

Summer Infant, Inc.
Form 10-Q
May 11, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Under Section 13 or 15D

of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2007

Summer Infant, Inc.

(Name of Registrant as Specified in Its Charter)

Commission file 000-51228

Delaware
(State of Incorporation)

20-1994619
(IRS Employment Number)

1275 Park East Drive
Woonsocket, RI 02895
(Address of principal executive offices)

(401) 671-6550
(Registrant's telephone number)

Indicate by check mark whether the 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 preceeding 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 last 90 days. Yes ☒ No ☐.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

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Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act. Yes ☐ No ☒

As of April 29, 2007, there were 13,907,892 shares outstanding of the registrant's Common Stock, \$.0001 par value per share.

Summer Infant, Inc.

Form 10Q

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Summer Infant Inc and Subsidiaries

Condensed Consolidated Balance Sheets

Note that all dollar amounts presented in the attached table are in thousands of US dollars except share amounts.

	Unaudited	
	March 31,	December 31,
	2007	2006
ASSETS		
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 7,865	\$ 52,094
Trade Receivables	10,845	0
Inventory principally finished goods	10,248	0
Prepays and other current assets	582	43
TOTAL CURRENT ASSETS	29,540	52,137
Property and Equipment, net	7,098	5
Goodwill and other intangible assets	39,240	0
Other Assets, net	509	966
TOTAL ASSETS	\$ 76,387	\$ 53,108
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts Payable and Accrued Expenses	\$ 7,918	\$ 1,666
Current Portion of Long Term Liabilities	3,222	0
TOTAL CURRENT LIABILITIES	11,140	1,666
Long term liabilities, less current portion	113	0
TOTAL LIABILITIES	11,253	1,666
STOCKHOLDERS' EQUITY		
Common Stock \$.0001 par value, issued and outstanding 13,907,892 and 11,200,000	1	1
Additional Paid in Capital	63,910	50,461
Retained Earnings	1,180	980
Accumulated other comprehensive income	43	0
TOTAL STOCKHOLDERS' EQUITY	65,134	51,442
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 76,387	\$ 53,108

See notes to condensed consolidated financial statements

Summer Infant Inc and Subsidiaries
Condensed Consolidated Statements of Income

Note that all dollar amounts presented in the attached table are in thousands of US dollars except share amounts.

	Unaudited For the three months ended	
	March 31,2007	March 31,2006
	In thousands of dollars except per share amounts)	
Net revenues	\$ 4,771	\$ 0
Cost of goods sold	2,925	0
Gross profit	1,846	0
Selling, general and administrative expenses (including non-cash compensation expense of \$153)	2,016	154
Amortization expense	29	0
Net operating loss	(199)	(154)
Interest income (expense), net	532	404
Income before provision for income taxes	\$ 333	250
Income tax expense	133	114
Net income	200	\$ 136
Net income per share - basic and diluted	\$ 0.02	\$ 0.01
Weighted average shares outstanding	11,944,000	11,200,000
See notes to condensed consolidated financial statements		

Summer Infant, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

Note that all dollar amounts presented in the attached table are in thousands of US dollars except share amounts.

	Unaudited For the three months ended	
	March 31, 2007	March 31, 2006
	(In thousands of dollars)	
Cash flows from operating activities:		
Net income	\$ 200	\$ 136
Adjustments to reconcile net income to net cash provided by (used in) operating activities		
Depreciation and amortization	107	0
Non cash stock option expense	153	
Changes in assets and liabilities net of effects of acquisition:		
Decrease in accounts receivable	1,334	0
Increase in inventory	(131)	0
Decrease in accounts payable and accrued expenses	(836)	(263)
Decrease in prepaids and other assets	257	32
Net cash provided by (used in) operating activities	1,084	(95)
Cash flows from investing activities:		
Acquisitions of property and equipment	(298)	(2)
Acquisition of Summer Infant, Inc. net of cash acquired of \$867	(22,668)	0
Net cash used in investing activities	(22,966)	(2)
Cash flows from financing activities:		
Net (repayments) on line of credit	(14,992)	0
Principal payments on note payable and other debt	(515)	0
Redemptions of common stock	(6,883)	
Net cash (used in) financing activities	(22,390)	0
Effect on exchange rate changes on cash and cash equivalents	43	0
Net decrease in cash and cash equivalents	(44,229)	(97)
Cash and cash equivalents at beginning of period	52,094	649
Cash and cash equivalents at end of period	\$ 7,865	\$ 552
Non cash investing activities:		
Issuance of common stock in conjunction with the acquisition of Summer Infant, Inc.	20,563	
See notes to condensed consolidated financial statements		

SUMMER INFANT, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note that all dollar amounts presented in the attached footnotes are in thousands of US dollars except share and per share amounts.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying interim condensed consolidated financial statements of the Company are unaudited, but in the opinion of management, reflect all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the results for the interim periods. Accordingly, they do not include all information and notes required by generally accepted accounting principles for complete financial statements. The results of operations for interim periods are not necessarily indicative of results to be expected for the entire fiscal year or any other period. The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These interim consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes for the year ended December 31, 2006 filed on Form 8-K on March 12, 2007.

The statements contained in this Report on Form 10-Q, that are not purely historical, are forward-looking information and statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These include statements regarding our expectations, intentions, or strategies regarding future matters. All forward-looking statements included in this document are based on information available to us on the date hereof. It is important to note that our actual result could differ materially from those projected in such forward-looking statements contained in this Form 10-Q. The forward-looking statements contained herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments regarding among other things, our ability to secure financing or investment for capital expenditures, future economic and competitive market conditions, and future business decisions. All these matters are difficult or impossible to predict accurately, many of which may be beyond our control. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-Q will prove to be accurate.

Acquisition of Summer Infant, Inc. by KBL Healthcare Acquisition Corp. II

On March 6, 2007, under an Agreement and Plans of Reorganization, dated as of September 1, 2006 (*Acquisition Agreement*), KBL Healthcare Acquisition Corp. II (*KBL*), and its wholly owned subsidiary, SII Acquisition Corp. (*Acquisition Sub*), consummated a transaction by which (i) Summer Infant, Inc. (*SII*) was merged with and into Acquisition Sub and (ii) all of the outstanding capital stock of each of Summer Infant Europe, Limited (*SIE*) and Summer Infant Asia, Ltd. (*SIA*) and, collectively, with SII and SIE, the *Targets*) was acquired directly by KBL. As used in this Report, the term *Summer* includes each of the Targets. As used in this Report, the term *Company* means the registrant on a post-acquisition basis. On March 7, 2007, the securities of the Company commenced listing on the Nasdaq Capital Market under the symbols SUMR (common stock), SUMRW (warrants) and SUMRU (units).

Effective upon closing, the Company changed its name to Summer Infant, Inc. and SII changed its name to Summer Infant (USA), Inc. Thus, the Company is now a holding company called Summer Infant, Inc. operating through its wholly-owned subsidiaries, Summer Infant (USA), Inc., Summer Infant Europe, Limited and Summer Infant Asia, Ltd.

At the closing of the acquisition, the Summer stockholders received from the Company an aggregate of \$20,000 in cash and 3,916,667 shares of Company common stock (*Transaction Shares*). The Summer stockholders also will be entitled to receive up to an additional aggregate of 2,500,000 shares of Company common stock (*Contingent Shares*) in the event that the last sales price of Company common stock is equal to or exceeds \$8.50 on any twenty (20) trading days during any thirty (30) consecutive trading day period commencing on the three-month anniversary of the closing of the acquisition and ending on April 20, 2009. The Summer stockholders also are entitled to receive cash payments equal to 50% of the difference between actual EBITDA (as defined in the Acquisition Agreement) for the years ended or ending December 31, 2006, 2007 and 2008 and prescribed EBITDA benchmarks for each of those years of \$4,200, \$10,000 and \$15,000, respectively. These cash payments shall not exceed \$5,000 in the aggregate for the three years.

Holders of 1,208,775 shares of common stock voted against the acquisition and elected to convert their shares into a pro rata portion of the trust fund (approximately \$5.69 per share or an aggregate of approximately \$6,900). After giving effect to the (i) issuance of shares of common stock in the acquisition and (ii) conversion of shares, there are currently 13,907,892 shares of the Company's common stock outstanding.

In connection with the consummation of the acquisition, the board of directors of the Company has been increased to seven members. The board includes two persons who were designated by the Summer stockholders, which designees are Jason P. Macari and Steven Gibree, and two persons who were designated by certain stockholders of the Company (Founding Company Holders), which designees are Dr. Marlene Krauss and Martin Fogelman. The other three members of the board, Myra Hart, Robert Stebenne and Richard Wenz, were mutually designated by the Summer stockholders and the Founding Company Holders. The Summer stockholders, on the one hand, and the Founding Company Holders, on the other hand, have entered into a voting agreement pursuant to which they have agreed to vote for the other s designees to the board of directors of the Company through the annual meeting of the stockholders of the Company to be held in 2009.

On March 6, 2007, upon the closing of the acquisition, the Company entered into separate employment agreements with Dr. Krauss, as Chairman of the Board, Mr. Macari, as Chief Executive Officer, Mr. Gibree, as Executive Vice President of Product Development, Joseph Driscoll, as Chief Financial Officer, and Rachelle Harel, as Director and General Manager of SIE.

The Company prior to March 6, 2007 was in the development stage. Effective upon the acquisition of Summer Infant, Inc. the Company is no longer a developmental stage Company.

Nature of Operations and basis of presentation

The Statement of Operations for the three months ended March 31, 2007 consists of the period from March 6, 2007 through March 31, 2007 for Summer plus the full three months of results of KBL. The acquisition of Summer by KBL occurred on March 6, 2007, and therefore the results of Summer are included from that date forward. The interim financial information as of March 31, 2007, and for the three months then ended, is unaudited and has been prepared on the same basis as the audited financial statements as of December 31, 2006. In the opinion of management, such unaudited financial information includes all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the interim information. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ended December 31, 2007. The audited balance sheet as of December 31, 2006 reflects the balance sheet of KBL on a stand alone basis on that date.

All significant intercompany accounts and transactions have been eliminated in the combined financial statements.

Goodwill and Other Intangible Assets

The Company accounts for Goodwill in accordance with Financial Accounting Standards Board SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS 142 requires that goodwill and intangible assets that have indefinite useful lives no longer be subject to amortization and be tested at least annually for impairment.

Intangible assets primarily include patents, licenses and brand name, which are the result of the acquisition of Summer by KBL.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition of Summer by KBL. The estimated fair values of intangible assets acquired were obtained through a preliminary third party valuation. The estimated fair value of accounts receivable, inventory, and all other assets and liabilities are preliminary and could be adjusted based on a final determination.

Accounts receivable	\$ 12,179
Inventory	10,117
Other current assets	1,500
Property and equipment	6,877
Brand Name	8,300
Patents	1,300
Goodwill	29,665
Other Assets	164
Total assets acquired	70,102
Debt	18,822
Other liabilities assumed	8,049
Total liabilities assumed	26,871

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Net assets acquired	\$ 43,231
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Goodwill and Brand Name have an indefinite life; Patents will be amortized using a 5 year life.

