to the Purchase Agreement, which is an exhibit to the registration statement of which this prospectus forms a part.

General

On December 23, 2004, we issued warrants to purchase an aggregate of 426,951 shares of our common stock at an exercise price of $7.0265, the Exercise Price, subject to certain adjustments. The warrants may be exercised at any time prior to 5:00 p.m. Eastern time, on December 23, 2009. Any warrants not exercised prior to such time will expire.

Exercise of Warrants

If a warrant is not exercised in full, the number of common shares to be available for purchase thereunder shall be reduced by the number of such common shares for which that warrant is exercised. We must deliver the stock certificates within three business days after we receive the exercise delivery documents.

Issuance Limitations

We will not be obligated to issue any shares of our common stock upon exercise of the warrants if the issuance would exceed the aggregate number of shares of our common stock that we may issue upon conversion and exercise of the convertible notes and warrants without breaching the Nasdaq rules. However, in such event, we will be required to obtain stockholder approval under applicable Nasdaq rules to permit the full exercise of the warrants.

Exercise Price Adjustments

The Exercise Price will be reduced in certain instances where shares of common stock are sold or deemed to be sold at a price less than the applicable Exercise Price, including the issuance of certain options, the issuance of convertible securities, or the change in exercise price or rate of conversion for option or convertible securities. The Exercise Price will be proportionately adjusted if we subdivide (by stock split, stock dividend, recapitalization or otherwise) or combine (by combination, reverse stock split or otherwise) one or more classes of our common stock.

Warrant Holder not a Stockholder

Except as otherwise provided in the warrant, the holders of the warrants, solely in their capacities as holders of warrants, shall not be deemed to be stockholders of Immersion nor have the rights of stockholders of Immersion.

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SELLING STOCKHOLDERS

The shares of common stock covered hereby are issuable by us pursuant to a private placement of debentures and warrants on terms and conditions set forth in a series of agreements with the selling stockholders including a purchase agreement, registration rights agreement, 5% senior subordinated convertible debenture and warrants to purchase common stock. The selling stockholders may, from time to time, offer and sell pursuant to this prospectus any or all of the common stock covered hereby or interests herein.

The following table contains information as of February 24, 2005, with respect to the selling stockholders and the principal amount of convertible debentures and the underlying common stock beneficially owned by each selling securityholder that may be disposed of pursuant to this prospectus.

Selling Stockholders	Principal Amount of Debentures ($)	Percentage of Debentures Outstanding	Number of Shares of Common Stock Issuable Upon Conversion of Debentures(1)	Number of Shares Issuable Upon Exercise of Warrants (2)	Total Number of Shares Offered Hereby	Percentage of Common Stock Outstanding(3)
DKR Soundshore Oasis Holding Fund Ltd. (4)	5,000,000	25.0	711,591	106,738	818,329	3.3
Morgan Stanley & Co. Incorporated (5)	5,000,000	25.0	711,591	106,738	818,329	3.3
Special Situations Private Equity Fund, L.P. (6)	4,000,000	20.0	569,273	85,391	654,664	2.7
Special Situations Fund III, L.P. (6)	3,800,000	19.0	540,809	81,121	621,930	2.6
Special Situations Cayman Fund, L.P. (6)	1,100,000	5.5	156,550	23,482	180,032	*
Special Situations Technology Fund II, L.P. (6)	925,000	4.6	131,644	19,746	151,390	*
Special Situations Technology Fund, L.P. (6)	175,000	0.9	24,905	3,735	28,640	*

* Less than one percent.

(1) Assumes conversion of all of the selling stockholder s convertible debentures at a conversion price of $7.0265 per share of common stock. However, this conversion price will be subject to adjustment as described under Description of Debentures Conversion Rights. As a result, the amount of common stock issuable upon

conversion of the convertible debentures may increase or decrease in the future.

(2) Assumes the exercise of all of the selling stockholder s warrants at an exercise price of $7.0265 per share of common stock. However, this exercise price will be subject to adjustment as described under Description of Warrants - Exercise Price Adjustments. As a result, the amount of common stock issuable upon exercise of the warrants may increase or decrease in the future.

(3) Calculated based on Rule 13d-3(d)(1)(i) of the Securities Exchange Act of 1934 using 23,717,486 shares of common stock outstanding as of February 24, 2005. In calculating this amount we treated as outstanding the number of shares of common stock issuable upon conversion of that particular selling stockholder s convertible debentures and exercise of that particular selling stockholder s warrants. However, we did not assume the conversion of any other selling stockholder s convertible debentures or the exercise of any other selling stockholder s warrants, not did we assume the issuance of any shares with respect to unpaid interest, if any, at the time of conversion of the convertible debentures.

(4) DKR Soundshore Oasis Holding Fund Ltd. (the Fund) is a master fund in a master-feeder structure. The Fund s investment manager is DKR Oasis Management Company LP (the Investment Manager). Pursuant to an investment management agreement among the Fund, the feeder funds and the Investment Manager, the Investment Manager has the authority to do any and all acts on behalf of the Fund. Mr. Seth Fischer is the managing partner of Oasis Management Holdings LLC, one of the general partners of the Investment Manager. Mr. Fischer has ultimate responsibility for trading and voting of shares held by the Fund. Mr. Fischer disclaims beneficial ownership of the shares.

