

FRANKLIN ELECTRONIC PUBLISHERS INC  
Form 10-Q  
November 14, 2003

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D. C. 20549

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**FORM 10-Q**

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**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended: September 30, 2003

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 0-14841

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**FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED**

(Exact Name of Registrant as Specified in Its Charter)

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**Pennsylvania**  
(State or other Jurisdiction of  
Incorporation or Organization)

**22-2476703**  
(I.R.S. Employer  
Identification No.)

**One Franklin Plaza, Burlington, New Jersey 08016-4907**

(Address of Principal Executive Office)

**(609) 386-2500**

(Registrant's Telephone Number)

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Indicate by check mark whether Registrant (1) has 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 Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

COMMON STOCK OUTSTANDING AS OF SEPTEMBER 30, 2003: **7,952,532 SHARES**

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

## AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	September, 30 2003	March 31, 2003
	(Unaudited)	(Audited)
<b><u>ASSETS</u></b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 1,708	\$ 1,459
Accounts receivable, less allowance for doubtful accounts of \$913 and \$892	11,870	6,579
Inventories	13,139	12,009
Prepays and other assets	2,314	2,261
<b>TOTAL CURRENT ASSETS</b>	<b>29,031</b>	<b>22,308</b>
<b>PROPERTY AND EQUIPMENT</b>	<b>6,774</b>	<b>6,606</b>
<b>OTHER ASSETS:</b>		
Deferred income tax asset	5,700	5,700
Trademark and goodwill	3,796	3,796
Software development costs	2,341	2,026
Other assets	4,662	4,378
<b>TOTAL OTHER ASSETS</b>	<b>16,499</b>	<b>15,900</b>
<b>TOTAL ASSETS</b>	<b>\$ 52,304</b>	<b>\$ 44,814</b>
<b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable and accrued expenses	\$ 13,500	\$ 10,600
Current portion of long-term liabilities - Other	126	47
<b>TOTAL CURRENT LIABILITIES</b>	<b>13,626</b>	<b>10,647</b>
<b>LONG-TERM LIABILITIES:</b>		
Revolving credit facility	9,508	6,134
Other liabilities	1,199	1,308
<b>TOTAL LONG-TERM LIABILITIES</b>	<b>10,707</b>	<b>7,442</b>

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**SHAREHOLDERS EQUITY:**

Preferred stock, \$2.50 par value, authorized 10,000,000 shares, 4,361 and 4,153 issued and outstanding (\$4,361 and \$4,153 liquidation value)	4,339	4,131
Common stock, \$0.01 par value, authorized 50,000,000 shares, issued and outstanding, 7,952,532 and 7,946,282 shares	80	79
Additional paid in capital	49,978	49,943
Accumulated deficit	(25,521)	(26,340)
Foreign currency translation adjustment	(905)	(1,088)
	<u>          </u>	<u>          </u>
<b>TOTAL SHAREHOLDERS EQUITY</b>	<b>27,971</b>	<b>26,725</b>
	<u>          </u>	<u>          </u>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 52,304</b>	<b>\$ 44,814</b>
	<u>          </u>	<u>          </u>

See notes to consolidated financial statements.

## FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

## AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except for per share data)

(unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2003	2002	2003	2002
<b>SALES</b>	\$ 15,671	\$ 21,054	\$ 30,654	\$ 37,571
<b>COST OF SALES</b>	8,138	11,401	16,138	20,671
<b>GROSS MARGIN</b>	7,533	9,653	14,516	16,900
<b>EXPENSES:</b>				
Sales and marketing	4,194	4,691	8,324	8,797
Research and development	681	714	1,403	1,543
General and administrative	1,732	1,820	3,244	3,412
Total operating expenses	6,607	7,225	12,971	13,752
<b>OPERATING INCOME</b>	926	2,428	1,545	3,148
Interest expense	(147)	(227)	(266)	(403)
Interest and investment income (loss)	(35)	223	(269)	(185)
Other, net	8	135	38	156
<b>INCOME BEFORE INCOME TAXES</b>	752	2,559	1,048	2,716
<b>INCOME TAX PROVISION</b>	5		21	
<b>NET INCOME</b>	747	2,559	1,027	2,716
<b>PREFERRED STOCK DIVIDEND</b>			208	188
<b>INCOME APPLICABLE TO COMMON SHAREHOLDERS</b>	\$ 747	\$ 2,559	\$ 819	\$ 2,528
<b>INCOME PER COMMON SHARE:</b>				
Basic	\$ 0.09	\$ 0.32	\$ 0.10	\$ 0.32
Diluted	\$ 0.09	\$ 0.32	\$ 0.10	\$ 0.32
<b>WEIGHTED AVERAGE COMMON SHARES:</b>				
Basic	7,970	7,947	7,955	7,947
Diluted	8,341	7,958	8,287	8,007

See notes to consolidated financial statements.

## FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

## AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(in thousands, except for share data)

	Common Stock			Preferred Stock		Accumulated Other Comprehensive Income *	Total Shareholders Equity	
	Shares	Amount	Additional Paid in Capital	Shares	Amount			
<b>BALANCE - MARCH 31, 2003</b>	7,946,282	\$ 79	\$ 49,943	4,153	\$ 4,131	\$ (26,340)	\$ (1,088)	\$ (23,218)
Issuance of common shares under employee stock option plan	24,250	1	35					1
Preferred stock dividend				208	208	(208)		
Income for the period						1,027		1,027
Foreign currency translation adjustment							183	183
<b>BALANCE - SEPTEMBER 30, 2003 (unaudited)</b>	<b>7,970,532</b>	<b>\$ 80</b>	<b>\$ 49,978</b>	<b>4,361</b>	<b>\$ 4,339</b>	<b>\$ (25,521)</b>	<b>\$ (905)</b>	<b>\$ (22,007)</b>

\* Comprehensive income, i.e., net income, plus, or less, the change in foreign currency balance sheet translation adjustments, totaled \$1,210 for the six months ended September 30, 2003.

See notes to consolidated financial statements.

## FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

## AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended September 30,	
	2003	2002
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
NET INCOME	\$ 1,027	\$ 2,716
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Depreciation and amortization	1,587	1,671
Provision for losses on accounts receivable	76	132
Loss (gain) on disposal of property and equipment	(4)	3
Stock issued for services		45
Source (use) of cash from change in operating assets and liabilities:		

If Mr. Mathur's employment is terminated (i) as a result of Mr. Mathur's death or disability; (ii) without cause (as defined in the agreement), by non-renewal of the agreement by the Company at any time; or (iii) within six months after a change of control (as defined in the agreement) by Mr. Mathur, in each case he is to receive severance of one (1) year's salary and continuation of health and dental benefits until the earlier of one (1) year after termination or his coverage commencing under another employer's health plan. Pursuant to Mr. Mathur's employment agreement, Mr. Mathur was granted options to purchase 500,000 shares of stock on January 1, 2007, with an exercise price based on the average closing price of the Company's common stock during the thirty (30) day period prior to the grant date. Options with respect to 250,000 shares vest on the first anniversary of employment and options with respect to the other 250,000 shares vest on the second anniversary of employment. Under the terms of this agreement, the Company will be in breach of the agreement if Mr. Mathur is not nominated for election to the Board of Directors of the Company for each year that the agreement is still in effect.

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## REPORT OF THE AUDIT COMMITTEE

The ultimate responsibility for good corporate governance rests with the Board of Directors, whose primary roles are oversight, counseling and direction to the Company's management in the best long-term interests of the corporation and its stockholders. The Board's Audit Committee (the "Audit Committee") has been established for the purpose of overseeing the accounting and financial reporting processes of the Company and auditing of the Company's annual financial statements. The Sarbanes-Oxley Act of 2002 added a number of provisions to federal law to strengthen the authority of, and increase the responsibility of, corporate audit committees. The Company is subject as well to related rules concerning audit committee



structure, membership, authority and responsibility recently adopted by the AMEX.

The Company's Audit Committee operates under a written charter adopted by the Board. The composition of the Audit Committee and the attributes of its members and its responsibilities, as reflected in its charter, is intended to be in accordance with applicable requirements for corporate audit committees. The Audit Committee reviews and assesses the adequacy of its charter on an annual basis.

The Audit Committee charter requires that the Audit Committee consist solely of no fewer than three (3) independent directors. At the present time, the Audit Committee is comprised of Sunil K. Pai, Terrence O'Donnell and Stephen J. Morris. Prior to Mr. Pai joining the Board, the Audit Committee consisted of only two (2) directors. AMEX Rule 121(c), however, provides that "Small Business Issuers" (as defined in SEC Regulation S-B) are only required to maintain a Board of Directors comprised of at least 50% of independent directors and an Audit Committee of at least two (2) members, comprised solely of independent directors. The Company qualifies as a Small Business Issuer (*i.e.*, the Company is a U.S. issuer with revenues less than \$25,000,000 and has a public float less than \$25,000,000).

As described more fully in its charter, the purpose of the Audit Committee is to assist the Board in its general oversight of the Company's financial reporting, internal controls and audit functions. Management is responsible for the preparation, presentation and integrity of the Company's financial statements; accounting and financial reporting principles; internal controls; and procedures designed to ensure compliance with accounting standards, applicable laws and regulations. The Company's independent auditing firm is responsible for performing an independent audit of the consolidated financial statements in accordance with generally accepted auditing standards. In accordance with the Sarbanes-Oxley Act, the Audit Committee has ultimate authority and responsibility to select, compensate, evaluate and, when appropriate, replace the Company's independent auditors.

The Audit Committee members are not professional accountants or auditors, and their functions are not intended to duplicate or to certify the activities of management and the independent auditors, nor can the Audit Committee certify that the independent auditors are "independent" under applicable rules. The Audit Committee serves a board-level oversight role, in which it provides advice, counsel and direction to management and the auditors on the basis of the information it receives, discussions with management and the auditors, and the experience of the Audit Committee's members in business, financial and accounting matters. The Audit Committee has the authority to engage its own outside advisers, including experts in particular areas of accounting, as it determines appropriate, apart from counsel or advisers hired by management.