Unaudited Pro Forma Summary

The following pro forma consolidated amounts give effect to the acquisition of Summer by KBL accounted for by the purchase method of accounting as if it had occurred at the beginning of the periods presented. The pro forma consolidated results are not necessarily indicative of the operating results that would have been achieved had the transaction been in effect as of the beginning of the periods presented and should not be construed as being representative of future operating results.

Pro Forma Consolidated Statements of Income

For the Three Months Ending March 31, 2007 and 2006

(In thousands)

	Three Months Ended March 31, 2007 (Unaudited)	Three Months Ended March 31, 2006 (Unaudited)
Net sales	\$ 17,170	\$ 13,288
Cost of goods sold	10,607	8,360
Gross profit	6,563	4,928
Operating expenses net of interest income	5,350	4,056
Income tax expense	485	349
Net income	728	523
Basic and Diluted earnings per share	\$ 0.05	\$ 0.04

Income taxes. The provision for income taxes is based on the Company's estimated annualized effective tax rate for the year.

Effective January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes. An Interpretation of FASB Statement No. 109. FIN 48 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in the financial statements in accordance with SFAS No. 109. Tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. Upon the adoption of FIN 48, the Company had no unrecognized tax benefits. During the first quarter of 2007, the Company recognized no adjustments for uncertain tax benefits.

Income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred tax asset or liability is recognized for estimated future tax effects attributable to temporary differences and carryforwards. The measurement of deferred income tax assets is adjusted by a valuation allowance, if necessary, to recognize future tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. The Company recognizes interest and penalties, if any, related to uncertain tax positions in selling, general and administrative expenses. No interest and penalties related to uncertain tax positions were accrued at March 31, 2007.

The tax years 2004 through 2006 remain open to examination by the major taxing jurisdictions in which the Company operates. The Company expects no material changes to unrecognized tax positions within the next twelve months.

Translation of Foreign Currencies

The assets and liabilities of the Company's European and Asian operations have been translated into U.S. dollars at quarter-end exchange rates. All assets and liabilities of the Company's foreign affiliates are translated into U.S. dollars at the exchange rate in effect at the end of the year and the income and expense accounts of these affiliates have been translated at average rates prevailing during each respective year. Resulting translation adjustments are made to a separate component of stockholders' equity within accumulated other comprehensive income.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Net Income Per Share

Basic earnings per share for the Company is computed by dividing net income by the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per share has not been presented in the accompanying condensed consolidated statement of income since the Company has no dilutive options, warrants and other potential common stock outstanding during the periods based on the stock price as of the end of the quarter. Options to purchase 500,000 shares of the Company's common stock and 18,400,000 warrants to purchase shares of common stock were not included in the calculation, due to the fact that these options and warrants were anti-dilutive for the period ended March 31, 2007. For the period ended March 31, 2006 the 18,400,000 warrants to purchase shares of common stock were not included in the calculation, due to the fact that these were anti-dilutive.

New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123(R) (revised in 2004), Share Based Payment (SFAS 123(R)), which revised SFAS No. 123, Accounting for Stock-Based Compensation, and supercedes APB Opinion No. 25, Accounting for Stock Issued to Employees. FAS No. 123(R) requires the recognition of stock-based compensation expense in the financial statements. Effective January 1, 2006, the Company adopted FAS No. 123(R). The implementation of FAS 123(R) resulted in an expense of approximately \$153 in the consolidated statements of income for the three month period ended March 31, 2007. There were no options granted during the three month period ended March 31, 2006. The Company used the Black-Scholes option pricing model to measure the estimated fair value of the options granted.

In June of 2005, the FASB issued Statement of Financial Accounting Standards No. 154, (SFAS 154), Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS 154 applies to all voluntary changes in accounting principle and changes the requirements for accounting for and reporting a change in accounting principle. SFAS 154 requires the retrospective application to prior periods' financial statements of the direct effect of a voluntary change in accounting principle unless it is impracticable. APB No. 20 required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. The Company has adopted the provisions of FAS 154 and does not expect any material effect on its results of operations or financial position.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly, does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 157 on its consolidated financial statements.

The Company does not believe that any other recently issued, but not yet effective accounting standards will have a material effect on the Company's consolidated financial position, results of operations or cash flows.

2. LOAN PAYABLE

As of March 31, 2007, the Company had an outstanding loan of \$3,100 related to the construction of its new corporate headquarters/distribution center. This construction loan will be converted to a permanent mortgage during 2007, which is expected to have a 10 year term. The final amount of the loan is expected to be in the range of \$4,000. The interest rate on the loan is LIBOR plus 1.35%.

3. LINE OF CREDIT

In July, 2005, the Company entered into a revolving line of credit with a bank, which provides for borrowings based on levels of qualified accounts receivable and inventory. The line of credit is secured by all assets of the Company. The line of credit has been increased several times, and currently the maximum borrowings total \$17,000. The line of credit runs through June 30, 2007; this date has been extended several times by the bank, and the Company believes that the bank will extend the line of credit beyond this date. Interest on the line of credit is payable at LIBOR plus 1.75%. There were no amounts outstanding on the Line of Credit as of March 31, 2007.

In connection with the new Line of Credit, the Company is subject to certain covenants, which require, among other things, maintenance of a minimum cash flow to debt service ratio, a total liabilities to tangible net worth ratio, and a certain level of net worth. The Company was in compliance with all covenants as of March 31, 2007.

4. COMMITMENTS AND CONTINGENCIES

Construction costs

The Company is in the process of constructing a new corporate headquarters and is committed to spend approximately \$4,000 in construction costs (of which \$3,100 has already been disbursed by the bank).

Litigation

The Company is also involved in various claims and legal actions arising in the ordinary course of business. Management is of the opinion that the ultimate outcome of these matters would not have a material adverse impact on the financial position of the Company or the results of its operations.

In August 2006, Dorel Juvenile Group, Inc. (Dorel) filed a complaint in the United States District Court for the Southern District of Indiana against Lois DiMartinis, a current employee of Summer, claiming, among other things, that she breached her non-disclosure obligations by taking confidential information with her when departing employment from Dorel, and that she would inevitably disclose confidential information in the course of performing duties for her new employer, Summer. Dorel, in its complaint, accused Summer of engaging in a pattern of hiring employees from Dorel for the purpose of obtaining Dorel's confidential information for use in Summer's product designs and business. On October 20, 2006, the court denied Dorel's motion for preliminary injunction, finding that Dorel was not reasonably likely to succeed on the merits of its case. Dorel has appealed the court's decision. As of March 31, 2007, appeal briefs have been filed by both parties, and oral arguments have not been scheduled as of this time. Summer agreed to provide Ms. DiMartinis legal counsel for defending the action, and to pay the legal fees and costs for her defense, including the appeal, which as of March 31, 2007 were approximately \$250 (this was virtually all expensed on the books of Summer Infant in 2006).

5. STOCK OPTIONS

Summer has granted stock options under its 2006 Performance Equity Plan (2006 Plan). Under the 2006 Plan, awards may be granted to participants in the form of Non-Qualified Stock Options, Incentive Stock Options, Restricted Stock, Deferred Stock, Stock Reload Options and other stock-based awards. Subject to the provisions of the plan, awards may be granted to employees, officers, directors, advisors and consultants who are deemed to have rendered or are able to render significant services to us or our subsidiaries and who are deemed to have contributed or to have the potential to contribute to our success. Incentive stock options may only be awarded to individuals who are our employees at the time of grant.

As discussed in Note 1, Basis of Presentation and Summary Significant Accounting Policies Equity-Based Compensation, effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), using the modified prospective transition method. The adoption of SFAS 123(R) resulted in share-based compensation expense for the 3 months ended March 31, 2007 and 2006 of approximately \$153 and \$0, respectively.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model that uses the assumptions noted in the following table. Because the Company's common shares have only traded publicly since April 2005, expected volatility for the three month period ended March 31, 2007 is estimated based on an arithmetic average

of the volatility of 4 publicly-traded companies that operate in Summer's space or sell into similar markets. Summer has insufficient history by which to estimate the expected term of the options, but used an estimate for grants of plain vanilla stock options based on a formula proscribed by the Securities and Exchange Commission's Staff Accounting Bulletin No. 107. Because Summer's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock options.

The following table summarizes the assumptions used for options granted during the 3 months ended March 31, 2007. There were no option grants during the 3 months ended March 31, 2006.

Expected life (in years)	5.0
Risk-free interest rate	4.75%
Volatility	25.0%
Dividend yield	

A summary of the status of the Company's options as of March 31, 2007 and changes during the year then ended is presented below:

	Number Of	Weighted Average Exercise Price
	Shares	
Outstanding at beginning of year	0	\$ 5.25
Granted	500,000	\$ 5.25
Canceled		
Outstanding at end of period	500,000	\$ 5.25
Options exercisable at 3/31/07	125,000	\$ 5.25
Weighted-average fair value of options granted during the year		\$ 5.25

The intrinsic value of shares outstanding at March 31, 2007 was \$0.

The fair value of options granted during the period was \$610.

The following table summarizes information about stock options at March 31, 2007:

	Options Outstanding			Options Exercisable	
	Number	Weighted-Average	Exercise Price	Number	Weighted-Average Exercise Price
		Remaining Contractual Life			
		(Years)			
Range of Exercise Prices	Outstanding			Exercisable	
\$5.25	500,000	4.8	\$ 5.25	125,000	\$ 5.25

	Number	Weighted-Average	
		Fair Value at	
		Grant Date	Contractual Life
Non-Vested shares at December 31, 2006	0	\$	
Options Granted	500,000	\$ 1.22	5
Options Vested	(125,000)	\$ 1.22	4.8
Options forfeited or expired			
Non-Vested shares at March 31, 2007	375,000	\$ 1.22	4.8

As of March 31, 2007, there was approximately \$500 of unrecognized compensation cost related to non-vested stock option awards, which is expected to be recognized over a remaining weighted-average vesting period of 2.8 years. The total fair value of shares vested during the period ended March 31, 2007 was \$153.

6. WARRANTS

The Company has 18,400,000 redeemable common stock purchase warrants (the "Warrants") outstanding. Each Warrant entitles the holder to purchase one share of common stock at an exercise price of \$5.00 per share; the Warrants expire in April 2009. The Warrants are redeemable at a price of \$0.01 per Warrant, only in the event that the last sale price of the common stock is at least \$8.50 per share for any 20 trading days within a 30 trading day period.

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

The information contained in this section has been derived from Summer's consolidated financial statements and should be read together with the consolidated financial statements and related notes included elsewhere in this filing.

The following discussion is intended to assist in the assessment of significant changes and trends related to the results of operations and financial condition of Summer Infant, Inc. This discussion and analysis should be read in conjunction with Summer's consolidated financial statements and notes thereto included herein. Summer's business has grown organically in all of its markets. Summer derives its revenues from the sale of health, safety and wellness products for infants and toddlers. Summer's revenue is driven by its ability to design and market desirable products, identify business opportunities and secure new and renew existing distribution channels. Summer's income from operations is derived from its ability to generate revenue and collect cash in excess of labor and other costs of providing its products and selling, general and administrative costs.

Summary of critical accounting policies and estimates

This summary of critical accounting policies of Summer is presented to assist in understanding Summer's consolidated financial statements. The consolidated financial statements and notes are representations of Summer's management, which is responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the consolidated financial statements.