(5) Morgan Stanley & Co. Incorporated is a registered broker dealer.

(6) MGP Advisers Limited (MGP) is the general partner of Special Situations Fund III, L.P. AWM Investment Company, Inc. (AWM) is the general partner of MGP and the general partner of and investment adviser to the Special Situations Cayman Fund, L.P. SST Advisers, L.L.C. (SSTA) is the general partner of and investment adviser to the Special Situations Technology Fund, L.P. and the Special Situations Technology Fund II, L.P. MG Advisers, L.L.C. (MG) is the general partner of and investment adviser to the Special Situations Private Equity Fund, L.P. Austin W. Marxe and David M. Greenhouse are the principal owners of MGP, AWM, SSTA and MG and are solely responsible for the selection, acquisition and disposition of the portfolio securities by each investment adviser on behalf of its fund.

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PLAN OF DISTRIBUTION

The selling stockholders, which as used herein includes donees, pledgees, transferees or other successors-in-interest selling shares of common stock or interests in shares of common stock received after the date of this prospectus from a selling stockholder as a gift, pledge, partnership distribution or other transfer, may, from time to time, sell, transfer or otherwise dispose of any or all of their shares of common stock or interests in shares of common stock on any stock exchange, market or trading facility on which the shares are traded or in private transactions. These dispositions may be at fixed prices, at prevailing market prices at the time of sale, at prices related to the prevailing market price, at varying prices determined at the time of sale, or at negotiated prices.

The selling stockholders may use any one or more of the following methods when disposing of shares or interests therein:

ordinary brokerage transactions and transactions in which the broker-dealer solicits purchasers;

block trades in which the broker-dealer will attempt to sell the shares as agent, but may position and resell a portion of the block as principal to facilitate the transaction;

purchases by a broker-dealer as principal and resale by the broker-dealer for its account;

an exchange distribution in accordance with the rules of the applicable exchange;

privately negotiated transactions;

short sales effected after the date the registration statement of which this prospectus is a part is declared effective by the SEC;

through the writing or settlement of options or other hedging transactions, whether through an options exchange or otherwise;

broker-dealers may agree with the selling stockholders to sell a specified number of such shares at a stipulated price per share;

a combination of any such methods of sale; and

any other method permitted pursuant to applicable law.

The selling stockholders may, from time to time, pledge or grant a security interest in some or all of the shares of common stock owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of common stock, from time to time, under this prospectus, or under an amendment to this prospectus under Rule 424(b)(3) or other applicable provision of the Securities Act amending the list of selling stockholders to include the pledgee, transferee or other successors in interest as selling stockholders under this prospectus. The selling stockholders also may transfer the shares of common stock in other circumstances, in which case the transferees, pledgees or other successors in interest will be the selling beneficial owners for purposes of this prospectus.

In connection with the sale of our common stock or interests therein, the selling stockholders may enter into hedging transactions with broker-dealers or other financial institutions, which may in turn engage in short sales of the common stock in the course of hedging the positions they assume. The selling stockholders may also sell shares of our common stock short and deliver these securities to close out their short positions, or loan or pledge the common stock to broker-dealers that in turn may sell these securities. The selling stockholders may also enter into option or other transactions with broker-dealers or other financial institutions or the creation of one or more derivative securities which require the delivery to such broker-dealer or other financial institution of shares offered by this prospectus, which shares such broker-dealer or other financial institution may resell pursuant to this prospectus (as supplemented or amended to reflect such transaction).

The aggregate proceeds to the selling stockholders from the sale of the common stock offered by them will be the purchase price of the common stock less discounts or commissions, if any. Each of the selling stockholders reserves the right to accept and, together with their agents from time to time, to reject, in whole or in part, any proposed purchase of common stock to be made directly or through agents. We will not receive any of the proceeds

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from this offering. Upon any exercise of the warrants by payment of cash, however, we will receive the exercise price of the warrants.

The selling stockholders also may resell all or a portion of the shares in open market transactions in reliance upon Rule 144 under the Securities Act of 1933, provided that they meet the criteria and conform to the requirements of that rule.

The selling stockholders and any underwriters, broker-dealers or agents that participate in the sale of the common stock or interests therein may be underwriters within the meaning of Section 2(11) of the Securities Act. Any discounts, commissions, concessions or profit they earn on any resale of the shares may be underwriting discounts and commissions under the Securities Act. Selling stockholders who are underwriters within the meaning of Section 2(11) of the Securities Act will be subject to the prospectus delivery requirements of the Securities Act. Morgan Stanley & Co. Incorporated is an underwriter.

To the extent required, the shares of our common stock to be sold, the names of the selling stockholders, the respective purchase prices and public offering prices, the names of any agents, dealer or underwriter, any applicable commissions or discounts with respect to a particular offer will be set forth in an accompanying prospectus supplement or, if appropriate, a post-effective amendment to the registration statement that includes this prospectus.