The Audit Committee has an annual agenda that includes reviewing the Company's financial statements, internal controls and audit matters. The Audit Committee meets each quarter with the Company's external auditors and management to review the Company's interim financial results before the publication of the Company's quarterly earnings press releases. Management's and independent auditors' presentations to and discussions with the Audit Committee cover various topics and events that may have significant financial impact and/or are the subject of discussions between management and the independent auditors. In addition, the Audit Committee generally oversees the Company's internal compliance programs. In accordance with law, the Audit Committee is responsible for establishing procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters, including the confidential, anonymous submission by the Company's employees, received through established procedures, of concerns regarding questionable accounting or auditing matters.

Among other matters, the Audit Committee monitors the activities and performance of the Company's external auditors, including the audit scope, external audit fees, auditor independence matters and the extent to which the independent auditors may be retained to perform non-audit services. The Company's independent auditors provide the Audit Committee with the written disclosures required by Independence Standards Board Standard No. 1, "Independence Discussions with Audit Committees", and the Audit Committee discusses with the independent auditors and management that firm's independence.

Additionally, the Committee considered all audit services provided by the independent auditors and the fees and costs billed and expected to be billed by the independent auditors for those services. The Committee has discussed with management the procedures for selection of consultants and the related competitive bidding practices and fully considers whether those services provided by the independent auditors are compatible with maintaining auditor independence.

In accordance with existing Audit Committee policy and the more recent requirements of the Sarbanes-Oxley Act, all services to be provided by the Company's independent auditors are subject to pre-approval by the Audit Committee. This includes audit services, audit-related services, tax services and other services. The Sarbanes-Oxley Act prohibits an issuer from obtaining certain non-audit services from its auditing firm so as to avoid certain potential conflicts of interest. The Company has not in recent years obtained any of these services from its independent auditors, and the Company is able to obtain such services, if needed, from other service providers at competitive rates. See "Relationship with Independent Accountants" for more information regarding fees paid to the Company's independent auditors for services in fiscal years 2006 and 2005.

Audit Committee

Sunil K. Pai (Chairman)  
Terrence O'Donnell  
Stephen J. Morris

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RELATIONSHIP WITH INDEPENDENT PUBLIC ACCOUNTANTS

The Audit Committee has selected Amper, Politziner & Mattia, P.C. to serve as the Company's independent auditors for the fiscal year ending December 31, 2007. No representatives from Amper, Politziner & Mattia, P.C. are expected to attend the annual meeting. The Company does not have a policy of asking its stockholders to ratify the appointment of auditors.

Fees Paid to Independent Auditors

The following table shows the fees for the audit and other services provided by Amper, Politziner & Mattia, P.C. for fiscal years 2006 and 2005:

Amper, Politziner & Mattia, P.C.	
2006	2005
<hr/>	<hr/>

Audit Fees (1)	\$128,500	\$125,540
Audit-Related Fees	--	--
Tax Fees	--	--
All Other Fees	--	--
	<hr/>	<hr/>
Total	\$128,500	\$125,540
	<hr/>	<hr/>

- (1) These are fees for professional services rendered for the audit of the Company's 2006 financial statements and review of financial statements included in the Company's quarterly reports on Form 10-QSB, and services that are normally provided in connection with statutory and regulatory filings or engagements.

Representatives of Amper, Politziner & Mattia, P.C. attended all meetings of the Audit Committee in 2006. The Audit Committee pre-approves and reviews audit services performed by the Company's independent auditors as well as the fees charged by for such services. In its pre-approval and review of non-audit service fees, the Audit Committee considers, among other things, the possible effect of the performance of such services on the auditors' independence. Amper, Politziner & Mattia, P.C. did not perform any non-audit services for IGI during fiscal year 2006.

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#### PROPOSALS WITH RESPECT TO EQUITY PLANS

As set forth below the Company is proposing to amend two (2) of its compensation plans. The benefits to be derived under the increased authorized shares in each of such plans is set forth below:

#### NEW PLAN BENEFITS

Name and Position (2)	1999 Director Stock Option Plan		1999 Stock Incentive Plan	
	Dollar Value	Number of Units	Dollar Value	Number of Units
Frank Gerardi, Chief Executive Officer	\$0	0	(1)	(1)
Nadya Lawrence, Executive Vice President of Operations	\$0	0	(1)	(1)
Executive Group	\$0	0	(1)	(1)
Non-Executive Director Group	(1)	300,000	(1)	(1)
Non-Executive Officer Employee Group	\$0	0	(1)	(1)

- (1) Cannot Be Determined
- (2) Lists the principal positions held as of December 31, 2006. On January 4, 2007, Rajiv Mathur assumed the position of Chief Executive Officer of the Company.