Summer makes certain estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses. The accounting policies described below are those Summer considers critical in preparing its financial statements. Some of these policies include significant estimates made by management using information available at the time the estimates were made. However, these estimates could change materially if different information or assumptions were used.

Nature of operations

Summer is engaged in the design, marketing and distribution of juvenile products. The majority of its revenues are derived from retail customers in North America, with approximately 10% of the business being generated in the UK. The Company also maintains a research and development staff in Asia (no revenues are generated directly out of Asia).

Revenue recognition

The Company follows the guidance of the Securities and Exchange Commission (SEC) Staff Accounting Bulletin 104 for revenue recognition. In general, the Company records revenue when persuasive evidence of an arrangement exists, product delivery has occurred, the sales price to the customer is fixed or determinable and collectability is reasonably assured. Sales are recorded net of provisions for returns and allowances, customer discounts and other sales related discounts. The Company bases its estimates for discounts, returns and allowances on negotiated customer terms and historical experience. These estimates are subject to variability, as actual deductions taken by customers may be different from the estimates recorded.

Sales incentives or other consideration given by the Company to customers that are considered adjustments of the selling price of its products, such as allowances and product placement fees, are reflected as reductions of revenue. Sales incentives and other consideration that represent costs incurred by the Company for assets or services received, such as the appearance of the Company's products in a customer's national circular ad, are reflected as selling and marketing expenses in the accompanying statements of income.

Trade receivables

Summer carries its trade receivables at net realizable value. On a periodic basis, Summer evaluates its trade receivables and establishes an allowance for doubtful accounts based on a history of past bad debt expense, collections and current credit conditions. The allowance is adjusted based on actual write offs that occur. Summer has a credit insurance policy to protect against potential losses up to stated amounts from certain customers.

Summer does not accrue interest on trade receivables. A receivable is considered past due if payments have not been received within the credit terms on the account, typically 60 days for most customers. Summer will turn an account over for collection around 120 days past due. Accounts are considered uncollectible if no payments are received 60 to 90 days after they have been turned over for collection.

Inventory

Inventory is comprised of finished goods and is stated at the lower of cost, inclusive of freight and duty, or market (net realizable value) using the first-in, first-out (FIFO) method. Company warehousing costs are charged to expense as incurred. Inventory write-downs are recorded for damaged, obsolete or slow-moving inventory. Management uses estimates to record these write-downs based on its review of inventory by product category, including length of time on hand and estimates of future orders for each product. Changes in consumer preferences, demand for products, customer buying patterns and inventory management could impact the inventory valuation.

Goodwill and Other Intangible Assets

Effective January 1, 2002, Summer adopted Financial Accounting Standards Board SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS 142 requires that goodwill and intangible assets that have indefinite useful lives no longer be subject to amortization and be tested at least annually for impairment.

Income taxes

The provision for income taxes is based on our estimated annualized effective tax rate for the year.

Effective January 1, 2007, we adopted the provisions of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. An Interpretation of FASB Statement No. 109. FIN 48 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in the financial statements in accordance with SFAS No. 109. Tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. Upon the adoption of FIN 48, we had no unrecognized tax benefits. During the first quarter of 2007, we recognized no adjustments for uncertain tax benefits.

Income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred tax asset or liability is recognized for estimated future tax effects attributable to temporary differences and carryforwards. The measurement of deferred income tax assets is adjusted by a valuation allowance, if necessary, to recognize future tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. We recognize interest and penalties, if any, related to uncertain tax positions in selling, general and administrative expenses. No interest and penalties related to uncertain tax positions were accrued at March 31, 2007.

The tax years 2004 through 2006 remain open to examination by the major taxing jurisdictions in which we operate. We expect no material changes to unrecognized tax positions within the next twelve months.

Translation of foreign currencies

The assets and liabilities of the European and Asian operations have been translated into U.S. dollars at quarter-end exchange rates. The income and expense accounts of the European and Asian operations have been translated at average rates prevailing during each respective year. Resulting translation adjustments are made to a separate component of stockholders' equity within accumulated other comprehensive income.

Advertising costs and accrued allowances

Summer charges advertising costs and other customer allowances to expense as incurred. Advertising expense, which consists primarily of promotional and cooperative advertising allowances provided to customers, is typically agreed to in advance for each customer and is generally based upon a percentage of sales to that customer. Other allowances are provided for defective goods or returned merchandise; some customers have these allowances negotiated as a percentage of sales, while other customers take deductions on payments made to Summer based upon actual defectives or returns. The company will record expense based on either the agreed-upon terms or accrue for these costs based on historical experience, and will adjust the expense as actual results vary from the estimates that have been recorded.

Product liability and warranty reserves

Summer maintains insurance to protect against product liability claims. Premiums are charged to expense during the period of coverage. In the normal course of business, Summer may offer warranties on certain of its products, generally limited to product replacement. A reserve would be recorded if the Company's experience (including industry data) showed that there was a material exposure related to certain types of products. This experience would include looking at actual claims experience and other factors. To the extent Summer establishes that a material liability exists, a reserve is established and would be included in accrued liabilities. The levels of reserves could vary based on actual claims experience in the future.

Other use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Company Overview

Summer is a designer, marketer, and distributor of branded juvenile health, safety and wellness products which are sold principally to large North American and UK retailers. Summer currently has more than 60 proprietary products in seven product categories including nursery audio/video monitors, safety gates, durable bath products, bed rails, infant thermometers and related health and safety products, booster and potty seats and bouncers.

Summer's strategy is to grow its sales through a variety of methods, including:

increased product penetration (more products at each store);

increased store penetration (more stores within each retail customer);

new products (at existing and new customers);

new mass merchant retail customers;

new distribution channels (food and drug chains, price clubs, home centers, web-based retailers);

new geographies (international expansion); and

new product categories (soft goods division started in 2006).

Summer has been able to grow its annual revenues by approximately \$50 million over the past five years through a combination of all of the above factors. Each year it has been able to expand the number of products into its main distribution channel, mass merchant retailers, and has also added new customers each year. Therefore, even without new product introductions, Summer could grow its business by simply selling more of its existing product line to existing customers.

For 2007 and beyond, the growth strategy of Summer will be to continue to develop and sell new products to its existing customer base, sell new and existing products to new customers (or expand relationships with existing customers), to begin to sell products from its soft goods product line, and to expand in the UK and in other geographic regions (including Japan, Mexico and Australia, among others). In addition, there are a number of potential acquisition candidates that could be pursued in order to obtain new innovative products, new product categories, new retail customers or new sales territories. There are approximately 400 active juvenile product companies, of which approximately 300 have less than \$10 million in sales. In addition, there are various product categories that Summer does not currently compete in, including car seats, strollers, play yards, high chairs, swings, walkers, nursery care, and other categories. Summer may look to develop its own products in these categories or attempt to gain entrance into these categories through acquisitions. Summer has no specific plans to acquire any companies at this time.

As Summer continues to grow through internal initiatives and any future acquisitions, it will incur additional expenses. Two of the key areas in which such increased expenses will likely occur are sales and product development. In order to grow sales, Summer will likely hire additional sales personnel to service new geographic territories, focus existing resources on specific parts of the United States market and retain product line specialists to drive sales of new and existing products in specific areas in which Summer believes it can readily increase sales. Product development expenses will increase as Summer develops new products in existing and new categories. If Summer were to acquire one or more companies as part of its growth strategy, it would face various challenges such as the integration of the acquired companies' product lines,

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employees, marketing requirements and information systems. Ongoing infrastructure investment also may be required to support realized growth, including expenditures with respect to upgraded and expanded information systems and enhancing the company's management team.

Sales

Summer's sales are primarily derived from the sale of juvenile health, safety and wellness products and are recognized upon transfer of title of product to Summer's customers. Summer's products are marketed through several distribution channels including chain retailers, specialty retailers and direct to consumers.

Approximately 90% of sales are currently made to customers in North America, with the remaining 10% made to customers in the UK. Sales are made utilizing standard credit terms of 30 to 90 days. Summer generally accept returns only for defective merchandise.

Cost of goods sold and other expenses

Summer's products are manufactured by third parties, with approximately 80-85% of the dollar value of products being manufactured in China and the majority of the balance being manufactured in Massachusetts. Cost of goods sold primarily represents purchases of finished products from these third party manufacturers. The remainder of Summer's cost of goods sold includes tooling depreciation, freight-in from suppliers and miscellaneous charges from contract manufacturers. Substantially all of Summer's purchases are made in US dollars, therefore most of this activity is not subject to currency fluctuations. If Summer's suppliers experience increased raw materials, labor or other costs and pass along such cost increases through higher prices for finished goods, Summer's costs of sales would increase, and to the extent we are unable to pass such price increases along to Summer's customers, Summer's gross margins would decrease.

Selling, general and administrative expenses primarily consist of payroll, insurance, professional fees, royalties, freight out to customers, product development costs, advertising and marketing expenses (including co-op advertising allowances as negotiated with certain customers) and sales commissions. Several of these items fluctuate with sales, some based on sales to particular customers and others based on sales of particular products.

There are not significant variations in seasonal demand for Summer's products. Sales to its retail customers are generally higher in the time frame when retailers take initial shipments of new products; these orders usually incorporate enough product to fill each store plus additional amounts to be kept at the customer's distribution center. The timing of these initial shipments varies by customer depending on when they finalize store layouts for the upcoming year, and whether there are any mid-year product introductions.

Results of Operations

Summer Infant (formerly KBL Healthcare Acquisition Corp.)

Consolidated Statements of Income

For the Three Months Ending March 31, 2007 and 2006

(In thousands)

	Three Months Ended	Three Months Ended
	March 31, 2007	March 31, 2006
	(Unaudited)	(Unaudited)
Net sales	\$ 4,771	\$ 0
Cost of goods sold	2,925	0
Gross profit	1,846	0
Operating expenses net of interest income	1,513	(250)
Income tax expense	133	114
Net income	200	136

The results of operations for the three months ended March 31, 2006 represents the general and administrative expenses of KBL Healthcare net of interest income generated by the approximate \$52 million in cash that KBL had on its balance sheet. This cash ultimately funded the acquisition of Summer Infant. The results of operations for the three months ended March 31, 2007 represents the combined activity of KBL Healthcare from January 1, 2007 through March 6, 2007 (which represents general and administrative expenses of KBL Healthcare, net of interest income generated by the \$52 million cash balance prior to the acquisition of Summer Infant on March 6, 2007) and the activity of Summer Infant from March 6, 2007 through March 31, 2007. KBL Healthcare historically had no sales or gross profit, while Summer has both sales and gross profit, in addition to other normal operating expenses. Therefore, the amounts in the two above periods cannot be compared in a meaningful fashion.

In order to give the reader some additional information on the performance of the underlying Summer Infant operations, the following table represents the unaudited results of the Summer Infant operating company for the three months ended March 31, 2007 and March 31, 2006. This table is being presented to give the reader more information about the underlying performance of the ongoing operating company, since KBL Healthcare had no operating business in 2006.