In order to comply with the securities laws of some states, if applicable, the common stock may be sold in these jurisdictions only through registered or licensed brokers or dealers. In addition, in some states the common stock may not be sold unless it has been registered or qualified for sale or an exemption from registration or qualification requirements is available and is complied with.

We have advised the selling stockholders that the anti-manipulation rules of Regulation M under the Exchange Act may apply to sales of shares in the market and to the activities of the selling stockholders and their affiliates. In addition, we will make copies of this prospectus (as it may be supplemented or amended from time to time) available to the selling stockholders for the purpose of satisfying the prospectus delivery requirements of the Securities Act. The selling stockholders may indemnify any broker-dealer that participates in transactions involving the sale of the shares against certain liabilities, including liabilities arising under the Securities Act.

We have agreed to indemnify the selling stockholders against liabilities, including liabilities under the Securities Act and state securities laws, relating to the registration of the shares offered by this prospectus.

We have agreed with the selling stockholders to keep the registration statement of which this prospectus constitutes a part effective until the earlier of (1) such time as all of the shares covered by this prospectus have been disposed of pursuant to and in accordance with the registration statement or (2) the date on which the shares may be sold pursuant to Rule 144(k) of the Securities Act.

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Timing

The common stock or interests therein may be disposed of from time to time by the selling stockholders or their transferees. There is no assurance that the selling stockholders will dispose of any of the shares of common stock covered hereby or any interests therein.

Selling stockholders will be subject to applicable provisions of the Securities Exchange Act of 1934 and the rules and regulations thereunder, which provisions may limit the timing of purchases and sales of our securities by them.

Proceeds, Commissions and Expenses

We will not receive any of the proceeds from the disposition of any shares of common stock covered hereby or interests therein. In the event that the warrants are exercised, we will receive the net proceeds of such exercises. We will use such proceeds for general corporate purposes.

The selling stockholders will be responsible for payment of all commissions, concessions and discounts of underwriters, dealers or agents, if any.

We will pay for all costs of the registration of the securities, including, without limitation, SEC filing fees and expenses of compliance with state securities or blue sky laws.

Registration

We agreed with the selling stockholders to keep the registration statement of which this prospectus constitutes a part effective until the earlier of:

Such time as all of the shares have been disposed of by the selling stockholders; or

Such time as the selling stockholders may dispose of all of the shares held by them without registration pursuant to Rule 144(k) under the Securities Act.

We intend to de-register any of the shares not disposed of by the selling stockholders at the end of such period. At such time, however, any unsold shares may be freely tradable subject to compliance with Rule 144 under the Securities Act.

LEGAL MATTERS

The validity of the shares of common stock offered hereby will be passed upon for us by DLA Piper Rudnick Gray Cary US LLP, East Palo Alto, California.

EXPERTS

The consolidated financial statements, the related consolidated financial statement schedule, and management s report on the effectiveness of internal control over financial reporting incorporated in this prospectus by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2004, have been audited by Deloitte & Touche LLP, independent registered public accounting firm, as stated in their reports, which are incorporated herein by reference, and have been so incorporated in reliance upon the reports of such firm given upon their authority as experts in accounting and auditing.

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WHERE YOU CAN FIND MORE INFORMATION

We file reports, proxy statements and other information with the SEC. You may read and copy all or any portion of any materials we file with the SEC at the SEC s public reference room at Room 1024, Judiciary Plaza, 450 Fifth Street, N.W., Washington, D.C. 20549 and at the regional offices of the SEC. You can request copies of these documents upon payment of a duplicating fee, by writing to the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference rooms. Our SEC filings will also be available to you on the SEC s Web site at http://www.sec.gov. Our SEC filings are also available at the offices of the Nasdaq National Market, 1730 K Street, N.W., Washington, D.C. 20006-1500.

Copies of our SEC filings and other information about us are also available on our website at www.immersion.com. The information on our website is neither incorporated into, nor a part of, this prospectus.

The information incorporated by reference is considered to be a part of this prospectus, and information that we file later with the Commission will automatically update and supersede this information. We incorporate by reference the documents listed below and any future filings made by us with the Commission under Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act until this offering is complete:

- our Annual Report on Form 10-K for the year ended December 31, 2004;
- our Current Reports on Form 8-K filed on March 28 and April 6, 2005;
- our definitive Proxy Statement on Schedule 14A filed on April 12, 2005; and
- our Registration Statement on Form 8-A12G, filed on November 5, 1999, which contains a description of our common stock.

Any statement contained in a document that is incorporated by reference will be modified or superseded for all purposes to the extent that a statement contained in this prospectus (or in any other document that is subsequently filed with the Commission and incorporated by reference) modifies or is contrary to that previous statement. Any statement so modified or superseded will not be deemed a part of this prospectus except as so modified or superseded.

You may request a copy of these filings, at no cost, by writing or telephoning us at the following address: Investor Relations, Immersion Corporation, 801 Fox Lane, San Jose, California 95131 (408) 467-1900.