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**PROPOSAL 2 - APPROVAL OF AMENDMENT TO INCREASE SHARES  
AUTHORIZED UNDER THE 1999 DIRECTOR STOCK OPTION PLAN**

The Board of Directors proposes to increase the number of shares underlying authorized options under the 1999 Plan by 300,000 from 1,675,000 to 1,975,000. On September 15, 1999, the Company's Board of Directors adopted the Company's 1999 Director Stock Option Plan (the "1999 Plan") and authorized 675,000 shares of Common Stock for issuance under the 1999 Plan. In 2001, the stockholders of the Company approved an amendment that increased the number of shares of Common Stock underlying options under the Plan to 1,475,000, and in 2006 the stockholders of the Company approved a further amendment that increased the number of shares of Common Stock underlying options under the Plan to 1,675,000. The Company does not believe that the current number of shares authorized under the 1999 Plan is adequate for the Company's needs. As of March 15, 2007, 278,952 shares of Common Stock remained available for future grants of stock options under the 1999 Plan. Shareholders will not have any appraisal rights with respect to the amendment to the 1999 Plan

**Administration and Eligibility**

The 1999 Plan and the grant of options thereunder is administered by the Compensation and Stock Option Committee of the Company's Board of Directors. All non-employee directors of the Corporation are eligible to receive options under the 1999 Plan. As of March 15, 2007, the Company has four (4) non-employee directors. All of the options granted under the 1999 Plan are nonstatutory stock options (NSOs) and become fully vested twelve (12) months after the date of grant.

Under the 1999 Plan, on January 2 of each year, beginning with January 2000 (i) each non-employee director is granted a stock option for 15,000 shares and (ii) each of the Chairmen of the Audit Committee and the Stock Option and Compensation Committee is granted additional stock options for 15,000 and 10,000 shares, respectively. Additionally, under the 1999 Plan, each newly-elected director will receive a stock option grant of 15,000 shares at the time of his or her election. All of such options will be granted at an exercise price equal to the closing price of the Common Stock on the American Stock Exchange on the date of grant. Since January, 2006, the Board of Directors has temporarily waived their rights to receive the aforesaid options, but reserved the right to have such options in the future.

**Purchase Price and Option Terms**

The price at which shares of Common Stock may be purchased upon the exercise of options granted under the 1999 Plan is equal to the fair market value per share on the date of grant, which is deemed to be the closing price of the Common Stock on the American Stock Exchange on the date of grant. The last sale price of the Company's Common Stock reported by the American Stock Exchange on March 21, 2007 was \$.98 per share.

Except as the Compensation and Stock Option Committee may otherwise determine or provide in an option grant, options granted under the 1999 Plan cannot be assigned, either voluntarily or by operation of law, except by will or the laws of descent and distribution, and shall be exercised during the lifetime of the optionee and only by the optionee. Such options cease to be exercisable at the earlier of ten (10) years from

the date of grant or three (3) years after a director ceases to be a director for any reason. In the event that a director ceases to be a director on account of his or her death, the outstanding options (whether exercisable or not on the date of death) may be exercised within three (3) years after such date (subject to the condition that no such option may be exercised after the expiration of ten (10) years from its date of grant).

Optionees who exercise options to purchase securities under the 1999 Plan may pay cash in the amount of the option exercise price and/or deliver other shares of Common Stock owned by the optionee with a fair market value equal to the exercise price of the option shares to be purchased.

In the event of a dissolution, liquidation, merger, consolidation or reorganization of the Company (an "Event"), the Board may decide to terminate each outstanding option. If the Board so decides, such option shall terminate as of the effective date of the Event, but the Board shall provide optionees a reasonable notice period during which options which are then exercisable may be exercised.

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#### Federal Income Tax Consequences

The following is a summary of the United States federal income tax consequences that generally will arise with respect to options granted under the 1999 Plan and with respect to the sale of Common Stock acquired under the 1999 Plan.

A participant will not recognize taxable income upon the grant of a nonstatutory stock option ("NSO"). However, a participant who exercises an NSO generally will recognize ordinary compensation income in an amount equal to the excess of the fair market value of the Common Stock acquired through the exercise of the option ("NSO Stock") on the Exercise Date over the exercise price. With respect to any NSO Stock, a participant will have a tax basis equal to the exercise price plus any income recognized upon the exercise of the option. Upon selling NSO Stock, a participant generally will recognize capital gain or loss in an amount equal to the excess of the sale price of the NSO Stock over the participant's tax basis in the NSO Stock. This capital gain or loss will be a long-term gain or loss if the participant has held the NSO Stock for more than one year prior to the date of the sale.

#### Tax Consequences to the Company

The grant of an option under the 1999 Plan will have no tax consequences to the Company. Moreover, in general, the sale of any Common Stock acquired under the 1999 Plan will not have any tax consequences to the Company. The Company generally will be entitled to a business-expense deduction, however, with respect to any ordinary compensation income recognized by a participant under the 1999 Plan, including as a result of the exercise of an NSO. Any such deduction will be subject to the limitations of Section 162(m) of the Code. The Company will have a withholding obligation with respect to ordinary compensation income recognized by participants with respect to NSOs under the 1999 Plan who are subject to withholding.

#### Stockholder Vote Required

The affirmative vote of a majority of the shares present in person and by proxy and voting at the meeting is required for the amendment of the 1999 Plan.

#### Board Recommendation

The Board recommends that shareholders vote "FOR" ratification of the Plan Amendment to the 1999 Director Stock Option to increase the number of shares reserved for issuance under such plan from 1,675,000 to 1,975,000.