Summer Infant and Subsidiaries

Consolidated Statements of Income

For the Three Months Ending March 31, 2007 and 2006

(In thousands)

	Three Months Ended March 31, 2007 (Unaudited)		Three Months Ended March 31, 2006 (Unaudited)	
Net sales	\$ 17,170	100.0%	\$ 13,288	100.0%
Cost of goods sold	10,607	61.8%	8,360	62.9%
Gross profit	6,563	38.2%	4,928	37.1%
OPERATING EXPENSES				
Selling, general and administrative expenses (excluding depreciation and amortization)	4,907	28.6%	3,683	27.7%
EBITDA	1,656	9.6%	1,245	9.4%

Three months ended March 31, 2007 compared with three months ended March 31, 2006

Net sales increased 29% from approximately \$13,288 in the three months ended March 31, 2006 to approximately \$17,170 for the three months ended March 31, 2007. This sales increase was primarily attributable to increased distribution of Summer's products throughout Summer's customer base, plus new product introductions. Significant increases were noted in both large accounts such as Babies R Us, in addition to several other new accounts which have been added over the past year.

Gross profit increased 33% from approximately \$4,928 for the three months ended March 31, 2006 to approximately \$6,563 for the three months ended March 31, 2007. The gross profit % increased to 38.2% from 37.1% in the prior year. This increase was primarily attributable to the 29% increase in net sales, combined with sales of higher margin products in 2007 and a reduction of customer returns and allowances as a percentage of sales.

Selling, general and administrative expenses increased from approximately \$3,683 for the three months ended March 31, 2006 to approximately \$4,907 for the three months ended March 31, 2007. This increase was primarily attributable to increases in headcount in order to build the infrastructure required to support the rapid sales increase, higher variable selling expenses due to the increase in sales, and the inclusion in 2007 of approximately \$300 in costs incurred by the Soft Goods division, which started in mid 2006 (and therefore had zero expense in the first three months of 2006).

EBITDA increased from approximately \$1,245 for the three months ended March 31, 2006 to approximately \$1,656 for the three months ended March 31, 2007, an increase of 33%. This increase was primarily attributable to the increased sales and gross profit percentage as described above.

Liquidity and Capital Resources

Summer generally funds its operations and working capital needs through cash generated from operations and borrowings under its credit facility. In addition, the recent merger with KBL has resulted in a substantial cash infusion into Summer which has enabled it to pay down much of its existing debt.

Summer's sales have increased significantly over the past several years. For the year ended December 31, 2003, net sales were \$17,600. For the year ended December 31, 2006, net sales exceeded \$52,000. This sales growth has led to a substantial increase in working capital requirements, specifically accounts receivable and inventory. The typical cash flow cycle is as follows:

Inventory is purchased to meet expected demand plus a safety stock. Since the majority of Summer's vendors are based in Asia, inventory takes from four to six weeks to arrive from Asia to the various distribution points Summer maintains in the US and the UK. Payment terms for these vendors average 60 days from the date the product ships from Asia, therefore Summer is generally paying for the product a short time after it is physically received in the US. The increased sales Summer has experienced result in increased levels of inventory, and therefore an increase in the amount of cash required to fund its inventory level.

Sales to customers generally have payment terms of 30 to 60 days. The increased sales have resulted in an increase in the level of accounts receivable, and therefore have increased the amount of cash required to fund working capital.

Summer had traditionally been able to fund its increased working capital through asset-based lines of credit with banks. The lenders generally follow a borrowing base formula that allows advances based on the levels of accounts receivable and inventory. Summer's current line of credit contains traditional borrowing base formulas. The merger with KBL on March 6, 2007 enabled Summer to pay down its line of credit to zero, and in addition maintain a positive cash balance of \$7,865 as of March 31, 2007.

The majority of capital expenditures for Summer are for tools related to new product introductions. Summer receives indications from retailers generally around the middle of each year as to what products the retailer will be taking into its product line for the upcoming year. Based on these indications, Summer will then acquire the tools required to build the products. The majority of these expenditures are therefore made in the third and fourth quarters of each year so that initial shipments of products can be made in December and January (the typical time frame for new product shipments). In most cases the payments for the tools are spread out over a three to four month period.

For the three months ended March 31, 2007, net cash provided by operating activities was \$1,084. This primarily represents the reduction in accounts receivable for the period from March 6 (date of acquisition of Summer Infant) to March 31 due to large collections during that time frame. Net cash used in investing activities was \$22,966, which primarily related to the cash paid to Summer shareholders (plus deal fees) in conjunction with the acquisition of Summer that was completed on March 6. Net cash used in financing activities was \$22,390, which primarily consists of the paydown of Summer's outstanding line of credit balance of \$14,992 (using the proceeds from the KBL acquisition) plus the \$6,883 paid to the KBL shareholders who voted against the merger with Summer, and who therefore received cash in exchange for their shares of common stock. The net cash use for the three months ended March 31, 2007 was \$44,229, which has resulted in a reduction in the cash balance from \$52,094 as of December 31, 2006 to \$7,865 as of March 31, 2007.

Summer believes that its cash on hand and current banking facilities are sufficient to fund its cash requirements for at least the next 12 months. However, unforeseen circumstances, such as softness in the retail industry or deterioration in the business of a significant customer, could create a situation where Summer cannot access all of the available lines of credit due to not having sufficient accounts receivable. In addition, there is no assurance that Summer will meet all of its bank covenants in the future, or that its lenders will grant waivers if there are covenant violations.

Summer's strategy for funding its business going forward is a combination of the following: increased profitability; increased borrowing lines as required with traditional lenders (asset-based); and utilization of the proceeds available from the business combination with KBL to fund its business as well as potential acquisitions. This liquidity could potentially be used to pay off the existing building debt of Summer; fund working capital increases going forward; acquire other businesses; pay dividends; or repurchase KBL common stock or warrants.

In July 2005, the Company entered into a revolving line of credit with a bank, which provides for borrowings based on levels of qualified accounts receivable and inventory. The line of credit is secured by all assets of the Company. The line of credit has been increased several times, and currently the maximum borrowings total \$17,000. The line of credit runs through June 30, 2007; this date has been extended several times by the bank, and the Company believes that the bank will extend the line of credit beyond this date. Interest on the line of credit is payable at LIBOR plus 1.75%. There were no amounts outstanding on the Line of Credit as of March 31, 2007.

In connection with the new Line of Credit, the Company is subject to certain covenants, which require, among other things, maintenance of a minimum cash flow to debt service ratio, a total liabilities to tangible net worth ratio, and a certain level of net worth. The Company was in compliance with all covenants as of March 31, 2007.

We believe that Summer's cash flows from operations, cash on hand, funds from the business combination with KBL, and available borrowings will be sufficient to meet Summer's working capital and capital expenditure requirements and provide us with adequate liquidity to meet anticipated operating needs for at least the next 12 months. Summer's cash requirements for the period beyond that are expected to be met by a combination of the cash proceeds from the business combination with KBL plus continued use of bank facilities to meet working capital requirements.

Non-GAAP Discussion

In addition to its GAAP results, Summer considers non-GAAP measures of its performance. EBITDA, as defined below, is an important supplemental financial measure of Summer's performance that is not required by, or presented in accordance with, GAAP. EBITDA represents net income (loss) before income taxes, minority interest in net income of affiliates, interest expense, and depreciation and amortization. Summer's management uses EBITDA as a financial measure to assess the ability of its assets to generate cash sufficient to pay interest on its indebtedness, meet capital expenditure and working capital requirements, and otherwise meet its obligations as they become due. Summer's management believes that the presentation of EBITDA provides useful information regarding Summer's results of operations because they assist in analyzing and benchmarking the performance and value of Summer's business. Summer believes that EBITDA is useful to stockholders as a measure of comparative operating performance, as it is less susceptible to variances in actual performance resulting from depreciation and amortization and more reflective of changes in pricing decisions, cost controls and other factors that affect operating performance.

EBITDA also is used by Summer's management for multiple purposes, including:

to calculate and support various coverage ratios with Summer's lenders;

to allow lenders to calculate total proceeds they are willing to loan to Summer based on its relative strength compared to other competitors; and

to more accurately compare Summer's operating performance from period to period and company to company by eliminating differences caused by variations in capital structures (which affect relative interest expense), tax positions and amortization of intangibles.

In addition, EBITDA is an important valuation tool used by potential investors when assessing the relative performance of a company in comparison to other companies in the same industry. Although Summer uses EBITDA as a financial measure to assess the performance of its business, there are material limitations to using a measure such as EBITDA, including the difficulty associated with using it as the sole measure to compare the results of one company to another and the inability to analyze significant items that directly affect a company's net income (loss) or operating income because it does not include certain material costs, such as interest and taxes, necessary to operate its business. In addition, Summer's calculation of EBITDA may not be consistent with similarly titled measures of other companies and should be viewed in conjunction with measures that are computed in accordance with GAAP. Summer's management compensates for these limitations in considering EBITDA in conjunction with its analysis of other GAAP financial measures, such as net income (loss).

The following table presents a reconciliation of the Summer stand alone EBITDA to net income, its most directly comparable GAAP financial measure, on a historical basis, for the periods presented:

Reconciliation of unaudited EBITDA, as adjusted, to Net Income (In thousands)

	Three Months Ended	
	March 31, 2007	2006
Net income- Summer stand alone results (pro forma)	\$ 640	\$ 945

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Income taxes (assuming 3 months as a C corp)	426	0
Non cash stock option expense	153	0
Interest expense	157	170
Depreciation and amortization	280	130
EBITDA- Summer stand alone results (pro forma)	\$ 1,656	\$ 1,245

Recently Issued Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123(R) (revised in 2004), Share Based Payment (SFAS 123(R)), which revised SFAS No. 123, Accounting for Stock-Based Compensation, and supercedes APB Opinion No. 25, Accounting for Stock Issued to Employees. FAS No. 123(R) requires the recognition of stock-based compensation expense in the financial statements. Effective January 1, 2006, the Company adopted FAS No. 123(R). The implementation of FAS 123(R) resulted in an expense of approximately \$153 in the consolidated statements of income for the three month period ended March 31, 2007. The Company used the Black-Scholes option pricing model to measure the estimated fair value of the options granted.

In June of 2005, the FASB issued Statement of Financial Accounting Standards No. 154, (SFAS 154), Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS 154 applies to all voluntary changes in accounting principle and changes the requirements for accounting for and reporting a change in accounting principle. SFAS 154 requires the retrospective application to prior periods financial statements of the direct effect of a voluntary change in accounting principle unless it is impracticable. APB No. 20 required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. The Company has adopted the provisions of FAS 154 and does not expect any material effect on its results of operations or financial position.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly, does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact of SFAS No. 157 on our consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. This was adopted effective January 1, 2007. As a result of the implementation of FIN 48, the Company recognized no adjustments in uncertain tax benefits. As of March 31, 2007, the Company has \$0 of accrued interest related to uncertain tax positions.

There are no other recently issued accounting pronouncements that need to be considered when reading the financial statements or related footnotes.

Management does not believe that any other recently issued, but not yet effective, accounting standards if currently adopted would have a material effect on the accompanying financial statements.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Summer's exposure to market risk is limited to interest rate risk associated with Summer's credit facilities and foreign currency exchange risk associated with Summer's foreign operations.