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### PROPOSAL 3 - AMENDMENT OF 1999 STOCK INCENTIVE PLAN

#### General

The Board of Directors proposes that the stockholders ratify an amendment (the "Plan Amendment") to the Company's 1999 Stock Incentive Plan (the "1999 Incentive Plan") in order to increase the number of shares of the Company's Common Stock issuable under the Plan from 2,500,000 to 3,200,000. The Board of Directors believes that the 1999 Incentive Plan has been and will continue to advance the interests of the Company's stockholders by enhancing the Company's ability to attract, retain and motivate persons who make (or are expected to make) important contributions to the Company by providing such persons with equity ownership opportunities and performance-based incentives and thereby better aligning the interests of such persons with those of the Company's stockholders. As of March 15, 2007, 306,200 shares of Common Stock remain available for future grants of awards under the 1999 Incentive Plan. The Board of Directors approved the amendment on March 19, 2007, subject to stockholder approval. The closing price of shares of Common Stock as reported by the American Stock Exchange was \$.98 on March 21, 2007. The number of shares of the Company's Common Stock issuable under the Plan was previously increased from 1,200,000 to 2,000,000 and from 2,000,000 to 2,500,000. As of March 15, 2007, approximately fifteen (15) employees of the Company and five (5) directors of the Company who are not also employees of the Company were eligible to receive Awards under the 1999 Incentive Plan. Shareholders will not have any appraisal rights with respect to the amendment to the 1999 Incentive Plan.

#### Summary of the 1999 Incentive Plan

The 1999 Incentive Plan provides for the grant of incentive stock options intended to qualify under Section 422 of the Internal Revenue Code ("the Code") as non-statutory stock options and restricted stock awards (collectively "Awards"). The 1999 Incentive Plan authorizes the Board to determine the number of shares of Common Stock to be covered by each option, the exercise price of each option and the conditions and limitations applicable to the exercise of each option grant, including conditions relating to applicable federal or state securities laws, as it considers necessary or advisable.

No option will be granted for a term in excess of ten (10) years. The 1999 Incentive Plan permits the Board to determine the manner of payment of the exercise price of options, including through payment by cash, check or in connection with a "cashless exercise" through a broker, by surrender to the Company of shares of Common Stock, by delivery to the Company of a promissory note or by any other lawful means.

The Board may grant Awards entitling recipients to acquire shares of Common Stock, subject to the right of the Company to repurchase all or part of such shares at their issue price or other stated or formula price (or to require forfeiture of such shares if issued at no cost) from the recipient in the event that conditions specified by the Board in the applicable Award are not satisfied prior to the end of the applicable restriction period or periods established by the Board for such Award.

If any Award expires or is terminated, surrendered or canceled without having been fully exercised or is forfeited in whole or in part or results in any Common Stock not being issued, the unused Common Stock covered by such Award shall again be available for the grant of Awards under the 1999 Incentive Plan, subject, however, in the case of incentive stock options, to any limitation required under the Code. Shares

issued under the 1999 Incentive Plan may consist in whole or in part of authorized but unissued shares or treasury shares.

All of the Company's employees, officers, directors, consultants and advisors (and any individuals who have accepted an offer for employment) are eligible to be granted Awards under the 1999 Incentive Plan. Subject to adjustment, the maximum number of shares of Common Stock with respect to which Awards may be granted to any participant under the 1999 Incentive Plan shall be 300,000 per calendar year. This per-participant limit described shall be construed and applied consistently with Section 162(m) of the Code. The granting of Awards under the 1999 Incentive Plan is discretionary.

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#### Administration

The 1999 Incentive Plan is administered by the Compensation and Stock Option Committee, who then recommends Awards to the Board of Directors for approval. The Board has authority to grant Awards and to adopt, amend and repeal such administrative rules, guidelines and practices relating to the 1999 Incentive Plan as it shall deem advisable. Pursuant to the terms of the 1999 Incentive Plan, the Board of Directors may delegate authority under the 1999 Incentive Plan to one or more committees of the Board, and subject to certain limitations, to one or more executive officers of the Company. Subject to any applicable limitations contained in the 1999 Incentive Plan, the Board of Directors, or any committee or executive officer to whom the Board delegates authority, as the case may be, selects the recipients of Awards and determines (i) the number of shares of Common Stock covered by options and the dates upon which such options become exercisable, (ii) the exercise price of options, (iii) the duration of options, and (iv) the number of shares of Common Stock subject to any restricted stock or other stock-based Awards and the terms and conditions of such Awards, including conditions for repurchase, issue price and repurchase price. The Board of Directors may make appropriate adjustments in connection with the 1999 Incentive Plan and any outstanding Awards to reflect stock dividends, stock splits and other certain events that affect the Company's capitalization.

In the event of a merger, liquidation or other Acquisition Event (as defined in the 1999 Incentive Plan), the Board of Directors is authorized to provide for outstanding options or other stock-based Awards to be assumed or substituted for, to accelerate the Awards to make them fully exercisable prior to consummation of the Acquisition Event, or to provide for a cash-out of the value of any outstanding options. Upon the occurrence of an Acquisition Event in the case of restricted stock, the rights of the Company shall inure to the benefit of the Company's successor. If any Award expires or is terminated, surrendered, canceled or forfeited, the unused shares of Common Stock covered by such Award will again be available for grant under the 1999 Incentive Plan.