Based on Summer's interest rate exposure on variable rate borrowings at March 31, 2007, a one percentage point increase in average interest rates on Summer's borrowings would increase future interest expense by approximately \$3 per month. Summer determined these amounts based on approximately \$3,145 of variable rate borrowings at March 31, 2007, multiplied this amount by 1% and divided by twelve. Summer is currently not using any interest rate collars or hedges.

to manage or reduce interest rate risk. As a result, any increase in interest rates on Summer's variable rate borrowings would increase interest expense. The increase in interest expense could potentially be offset by an increase in interest income as long as Summer has a positive cash balance. As of March 31, 2007, the cash balance was approximately \$7,865.

The majority of Summer's operating activities are conducted in US dollars. Approximately 10% of Summer's sales are denominated in other currencies such as British pounds sterling or Canadian dollars. Summer's purchases of finished goods from Chinese manufacturers are denominated in US dollars. A 10% change in the exchange rate of the US dollar with respect to Canadian dollars or British pounds sterling would not have a significant impact on Summer's earnings.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings (amounts in \$000 s)

In July 2006, Summer received a letter from Ideaz, LLC claiming that Summer misappropriated trade secrets to create certain products by Summer. This dispute was settled in the first quarter of 2007 with a payment of approximately \$33 to Ideaz.

In August 2006, Summer entered into a settlement and license agreement with Marshall Sleep Systems, LLC, relating to the settlement of certain patent infringement claims by Marshall Sleep Systems against Summer regarding its triple bedrail product. Under the settlement and license agreement, Summer paid Marshall Sleep Systems \$25 for a non-exclusive, worldwide license to certain of Marshall Sleep System's patents covering Summer's triple bedrail product.

In August 2006, Summer entered into a consent injunction and settlement agreement and release among Summer, Springs Global US, Inc. (Springs), and certain Summer employees who were formerly employed by Springs relating to the settlement of certain claims by Springs against Summer regarding the use of certain confidential information of Springs. Under the settlement, the parties released all claims or causes of actions they may have against each other, and Summer agreed that it would not engage in the sale of any soft goods to K-Mart until after December 22, 2006. Summer and the former Springs employees also agreed to pay Springs attorneys fees and expenses incurred in connection with the dispute, not to exceed \$70.

In August 2006, Summer resolved an ongoing patent dispute with EICO Industries, LLC regarding its rear seat monitor product by entering into a license agreement. Under the license agreement, Summer has an exclusive license to manufacture its rear seat monitor product using certain proprietary information of EICO. The license term is three years. Summer paid EICO a fee of \$10 under the license agreement, and Summer will pay royalties to EICO for the term of the license agreement, with a minimum payment of \$15 per year.

In August 2006, Dorel Juvenile Group, Inc. (Dorel) filed a complaint in the United States District Court for the Southern District of Indiana against Lois DiMartinis, a current employee of Summer, claiming, among other things, that she breached her non-disclosure obligations by taking confidential information with her when departing employment from Dorel, and that she would inevitably disclose confidential information in the course of performing duties for her new employer, Summer. Dorel, in its complaint, accused Summer of engaging in a pattern of hiring employees from Dorel for the purpose of obtaining Dorel's confidential information for use in Summer's product designs and business. On October 20, 2006, the court denied Dorel's motion for preliminary injunction, finding that Dorel was not reasonably likely to succeed on the merits of its case. Dorel has appealed the court's decision. As of March 31, 2007, appeal briefs have been filed by both parties, and oral arguments have not been scheduled as of this time. Summer agreed to provide Ms. DiMartinis legal counsel for defending the action, and to pay the legal fees and costs for her defense, including the appeal, which as of March 31, 2007 were approximately \$250 (this was virtually all expensed in 2006).

ITEM 1A. Risk Factors

There have been no material changes pertaining to risk factors that were provided in the 8K filed on March 12, 2007.

ITEM 2. Unregistered Sales of Equity Securities and Use of Funds

None.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Submission of Matters to a Vote of Security Holders

On September 1, 2006, Summer entered into an Agreement and Plans of Reorganization with the former Summer Infant, Inc. and its affiliated companies, Summer Infant Europe Limited and Summer Infant Asia, Ltd. Pursuant to the agreement, the former Summer Infant, Inc. agreed to merge with and into our wholly-owned subsidiary. In addition, we agreed to purchase all the outstanding stock of Summer Infant Europe Limited and Summer Infant Asia, Ltd. Consummation of the transaction was dependent on shareholder approval of the Agreement, on changing our name to Summer Infant, Inc. and on increasing the number of our authorized shares. Accordingly, on March 6, 2007, we held a Special Meeting of Stockholders to consider several proposals related to this transaction. All of the proposals were approved. The proposals and the results of the stockholder holder vote were as follows:

On whether to approve the Agreement and Plans of Reorganization, holders of 8,606,681 shares voted for approval; 1,234,755 voted against (of which 1,208,755 exercised their right to convert their shares into a pro rata portion of the funds held in trust); and 4,000 abstained.

On whether to approve the amendment to the Certificate of Incorporation to change the name of the Company to Summer Infant, Inc., holders of 10,150,321 shares voted for approval; 552,189 voted against; and 239,000 abstained.

On whether to approve the amendment to the Certificate of Incorporation to increase the number of authorized shares of common stock from 35,000,000 to 100,000,000, holders of 10,147,821 shares voted for approval; 554,689 voted against; and 239,000 abstained.

On whether to approve the amendment to the Certificate of Incorporation to remove the preamble and sections A through D, inclusive, of Article Sixth from the Certificate of Incorporation, from and after the closing of the Merger, as they will no longer be applicable, and to redesignate section E of Article Sixth as Article Sixth, holders of 9,054,247 shares voted for approval, 552,189 voted against; and 239,000 abstained.

On whether to approve the 2006 Performance Equity Plan, holders of 7,806,564 shares voted for approval; 1,799,872 voted against; and 239,000 abstained.

ITEM 5. Other Information

None.

ITEM 6. Exhibits

31.1 Chief Executive Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Chief Financial Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Jason Macari, Chief Executive Officer of Summer Infant, Inc., pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Joseph Driscoll, Chief Financial Officer of Summer Infant, Inc., pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Signatures

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

Summer Infant, Inc.

May 11, 2007

/s/ Jason Macari

Jason Macari

Chief Executive Officer

May 11, 2007

/s/ Joseph Driscoll

Joseph Driscoll

Chief Financial Officer

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	386,500	507,475	25,892	370,000	149,600	17,250
James A. Firestone						
2003	450,000	432,400	20,095	402,500	187,000	15,391
Senior Vice President						
2002	430,000	452,000	19,000	338,650	171,500	14,225
2001	400,750	463,975	22,179	115,625	93,500	17,853
Michael C. Mac Donald						
2003	440,000	571,600	32,984	322,000	149,600	15,732
Senior Vice President						
2002	396,750	480,000	19,344	260,500	143,500	14,217
2001	355,500	495,775	41,489	115,625	93,500	18,537

(A) For 2003, the amount indicates payment of the annual incentive awards to all Named Officers. Included in this amount is 50% of a retention award to Michael C. Mac Donald paid in June 2003. See Certain Transactions for more information regarding this award. Cash bonuses paid for 2001 were for purposes of retention only and were not based on Company performance.

(B) Other Annual Compensation includes executive expense allowance, dividend equivalents paid on outstanding incentive stock rights and restricted stock awards, perquisite compensation, tax-related reimbursements arising from prizes, relocation and/or international assignments and above-market interest credited on amounts of salary and compensation earned prior to 2001 that was deferred. For 2003, above market interest credited was as follows: Anne M. Mulcahy \$3,501, Ursula M. Burns \$540, and Michael C. Mac Donald \$316. For 2003, the amounts for Anne M. Mulcahy and Lawrence A. Zimmerman include tax related reimbursements of approximately \$135,237 and \$3,746 respectively; both amounts are inclusive of interest.

(C) As discussed in the Report of the Compensation Committee of the Board of Directors, for 2003 this column reflects restricted stock awarded January 1, 2003 under LEEP. Restricted stock awarded under LEEP vested one year from the date of the grant. The number of restricted shares and units held by the Named Officers and their value as of December 31, 2003 (based on the closing market price on that date of \$13.80) was as follows: Anne M. Mulcahy 259,440 (\$3,580,272), Lawrence A. Zimmerman 50,000 (\$690,000), Ursula M. Burns 108,800 (\$1,501,440), James A. Firestone 58,580 (\$808,404) and Michael C. Mac Donald 40,000 (\$552,000). This excludes the grants of restricted stock units made on January 1, 2004 under E-LTIP as follows: Anne M. Mulcahy 366,000 (\$5,008,710), Lawrence A. Zimmerman 74,000 (\$1,012,690), Ursula M. Burns 83,000 (\$1,135,855), James A. Firestone 74,000 (\$1,012,690), and Michael C. Mac Donald 46,000 (\$629,510). This also excludes a grant of 9,000 (\$136,845) restricted stock units made under E-LTIP on February 12, 2004 to Michael C. Mac Donald. Restricted stock units granted under E-LTIP vest in three equal installments from the date of grant, except for

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those granted to Anne M. Mulcahy which vest 100% after three years from the date of grant, except that the vesting can be accelerated by one-third if the Company achieves annual revenue growth. All awards granted under E-LTIP are subject to a mandatory holding period. As determined by the Committee, executives must retain 50% of net shares for the later of one year, or until they achieve their required ownership level (see Report of the Compensation Committee of the Board of Directors).

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- (D) This excludes the grants of stock options made effective on January 1, 2004 under E-LTIP as follows: Anne M. Mulcahy 609,000, Lawrence A. Zimmerman 122,000, Ursula M. Burns 138,000, James A. Firestone 122,000, and Michael C. Mac Donald 77,000. This also excludes a grant of 15,000 stock options made under E-LTIP effective on February 12, 2004 to Michael C. Mac Donald. Stock options awarded under E-LTIP vest in three equal annual installments from the date of grant and remain exercisable for eight years from their date of grant. All awards granted under E-LTIP are subject to a mandatory holding period. As determined by the Committee, executives must retain 50% of net shares for the later of one year, or until they achieve their required ownership level (see Report of the Compensation Committee of the Board of Directors).
- (E) The amount shown in this column for 2003 consists of the Company match under the Company's Savings Plans, for which substantially all U.S. employees are eligible, and Company-paid premiums for the Xerox Universal Life Plan as discussed in the Report of the Compensation Committee of the Board of Directors. These premium amounts are: Anne M. Mulcahy \$21,253, Lawrence A. Zimmerman \$3,294, Ursula M. Burns \$6,653, James A. Firestone \$9,391 and Michael C. Mac Donald \$9,732.

Option Grants

The following table sets forth information about awards of stock options to the Named Officers under the Company's 1991 Plan effective during the fiscal year ended December 31, 2003. The amounts shown for potential realizable values are based on arbitrarily assumed annualized rates of stock price appreciation (5% and 10%) over the full ten-year term of the options, pursuant to SEC regulations. Based on a ten-year option term, this would result in stock price increases of 63% and 159% respectively or \$12.844 and \$20.452 for the options with the \$7.885 exercise price. The amounts shown as potential realizable values for all shareholders represent the corresponding increases in the market value of 793,884,396 shares outstanding held by all shareholders as of December 31, 2003. Any gains to shareholders and the Named Officers will depend on future performance of the Common Stock of the Company as well as overall market conditions.

OPTION GRANTS IN LAST FISCAL YEAR

Name	Individual Grants (1) (2) (3)				Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term	
	Number of Securities Underlying Options Granted (#)	% of Total Options Granted to Employees in Fiscal Year	Exercise or Base Price (\$/Sh)	Expiration Date	5% (\$)	10% (\$)
Anne M. Mulcahy	934,600	3.22%	\$ 7.8850	12/31/12	\$ 4,634,526	\$ 11,744,800
Lawrence A. Zimmerman	187,000	0.64%	\$ 7.8850	12/31/12	\$ 927,302	\$ 2,349,965
Ursula M. Burns	280,400	0.97%	\$ 7.8850	12/31/12	\$ 1,390,457	\$ 3,523,691
James A. Firestone	187,000	0.64%	\$ 7.8850	12/31/12	\$ 927,302	\$ 2,349,965
Michael C. Mac Donald	149,600	0.52%	\$ 7.8850	12/31/12	\$ 741,842	\$ 1,879,972
All Shareholders	N/A	N/A	N/A	N/A	\$ 3,936,741,040	\$ 9,976,474,726

- (1) Exercise price is based on fair market value on the effective date of the award. This excludes the grants of stock options made on January 1, 2004 under E-LTIP as follows: Anne M. Mulcahy 609,000, Lawrence A. Zimmerman 122,000, Ursula M. Burns 138,000, James A.

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Firestone 122,000, and Michael C. Mac Donald 77,000. The exercise price of stock options granted under E-LTIP based on the fair market value on the effective date of grant is \$13.685. This also excludes a grant of 15,000 stock options made under E-LTIP effective on February 12, 2004 to Michael C. Mac Donald, with an exercise price of \$15.205, based on the fair market value on the effective date of grant. Stock options awarded under E-LTIP vest in three equal annual installments from the date of grant and remain exercisable for eight years from their date of grant. All awards granted under E-LTIP are subject to a mandatory holding period. As determined by the Committee, executives must retain 50% of net shares for the later of one year, or until they achieve their required ownership level (see Report of the Compensation Committee of the Board of Directors).

- (2) Options may be accelerated as a result of a change in control as described under Option Surrender Rights .
- (3) Exercisable one-third on each of the following dates: January 1, 2004; January 1, 2005; and January 1, 2006.

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Option Exercises/ Year-End Values

The following table sets forth for each of the Named Officers the number of shares underlying options and SARs exercised during the fiscal year ended December 31, 2003, the value realized on exercise, the number of options/SARs unexercised at year-end and the value of unexercised in-the-money options/SARs at year-end.

AGGREGATE OPTION/ SAR EXERCISES IN THE LAST FISCAL YEAR AND FISCAL YEAR-END OPTION/ SAR VALUE

Name	Value of Shares Underlying Options/SARs Exercised(#)	Value Realized(\$)	Number of Shares Underlying Unexercised Options/SARs at FY-End(#)		Value of Unexercised In-the- Money Options/SARs at FY-End\$(A)(B)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Anne M. Mulcahy	0	\$0	1,363,407	2,929,201	\$ 6,601,384	\$ 14,707,819
Lawrence A. Zimmerman	0	\$0	40,500	418,000	\$ 190,755	\$ 2,172,610
Ursula M. Burns	0	\$0	206,794	570,001	\$ 1,056,669	\$ 3,257,499
James A. Firestone	0	\$0	475,690	399,167	\$ 691,405	\$ 2,059,247
Michael C. Mac Donald	0	\$0	154,185	323,101	\$ 660,416	\$ 1,780,356

- (A) Excludes the grants of stock options made effective on January 1, 2004 under E-LTIP as follows: Anne M. Mulcahy 609,000, Lawrence A. Zimmerman 122,000, Ursula M. Burns 138,000, James A. Firestone 122,000, and Michael C. Mac Donald 77,000. This also excludes a grant of 15,000 stock options made under E-LTIP effective on February 12, 2004 to Michael C. Mac Donald. All awards granted under E-LTIP are subject to a mandatory holding period. As determined by the Committee, executives must retain 50% of net shares for the later of one year, or until they achieve their required ownership level.
- (B) The value of unexercised options/SARs is based on the difference between the exercise price and the average of the high and low prices on December 31, 2003 of \$13.685. Options/SARs may be accelerated as a result of a change in control as described under Option Surrender Rights.

Retirement Plans

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Retirement benefits are provided to the executive officers of the Company including the Named Officers primarily under unfunded executive supplemental plans and, due to Internal Revenue Code limitations, to a much lesser extent under the Company's Retirement Income Guarantee Plan. The table below shows the approximate total annual retirement benefit that would accrue for the number of years of credited service at the respective average annual compensation levels. The earliest retirement age for benefit commencement generally is age 60. In the event of a change in control (as defined in the plans) there is no age requirement for eligibility. The benefit accrues generally at the rate of 1-2/3% per year of credited service, but an accelerated benefit may apply for certain executives. No additional benefits are payable for participation in excess of 30 years for those accruing benefits at the rate of 1-2/3% per year. The maximum benefit is 50% of the highest five-year average annual compensation reduced by 50% of the primary Social Security benefit. The benefits shown are payable on the basis of a straight life annuity and a 50% survivor annuity for a surviving spouse.

Accelerated accruals apply to Anne M. Mulcahy and Lawrence A. Zimmerman. The service reported for these two officers reflects these accelerated accruals (i.e., using the service and pay reported in the pension table will yield the appropriate benefit amount).

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Average annual compensation for five highest years	Annual age 65 benefits for years of credited service indicated			
	15 years	20 years	25 years	30 years
400,000	95,000	126,000	158,000	189,000
600,000	145,000	193,000	241,000	289,000
800,000	195,000	259,000	324,000	389,000
1,000,000	245,000	326,000	408,000	489,000
1,200,000	295,000	393,000	491,000	589,000
1,400,000	345,000	459,000	574,000	689,000
1,600,000	395,000	526,000	658,000	789,000
1,800,000	445,000	593,000	741,000	889,000
2,000,000	495,000	659,000	824,000	989,000
2,200,000	545,000	726,000	908,000	1,089,000
2,400,000	595,000	793,000	991,000	1,189,000
2,600,000	645,000	859,000	1,074,000	1,289,000
2,800,000	695,000	926,000	1,158,000	1,389,000
3,000,000	745,000	993,000	1,241,000	1,489,000

As of December 31, 2003, the following individuals have five-year highest average compensation and years of credited service for purposes of the plans as follows:

Name	Five-Year Highest Average Compensation(A)	Years of Credited Service	Projected Age 65 Years of Credited Service
Anne M. Mulcahy	\$1,459,279	30	30
Lawrence A. Zimmerman	998,750	5	17
Ursula M. Burns	595,528	23	30
James A. Firestone	644,168	6	21
Michael C. Mac Donald	589,626	27	30

(A) Compensation under the plans includes the amounts shown in the salary and bonus columns under the Summary Compensation Table.

Certain Transactions

Change In Control Severance Agreements

The Company has severance agreements with 38 executives (including each of the Named Officers), that provide severance benefits in the event of termination of employment under certain circumstances following a change in control of the Company (as defined in the agreement). The agreements provide for the following:

Lump sum severance payment equal to three times total annual cash compensation (base pay plus bonus) for Anne M. Mulcahy and generally two times total cash compensation for other executives

Continuation of certain welfare benefits following termination of employment for a period of 36 months for Anne M. Mulcahy and 24 months for other executives

Gross-up payment if the total payments are subject to excise tax imposed under Section 4999 of the Internal Revenue Code of 1986, as amended

Automatic annual renewal of the agreement unless the Company gives notice that it does not wish to extend it

Continuation of the agreement for two years after a change in control of the Company.

Each agreement also provides that in the event of a potential change in control, subject to the terms of the agreement, the executive will remain in the employ of the Company for nine months following the occurrence of any such potential change in control.

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Cash Retention Agreement

During 2003, with the prior approval of the Compensation Committee, the Company entered into a Cash Retention Agreement with Michael C. Mac Donald, Senior Vice President. Under this Agreement, Michael C. Mac Donald is entitled to receive an aggregate of \$300,000 payable in two 50% annual installments in June 2003 and December 2004. The amount payable in June 2003, which has been made, must be paid back to the Company if: (a) employment is terminated by the officer for any reason other than death, disability or for good reason, as defined, or (b) employment is terminated by the Company for cause, as defined. In the event of any such termination prior to December 31, 2004, the final payment will not be made. In the event of death or disability, a pro rata portion is payable.

Relationship With Fuji Xerox

Yotaro Kobayashi, one of our directors, is Chairman of the Board of Fuji Xerox Co., Ltd. (Fuji Xerox), our joint venture with Fuji Photo Film Corp., Ltd.

We have a technology agreement with Fuji Xerox whereby we receive royalty payments and rights to access their patent portfolio in exchange for access to our patent portfolio. In 2003, we earned royalty payment revenues from Fuji Xerox of \$110 million.

We also have arrangements whereby we purchase inventory from and sell inventory to Fuji Xerox. Pricing of the transactions under these arrangements is based on negotiations conducted at arm's length. Certain of these inventory purchases and sales are the result of mutual research and development arrangements. Our purchases from Fuji Xerox are in the normal course of business and typically have a lead-time of three months. In 2003, we sold \$129 million of inventory to Fuji Xerox and purchased \$871 million of inventory from Fuji Xerox. We anticipate that we will purchase approximately \$1 billion of products from Fuji Xerox in 2004.

In addition to the payments described above, in 2003 we paid Fuji Xerox \$33 million and Fuji Xerox paid us \$9 million for unique research and development.

Grantor Trusts

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The Company has established grantor trusts with a bank for the purpose of paying amounts due under the deferred compensation plan and the severance agreements described above, and the unfunded supplemental retirement plans described above. The trusts are presently unfunded, but the Company would be required to fund the trusts on the occurrence of certain events.

Legal Services

The law firm of Akin, Gump, Strauss, Hauer & Feld LLP, of which Vernon E. Jordan, Jr. is of counsel, was retained by and rendered services to the Company in 2003 and paid fees to such firm of approximately \$20,000. Fees paid to such firm during each of the last three years represented less than one percent of the total fees of the firm during each such year.

Equity Compensation Plan Information

The Equity Compensation Plan Information table provides information as of December 31, 2003, with respect to shares of Xerox Common Stock that may be issued under our existing equity compensation plans, including the 1991 Plan; the Xerox Corporation 1996 Non-Employee Director Stock Option Plan (the 1996 Plan); the 1998 Plan; Xerox Mexicana, S.A. de C.V. Executive Rights Plan (the Mexico Plan); and the Xerox Canada Inc. Executive Rights Plan (the Canada Plan). As of February 29, 2004, there were 799,541,247 common shares outstanding and 235,378,792 shares reserved for convertible securities for a total of 1,034,920,039 common shares outstanding and reserved.

This table does not include information about the proposed 2004 Performance Incentive Plan that is being submitted for shareholder approval at the annual meeting. No grants have been made under the 2004 Plan.