#### Amendment or Termination

No Award may be made under the 1999 Incentive Plan after March 16, 2009, but Awards previously granted may extend beyond that date. The Board may amend, modify or terminate any outstanding Award, including but not limited to, substituting therefor another Award of the same or a different type, changing the date of exercise or realization, and converting an incentive stock option to a non-statutory stock option. The Board may also amend, suspend or terminate the 1999 Incentive Plan or any portion thereof at any time, provided that, to the extent required by Section 162(m) of the Code, no Award granted to a participant designated as subject to Section 162(m) by the Board after the date of such amendment shall become exercisable, realizable or vested, as applicable to such Award (to the extent that such amendment to the 1999 Incentive Plan was required to grant such Award to a particular participant), unless and until such amendment shall have been approved by the Company's stockholders as required by Section 162(m) (including the vote required under Section 162(m)).

Additional information concerning the Company's equity compensation plans and other outstanding warrants is set forth in the notes to consolidated financial statements of the Company filed as part of the Company's Form 10-KSB Report for the year ended December 31, 2006 and is included in the Annual Report to Stockholders that accompanies this Proxy Statement.

#### Plan Benefits

The Company has not yet determined how the increased 700,000 shares reserved for issuance under the 1999 Incentive Plan will be distributed.

#### Plan Amendment

As noted above, there are presently 2,500,000 shares of Common Stock authorized for purposes of granting Awards under the 1999 Incentive Plan. The Board of Directors believes that having the ability to grant additional Awards under the 1999 Incentive Plan will enable the Company to attract, retain and motivate key employees and certain third parties. The Plan Amendment, if approved by shareholders, will increase the number of shares of Common Stock available under the 1999 Incentive Plan by 700,000.

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The text of the Plan Amendment is set forth in full on Exhibit A to this Proxy Statement, and the foregoing description is qualified in its entirety by reference to Exhibit A.

#### Federal Income Tax Consequences

The following is a summary of the United States federal income tax consequences that generally will arise with respect to Awards granted under the 1999 Incentive Plan and with respect to the sale of Common Stock acquired under the 1999 Incentive Plan.

*Incentive Stock Options.* In general, a participant will not recognize taxable income upon the grant or exercise of an incentive stock option. Instead, a participant will recognize taxable income with respect to an incentive stock option only upon the sale of Common Stock acquired through the exercise of the option ("ISO Stock"). The exercise of an incentive stock option, however, may subject the participant to the alternative minimum tax. Generally, the tax consequences of selling ISO Stock will vary with the length of time that the participant has owned the ISO Stock at the time it is sold. If the participant sells ISO Stock after having owned it for at least two years from the date the option was granted (the "Grant Date") and one year from the date the option was exercised (the "Exercise Date"), then the participant will recognize long-term capital gain in an amount equal to the excess of the sale price of the ISO Stock over the exercise price. If the participant sells ISO Stock for more than the exercise price prior to having owned it for at least two years from the Grant Date and one year from the Exercise Date (a "Disqualifying Disposition"), then all or a portion of the gain recognized by the participant will be ordinary compensation income and the remaining gain, if any, will be a capital gain. This capital gain will be long-term capital gain if the participant has held the ISO Stock for more than one year prior to the date of sale. If a participant sells ISO Stock for less than the exercise price, then the participant will recognize capital loss in an amount equal to the excess of the exercise price over the sale price of the ISO Stock. This capital loss will be long-term capital loss if the participant has held the ISO Stock for more than one year prior to the date of sale.

*Non-statutory Stock Options.* As in the case of an incentive stock option, a participant will not recognize taxable income upon the grant of a non-statutory stock option. Unlike the case of an incentive stock option, however, a participant who exercises a non-statutory stock option generally will recognize ordinary



compensation income in an amount equal to the excess of the fair market value of the Common Stock acquired through the exercise of the option ("NSO Stock") on the exercise date over the exercise price. With respect to any NSO Stock, a participant will have a tax basis equal to the exercise price plus any income recognized upon the exercise of the option. Upon selling NSO Stock, a participant generally will recognize capital gain or loss in an amount equal to the difference between the sale price of the NSO Stock and the participant's tax basis in the NSO Stock. This capital gain or loss will be a long-term capital gain or loss if the participant has held the NSO Stock for more than one year prior to the date of the sale.

*Restricted Stock Awards.* A participant will not recognize taxable income upon the grant of a restricted stock Award, unless the participant makes an election under Section 83(b) of the Code (a "Section 83(b) Election"). If the participant makes a Section 83(b) Election within 30 days of the date of the grant, then the participant will recognize ordinary compensation income, for the year in which the Award is granted, in an amount equal to the difference between the fair market value of the Common Stock at the time the Award is granted and the purchase price paid for the Common Stock. If a Section 83(b) Election is not made, the participant will recognize ordinary compensation income at the time that the forfeiture provisions or restrictions on transfer lapse, in an amount equal to the difference between the fair market value of the Common Stock at the time of such lapse and the original purchase price paid for the Common Stock. The participant will have a basis in the Common Stock acquired equal to the sum of the price paid and the amount of ordinary compensation income recognized. Upon the disposition of the Common Stock acquired pursuant to a restricted stock Award, the participant will recognize a capital gain or loss in an amount equal to the difference between the sale price of the Common Stock and the participant's basis in the Common Stock. This capital gain or loss will be a long-term capital gain or loss if the shares are held for more than one year. For this purpose, the holding period shall begin just after the date on which the forfeiture provisions or restrictions lapse if a Section 83(b) Election is not made or just after the Award is granted if a Section 83(b) Election is made.

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*Section 409A.* Any award (including Restricted Stock Awards) issued pursuant to our 1999 Stock Incentive Plan, except incentive stock options and nonstatutory options granted with an exercise price equal to or greater than the fair market value of the underlying stock on the date of grant, may be subject to the provisions of Section 409A of the Internal Revenue Code and, accordingly, subject to special rules.

Under Section 409A of the Internal Revenue Code, which was added by the American Jobs Creation Act of 2004, generally effective beginning in 2005, compensation deferred under nonqualified deferred compensation plans that do not satisfy election, distribution and funding restrictions will be subject to current income tax inclusion, a 20% tax and interest assessment in the year of deferral, to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Our 1999 Stock Incentive Plan will be operated in good faith compliance with the provisions of Section 409A, in order to avoid such assessment and will be amended accordingly upon issuance of regulatory guidance, if required.

#### Tax Consequences to the Company

The grant of an Award under the 1999 Incentive Plan will have no tax consequences to the Company. Moreover, in general, neither the exercise of an incentive stock option nor the sale of any Common Stock acquired under the 1999 Incentive Plan will have any tax consequences to the Company. The Company generally will be entitled to a business-expense deduction, however, with respect to any ordinary compensation income recognized by a participant under the 1999 Incentive Plan, including in connection with a restricted stock Award or as a result of the exercise of a non-statutory stock option or a Disqualifying Disposition. Any such deduction will be subject to the limitations of Section 162(m) of the Code.

Stockholder Vote Required

The affirmative vote of a majority of the shares present in person and by proxy and voting at the meeting is required for the ratification of the Plan Amendment.

Board Recommendation

The Board recommends that shareholders vote "FOR" ratification of the Plan Amendment to the 1999 Stock Incentive Plan to increase the number of shares reserved for issuance under the 1999 Stock Incentive Plan from 2

**,500,000 to 3,200,000.**

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STOCKHOLDER PROPOSALS FOR 2008 ANNUAL MEETING

Any proposal that a stockholder intends to present at the 2008 Annual Meeting of Stockholders must be submitted to the Secretary of the Company at its offices, 105 Lincoln Avenue, Buena, New Jersey 08310, no later than January 2, 2008, in order to be considered for inclusion in the Proxy Statement relating to that meeting.

If a stockholder of the Company wishes to present a proposal before the 2008 Annual Meeting and the Company has not received notice of such matter prior to January 2, 2008, the Company shall have discretionary authority to vote on such matter, if the Company includes a specific statement in the proxy statement or form of proxy to the effect that it has not received such notice in a timely fashion.

OTHER MATTERS

The Board of Directors knows of no other business which will be presented for consideration at the meeting other than that described above. However, if any other business should come before the meeting, it is the intention of the persons named in the enclosed Proxy to vote, or otherwise act, in accordance with their best judgment on such matters.

The Company will bear the costs of soliciting proxies. In addition to solicitations by mail, the Company's directors, officers and regular employees may, without additional remuneration, solicit proxies by telephone, telegraph, facsimile and personal interviews. The Company will also request brokerage houses, custodians, nominees and fiduciaries to forward copies of the proxy material to those persons for whom they hold shares and request instructions for voting the Proxies. The Company will reimburse such brokerage houses and other persons for their reasonable expenses in connection with this distribution.

**THE BOARD OF DIRECTORS HOPES THAT STOCKHOLDERS WILL ATTEND THE MEETING. WHETHER OR NOT YOU PLAN TO ATTEND, YOU ARE URGED TO COMPLETE, DATE, SIGN AND RETURN THE ENCLOSED PROXY IN THE ACCOMPANYING ENVELOPE. PROMPT RESPONSE WILL GREATLY FACILITATE ARRANGEMENTS FOR THE MEETING AND YOUR COOPERATION IS APPRECIATED. STOCKHOLDERS WHO ATTEND THE MEETING MAY VOTE THEIR STOCK PERSONALLY EVEN THOUGH THEY HAVE SENT IN THEIR PROXIES.**

By Order of the Board of Directors,

Carlene A. Lloyd, Secretary

April 20, 2007

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EXHIBIT A

THIRD AMENDMENT TO THE 1999 STOCK INCENTIVE PLAN OF IGI, INC.

AMENDMENT

:

1. **Increased Authorization.** The first sentence of Section 4(a) of the 1999 Stock Incentive Plan (the "Plan") is hereby amended in its entirety to read as follows:

"Subject to adjustment under Section 7, Awards may be made under the Plan for up to 3,200,000 shares of common stock, \$.01 par value per share of the Company (the 'Common Stock')."