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EQUITY COMPENSATION PLAN INFORMATION

Plan Category	A	B	C
	Number of Securities to be Issued upon Exercise of Outstanding Options and Rights	Weighted-Average Exercise Price of Outstanding Options and Rights	Number of Securities Remaining Available for Future Issuance under Equity Compensation Plans (Excluding Securities Reflected in Column A)
Equity Compensation Plans Approved by Shareholders ⁽¹⁾	95,314,760	\$21.448	17,884,453 ⁽³⁾
Equity Compensation Plans Not Approved by Shareholders ⁽²⁾	2,524,571	\$21.973	3,549,963
Total	97,839,331⁽⁴⁾	\$21.462	21,434,416⁽⁵⁾

(1) Consists of the 1991 Plan, 1996 Plan and the 1998 Plan. For each calendar year beginning 1999, shares of Common Stock under the 1991 Plan equal to 2% of the adjusted average shares of Common Stock outstanding used to calculate diluted earnings per share, as reported in the annual report to shareholders for the preceding year, shall become available for issuance under the 1991 Plan.

(2) Consists of the Mexico Plan and the Canada Plan.

(3) Includes 1,590,000 shares available under 1996 Plan. If the 2004 Equity Compensation Plan for Non-Employee Directors is approved by shareholders, no further awards will be made under the 1996 Plan. Under the terms of the 1998 Plan, no further grants can be made after May 21, 2003.

(4) Does not include 2,176,260 shares of restricted stock and units outstanding as of fiscal year end.

(5) If the 2004 Performance Incentive Plan is approved by Shareholders, any remaining authorized shares under the 1991 Plan, the Mexico Plan and the Canada Plan not subject to outstanding awards shall become available for issuance under the 2004 Plan, provided that any

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shares issued in connection with options or SARs shall be counted against this limit as 0.6 shares for each one (1) share issued. As of February 29, 2004, approximately 15,700,000 full-value shares (or 26,100,000 options) remained available for grant under these plans. Any shares underlying awards outstanding on May 20, 2004 under the 1991 Plan, the Mexico Plan, the Canada Plan and the 1998 Plan that are cancelled, are forfeited, or lapse shall become available for issuance under the 2004 Plan.

Xerox Mexicana, S.A. de C.V. Executive Rights Plan

The Xerox Mexicana, S.A. de C.V. Executive Rights Plan that became effective on January 1, 1999 had not been approved by shareholders. This plan provides for the granting of stock rights for the purpose of advancing the interests of Xerox Corporation and shareholders by providing the General Director or Executive Director and other employees with a proprietary interest in the growth and performance of the Company and incentives for continued service. If the 2004 Performance Incentive Plan is approved by shareholders, this plan will be discontinued.

Xerox Canada Inc. Executive Rights Plan

The Xerox Canada Inc. Executive Rights Plan became effective on July 1, 1995 and was amended as of March 17, 1999 and August 1, 1999. This plan had not been approved by shareholders. This plan provides for the granting of stock rights and other related vehicles for the purpose of advancing the interests of Xerox Corporation and shareholders by providing the President or a Vice President of Xerox Canada Inc. and other employees with a proprietary interest in the growth and performance of the Company and incentives for continued service. If the 2004 Performance Incentive Plan is approved by shareholders, this plan will be discontinued.

Option Surrender Rights

All non-qualified options under the 1991 Plan and the Xerox Corporation 1998 Employee Stock Option Plan (the 1998 Plan) are accompanied by option surrender rights. If there is a change in control, as defined in the plans, all such rights that are in the money become payable in cash based on a change in control price as defined in the plans. The 1991 Plan

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also provides that on the occurrence of such an event, all restricted stock and incentive stock rights become payable in cash. In the case of rights payable in shares, the amount of cash is based on such change in control price and in the case of rights payable in cash, the cash value of such rights. Rights payable in cash that have not been valued at the time of such an event are payable at the maximum value as determined by the Compensation Committee at the time of the award. In the event of accelerated payment, such rights and any related non-qualified stock options will be cancelled.

Litigation

In re Xerox Derivative Actions: A consolidated putative shareholder derivative action is pending in the Supreme Court of the State of New York, County of New York against several current and former members of the Board of Directors including William F. Buehler, B.R. Inman, Antonia Ax:son Johnson, Vernon E. Jordan, Jr., Yotaro Kobayashi, Hilmar Kopper, Ralph Larsen, George J. Mitchell, N.J. Nicholas, Jr., John E. Pepper, Patricia Russo, Martha Seger, Thomas C. Theobald, Paul Allaire, G. Richard Thoman, Anne Mulcahy and Barry Romeril, and KPMG. The plaintiffs purportedly brought this action in the name of and for the benefit of the Company, which is named as a nominal defendant, and its public shareholders. The second consolidated amended complaint alleged that each of the director defendants breached their fiduciary duties to the Company and its shareholders by, among other things, ignoring indications of a lack of oversight at the Company and the existence of flawed business and accounting practices within the Company's Mexican and other operations; failing to have in place sufficient controls and procedures to monitor the Company's accounting practices; knowingly and recklessly disseminating and permitting to be disseminated, misleading information to shareholders and the investing public; and permitting the Company to engage in improper accounting practices. The plaintiffs further alleged that each of the director defendants breached his/her duties of due care and diligence in the management and administration of the Company's affairs and grossly mismanaged or aided and abetted the gross mismanagement of the Company and its assets. The second amended complaint also asserted claims of negligence, negligent misrepresentation, breach of contract and breach of fiduciary duty against KPMG. Additionally, plaintiffs claimed that KPMG is liable to Xerox for contribution, based on KPMG's share of the responsibility for any injuries or damages for which Xerox is held liable to plaintiffs in related pending securities class action litigation. On behalf of the Company, the plaintiffs seek a judgment declaring that the director defendants violated and/or aided and abetted the breach of their fiduciary duties to the Company and its shareholders; awarding the Company unspecified compensatory damages against the director defendants, individually and severally, together with pre-judgment and post-judgment interest at the maximum rate allowable by law; awarding the Company punitive damages against the director defendants; awarding the Company compensatory damages against KPMG; and awarding plaintiffs the costs and disbursements of this action, including reasonable attorneys' and experts' fees. On December 16, 2002, the Company and the individual defendants answered the

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complaint. The plaintiffs filed a third consolidated and amended derivative action complaint on July 23, 2003 adding factual allegations relating to subsequent acts and transactions, namely indemnification of six former officers for disgorgements imposed pursuant to their respective settlements with the SEC and related legal fees, and adding a demand for injunctive relief with respect to that indemnification. On September 12, 2003, Xerox and the individuals filed an answer to the third consolidated and amended derivative action complaint. The individual defendants deny any wrongdoing and are vigorously defending the action.

Indemnification Actions

As we previously reported the SEC announced on June 5, 2003 that it had reached a settlement with Messrs. Allaire, Fishbach, Marchibroda, Romeril, Tayler and Thoman who are former officers of Xerox Corporation regarding the same accounting and disclosure matters which were involved in its previously settled investigation of Xerox Corporation. These individuals neither admitted nor denied wrongdoing and agreed to pay fines, disgorgement, and interest.

The Company's By-Laws provide for indemnification of officers and directors to the full extent permitted by New York law. Consistent with these By-Laws, the Board of Directors authorized the Company to pay the counsel fees and other reasonable fees and expenses incurred, and the payment of the disgorgement amount and interest paid by Messrs. Allaire, Fishbach, Marchibroda, Romeril, Tayler and Thoman in connection with the investigation by the SEC and the settlement with these individuals. The Company paid an aggregate of \$557,764 for fees and expenses since the previous report to shareholders in our April 18, 2003 Proxy Statement and \$19.4 million for the disgorgement and interest. These individuals are responsible for paying their own fines in the SEC matter.

Also consistent with the By-Laws, in connection with the derivative action mentioned above as well as *In re Xerox Corporation Securities Litigation; Carlson v. Xerox Corporation, et al; Bingham v. Xerox Corporation, et al; Florida*

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State Board of Administration, et al. v. Xerox Corporation; In Re Xerox Corp. ERISA Litigation; National Union Fire Insurance Company v. Xerox Corporation, et al, Lerner v. Allaire, et al. the U.S. Attorney's Office Investigation described in Note 15-Litigation, Regulatory Matters and Other Contingencies in the 2003 Annual Report to Shareholders accompanying this Proxy Statement, and a derivative action which was dismissed during 2003, the Board of Directors has authorized the Company to advance counsel fees and other reasonable fees and expenses, actually and necessarily incurred by the present and former directors and officers who are involved, and the Company has advanced, since the previous report to shareholders as to these fees and expenses, an aggregate of \$3,784,869. Each of the individuals is required, in accordance with the requirements of the Business Corporation Law of the State of New York (BCL), to execute an undertaking to repay such expenses if they are finally found not to be entitled to indemnification under the Company's By-Laws and the BCL.

Five-Year Performance Comparison

The graph below provides a comparison of Xerox cumulative total shareholder return with the Standard & Poor's 500 Composite Stock Index and the Business Week Computers and Peripherals Industry Group, excluding Xerox (Peer Group).

TOTAL SHAREHOLDER RETURNS

Company Name/Index	Years Ending					
	Base Period Dec 98	Dec 99	Dec 00	Dec 01	Dec 02	Dec 03
XEROX CORP	\$ 100	\$ 39.26	\$ 8.28	\$ 18.82	\$ 14.54	\$ 24.92
S&P 500 INDEX	100	121.04	110.02	96.95	75.52	97.18
PEER GROUP	100	167.06	120.81	94.29	64.10	85.44

The Peer Group consists of the following companies as of December 31, 2003: Apple Computer, Dell Computer, Diebold, EMC, Gateway, Hewlett-Packard, IMATION, International Business Machines, Lexmark International, Maxtor, NCR, Network Appliance, Palm, Quantum, Sandisk, Seagate Technology, Silicon Graphics, Storage Technology, Sun Microsystems and Western Digital.

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This graph assumes the investment of \$100 on December 31, 1998 in Xerox Common Stock, the S&P 500 Index and the Peer Group Common Stock, and reinvestment of quarterly dividends at the monthly closing stock prices. The returns of each company have been weighted annually for their respective stock market capitalizations in computing the S&P 500 and Peer Group indices.

Directors and Officers Liability Insurance and Indemnity

On August 18, 2003, the Company renewed its policies for directors and officers liability insurance covering all directors and officers of the Company and its subsidiaries. The policies are issued by Executive Risk Specialty Insurance Company,

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Gulf Insurance Company, XL Specialty Insurance Company, Twin City Fire Insurance Company, Houston Casualty Company, Arch Specialty Insurance Company and Allied World Assurance Company Ltd. The policies have a one-year term from August 18, 2003 to August 18, 2004 and a total annual premium of \$6,891,990.

Section 16(a) Beneficial Ownership Reporting Compliance

There was a failure to file Form 4, Statement of Changes in Beneficial Ownership of Securities, on a timely basis with the SEC as required under Section 16(a) of the Securities Exchange Act of 1934 on behalf of Antonia Ax:son Johnson, Vernon E. Jordan, Jr., Yotaro Kobayashi, Hilmar Kopper, Ralph S. Larsen, N. J. Nicholas, Jr. and John E. Pepper for the annual award of stock options granted May 15, 2003 due to a problem in the electronic systems used to report transactions to the SEC. The reports were filed as quickly as possible on May 27, 2003 following the resolution of the system problem.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE **FOR** THE ELECTION OF THE ELEVEN (11) DIRECTORS NOMINATED BY THE BOARD OF DIRECTORS.