2. **Miscellaneous.** Except as otherwise amended by this Amendment, the Plan is hereby ratified and approved, and shall continue in full force and effect.

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ANNUAL MEETING OF STOCKHOLDERS OF

IGI, INC.

May 10, 2007

Please date, sign and mail  
your proxy card in the  
envelope provided as soon  
as possible.

V

Please detach along perforated line and mail in the envelope provided. **V**

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THE BOARD OF DIRECTORS RECOMMENDS A VOTE "FOR" ALL NOMINEES LISTED IN PROPOSAL 1  
AND "FOR" PROPOSALS 2 AND 3.

PLEASE SIGN, DATE AND RETURN PROMPTLY IN THE ENCLOSED ENVELOPE.

PLEASE MARK YOUR VOTE IN BLUE OR BLACK INK AS SHOWN HERE [X]

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- | 1. Election of Directors: |   |   | FOR                      | AGAINST                  | ABSTAIN                  |
|---------------------------|---|---|--------------------------|--------------------------|--------------------------|
|                           | NOMINEES:                               | 2.  |                          |                          |                          |
| <input type="checkbox"/>  | FOR ALL NOMINEES                        | <input type="radio"/> Jane E. Hager   | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
|                           |   | <input type="radio"/> Stephen J. Morris   |                          |                          |                          |
| <input type="checkbox"/>  | WITHHOLD AUTHORITY FOR ALL NOMINEES     | <input type="radio"/> Terrence O'Donnell  |                          |                          |                          |
|                           |   | <input type="radio"/> Rajiv Mathur  |                          |                          |                          |
| <input type="checkbox"/>  | FOR ALL EXCEPT (See instructions below) | 3.  | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
|                           |   | Proposal to Amend the 1999 Director Stock Option Plan to Increase the Number of Shares Available For Issuance Thereunder. |                          |                          |                          |
|                           |   | Proposal to Amend the 1999 Stock Incentive Plan to Increase the Number of Shares Available For Issuance Thereunder.       |                          |                          |                          |

**INSTRUCTION:**

To withhold authority to vote for any individual nominee(s), mark "**FOR ALL EXCEPT**" and fill in the circle next to each nominee you wish to withhold, as shown here: 1

IN THEIR DISCRETION, THE PROXIES ARE AUTHORIZED TO VOTE UPON SUCH OTHER BUSINESS AS MAY PROPERLY COME BEFORE THE MEETING OR ANY ADJOURNMENT THEREOF.

THE SHARES REPRESENTED BY THIS PROXY WHEN PROPERLY EXECUTED WILL BE VOTED AS DIRECTED BY THE UNDERSIGNED. IF NO DIRECTION IS GIVEN, THE SHARES REPRESENTED WILL BE VOTED (1) FOR THE ELECTION OF DIRECTORS; (2) FOR THE AMENDMENT TO THE 1999 DIRECTOR STOCK OPTION PLAN; (3) FOR THE AMENDMENT TO THE 1999 STOCK INCENTIVE PLAN; AND (4) IN ACCORDANCE WITH THE PROXIES' DISCRETION ON SUCH OTHER BUSINESS THAT MAY PROPERLY COME BEFORE THE MEETING.

To change the address on your account,  please check the box at right and indicate your new address in the address space above. Please note that changes to the registered name(s) on the account may not be submitted via this method.

TO INCLUDE ANY COMMENTS, USE THE COMMENTS BOX ON THE REVERSE SIDE OF THIS CARD.

Signature of Stockholder \_\_\_\_\_ Date: \_\_\_\_\_ Signature of Stockholder \_\_\_\_\_ Date: \_\_\_\_\_

Note: Please sign exactly as your name or names appear on this Proxy. When shares are held jointly, each holder should sign. When signing as executor, administrator, attorney, trustee or guardian, please give full title as such. If the signer is a corporation, please sign full corporate name by duly authorized officer, giving full title as such. If signer is a partnership, please sign in partnership name by authorized person.

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IGI, INC.

PROXY FOR THE ANNUAL MEETING OF STOCKHOLDER

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TO BE HELD MAY 10, 2007

THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS OF THE COMPANY

The undersigned, having received notice of the meeting and management's proxy statement therefore, and revoking all prior proxies, hereby appoint(s) Rajiv Mathur, Nadya Lawrence, and Carlene A. Lloyd, and each of them, attorneys or attorney of the undersigned (with full power of substitution in them and each of them) for and in the name(s) of the undersigned to attend the Annual Meeting of Stockholders of IGI, Inc. (the "Company") to be held on Thursday, May 10, 2007 at 10:00 a.m. at the Holiday Inn, 398 Smith Street, Vineland, New Jersey, and at any adjourned sessions thereof, and there to vote and act upon the following matters in respect of all shares of stock of the Company which the undersigned will be entitled to vote or act upon, with all the powers the undersigned would possess if personally present.

PLEASE VOTE, DATE, AND SIGN ON REVERSE SIDE AND RETURN PROMPTLY IN THE ENCLOSED ENVELOPE.

(Continued and to be signed on the reverse side)

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COMMENTS:

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