Proposal 2 Ratification of Selection of Independent Auditors

The Audit Committee has selected PricewaterhouseCoopers LLP (PwC), independent certified public accountants, to act as independent auditors of the Company for 2004. Representatives of the firm are expected to be at the meeting to respond to appropriate questions and to make a statement, if they wish.

Principal Auditor Fees and Services

Aggregate fees for professional services rendered for the Company by PwC as of or for the years ended December 31, 2003 and 2002, were (\$ amounts in millions):

	2003	2002
Audit Fees	\$23.0	\$19.1
Audit Related Fees	5.9	2.6
Tax Fees	3.7	2.2
All Other Fees	0.5	10.8
Total Fees	\$33.1	\$34.7

The *Audit* fees for the years ended December 31, 2003 and 2002, were for professional services rendered for the audits of the consolidated financial statements of the Company, statutory and subsidiary audits, assistance with review of documents filed with the SEC, consents, comfort letters, international filings and other assistance required to be performed by our independent accountants.

The *Audit Related* fees for the years ended December 31, 2003 and 2002, were for assurance and related services associated with special international subsidiary reviews, employee benefit plan audits, due diligence related to a disposition, internal control reviews, other attest services and other consultations. The 2003 fees included \$4.7 million related to preliminary attestation services which are expected to benefit the 2004 attestation of the Company's internal controls over financial reporting, as mandated by the Sarbanes-Oxley Act of 2002.

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Tax fees for the years ended December 31, 2003 and 2002, were for services related to tax compliance, tax planning and tax advice.

All Other fees for the year ended December 31, 2003 related to services rendered that were not included in the categories above. The fees for the year ended December 31, 2002, were primarily related to services rendered arising from the engagement of PwC by Akin, Gump, Strauss, Hauer & Feld and Paul, Weiss, Rifkind, Wharton & Garrison and Skaaden, Arps, Slate, Meagher & Flom, respectively, in connection with the independent investigations on behalf of the Audit Committee with respect to accounting matters and the SEC settlement.

Audit Committee Report

The responsibilities of the Audit Committee are discussed under Committee Functions, Membership and Meetings on page 6 and the charter of the Committee is attached as Exhibit II to this Proxy Statement and is available on the Company's website.

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Management is responsible for the Company's internal controls and the financial reporting process. The independent accountants are responsible for performing an independent audit of the Company's consolidated financial statements in accordance with generally accepted auditing standards in the United States and to issue a report thereon. The Committee's responsibility is to monitor and oversee these processes.

Consistent with the foregoing the Audit Committee has:

Reviewed and discussed the audited consolidated financial statements of the Company for the year ended December 31, 2003 with the management of the Company and PwC including the Company's key accounting policies and use of estimates;

Discussed with PwC the matters required to be discussed by SAS 61 (Codification of Statements on Auditing Standards, AU §380); and

Received the written disclosures and the letter from PwC required by Independence Standards Board Standard No. 1 (Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees), and has discussed with PwC that firm's independence.

Based upon the foregoing review and discussions, the Audit Committee recommended to the Board of Directors that the audited consolidated financial statements be included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003 for filing by the Company with the SEC.

John E. Pepper, Chairman
Richard J. Harrington
William Curt Hunter
Antonia Ax:son Johnson
Hilmar Kopper
N. J. Nicholas, Jr.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE **FOR** THE RATIFICATION OF THE SELECTION OF PRICEWATERHOUSECOOPERS LLC AS THE COMPANY'S INDEPENDENT AUDITORS FOR THE YEAR 2004.

Proposal 3 Adoption of 2004 Performance Incentive Plan

Background

The Board of Directors believes that the future success of Xerox will depend, in large measure, on its ability to attract, retain and motivate executives with outstanding training, experience and ability. The Company must compete throughout the world with other corporations and institutions recruiting and retaining superior management and executive talent.

The Board of Directors and its Compensation Committee have determined that the adoption of a new incentive plan is necessary to give the Company the flexibility and advantages needed to adapt its compensation practices to today's changing marketplace. The new incentive plan is designed to:

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Consolidate all current employee equity programs under one new shareholder-approved plan;

Provide the Company with the ability to issue annual and long-term performance-based awards in order to attract, retain and motivate key employees;

Assure that the Company will be entitled to claim a tax deduction on awards;

Promote strong alignment between shareholder interests and management objectives;

Continue to foster stock ownership;

Apart from the 2004 Performance Incentive Plan provisions, the Compensation Committee has also implemented stock ownership guidelines and mandatory holding requirements for equity acquired under the Executive Long-Term Incentive Program as described in the Report of the Compensation Committee of the Board of Directors (page 17).

Adhere to strict principles of corporate governance.

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Accordingly, the Board of Directors has approved the 2004 Performance Incentive Plan (the "2004 Plan" or the "Plan") and recommends its adoption by shareholders. The 2004 Plan provides for both long-term and short-term (annual) incentives. The 2004 Plan replaces (i) the Xerox Corporation 1991 Long-Term Incentive Plan, (ii) the Xerox Corporation 1998 Employee Stock Option Plan; (iii) the Xerox Executive Performance Incentive Plan, (iv) the Xerox Mexicana, S.A. de C.V. Executive Rights Plan; and (v) the Xerox Canada Inc. Executive Rights Plan, any or all of which may be referred to as a "Predecessor Plan." Upon adoption of the 2004 Plan by shareholders, the Plan will become effective on May 20, 2004 (the "Effective Date") and no further grants will be made under any Predecessor Plan. A summary description of the 2004 Plan follows.

After reviewing the Company's corporate governance policies and practices, the Board also believes it is appropriate to adopt a plan that reflects a number of key governance provisions and plan features that align with shareholder interests. As such, the plan includes a number of "best practice" provisions, including:

The replacement of the annual "evergreen" allocation provision with a fixed allocation of shares over the term of the Plan;

The elimination of the Company's ability to grant shares in the future under any plan which has not been approved by Xerox shareholders;

The continued prohibition of repricing of options without shareholder approval;

A discounted "share reduction" formula in the pool of available shares upon the issuance of any shares in connection with options or stock appreciation rights ("SARs") whereby the issuance of one share reduces the pool of available shares by 0.6 shares;

A minimum vesting period of three years for restricted stock unless the award is performance-based, in which case the vesting period shall be no less than one year;

The exclusion of "reload" options;

The requirement that plan amendments of a material nature will require shareholder approval.

This description of the plan is qualified in its entirety by reference to the text of the 2004 Plan that is attached to this proxy statement as Exhibit V.

Shares Under the Plan

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Under the 2004 Plan, a total number of 10.0 million shares of Common Stock¹, par value \$1.00 per share, of the Company (Common Stock) will become available for issuance over the life of the Plan provided that any shares issued in connection with options and stock appreciation rights (SARs) will be counted against this limit as 0.6 shares for each one (1) share issued. In addition, any shares available for grant under any Predecessor Plan on the Effective Date not subject to outstanding awards shall become available for issuance under the Plan. (As of May 20, 2004, approximately 15.7 million shares² are expected to be available for issuance under Predecessor Plans.) Thus, the total number available for grant under the 2004 Plan is expected to be 25.7 million shares³. Moreover, any shares underlying awards outstanding after the Effective Date of the 2004 Plan under any Predecessor Plan that are cancelled, are forfeited, or lapse shall become available for issuance under the Plan.

For example, assume the Company issues 5 million restricted shares and 10 million options in 2005. In determining remaining shares available for issuance under the Plan, the initial available pool of 25.7 million shares will be reduced by

¹10.0 million reflects the number of shares if all grants were made in whole value shares (e.g., restricted stock or performance shares). If all grants were made in the form of options or SARs, the number available is 16.7 million.

²15.7 million reflects the number of shares if all grants were made in whole value shares (e.g., restricted stock or performance shares). If all grants were made in the form of options or SARs, the number available is 26.1 million.

³25.7 million reflects the number of shares if all grants were made in whole value shares (e.g., restricted stock or performance shares). If all grants were made in the form of options or SARs, the total number available is 42.8 million.

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0.6 shares for every grant of one option or SAR granted ($10,000,000 \times 0.6 = 6,000,000$). The remaining shares available for issuance under the plan would be 14.7 million ($25,700,000 - 5,000,000 - 6,000,000 = 14,700,000$).

In determining the number of shares available, the following will not be counted against shares available for issuance under the Plan: (i) settlement of stock appreciation rights (SAR) in cash or any form other than shares, and (ii) payment in shares of dividends and dividend equivalents in conjunction with outstanding awards. Any shares that are used by the Company, and any awards that are granted by, or become obligations of, the Company, through the assumption by the Company or any affiliate of, or in substitution for, outstanding awards previously granted by an acquired company will also not be counted against the shares available for issuance under the Plan.

In determining shares available for issuance under the Plan, any awards granted under the Plan that are cancelled, are forfeited, or lapse will become eligible again for issuance under the Plan. In addition, shares withheld or tendered to pay taxes under the Plan provisions, and shares tendered to exercise stock options, will be treated as shares again eligible for issuance under the Plan.

In no event, however, except as subject to adjustment in the case of a corporate change, will more than (a) 10.0 million shares of Common Stock be available for issuance pursuant to the exercise of incentive stock options (ISOs) awarded under the Plan; and (b) 15.0 million shares of Common Stock will be made the subject of awards under any combination of awards (other than cash awards) to any single individual over the life of the plan, of which no more than 10.0 million may be shares of restricted stock. SARs whether settled in cash or shares of Common Stock will be counted against the individual reserve limitation.

Any shares issued under the Plan may consist, in whole or in part, of authorized and unissued shares or of treasury shares, and no fractional shares will be issued under the Plan. Cash may be paid in lieu of any fractional shares in settlements of awards under the Plan.

In the event of changes in the outstanding Common Stock of the Company or other changes affecting shares, the 2004 Plan provides for appropriate adjustments in the number of shares available for issuance and covered by outstanding awards and/or in the price per share for outstanding awards.

Administration of the Plan

The 2004 Plan will be administered by the independent Compensation Committee (Committee) of the Board or such other independent committee appointed by the Board of Directors. The Committee is comprised entirely of non-employee members of the Board of Directors, who shall be qualified to administer this Plan as contemplated by (a) Rule 16b-3 under the Securities Exchange Act of 1934 (the 1934 Act) or any successor rule, (b) Section 162(m) of the Internal Revenue Code of 1986, as amended, and the regulations thereunder (Section 162(m)), and (c) any rules and regulations of a stock exchange on which Common Stock of the Company is listed. The Committee has full and exclusive power, within the limitations set forth in the 2004 Plan, to make all decisions and determinations regarding the selection of participants and the granting

of awards, establishing the terms and conditions relating to each award, adopting rules, regulations and guidelines for carrying out the Plan's purposes, and interpreting and otherwise construing the Plan. Except for the power to amend and except as may otherwise be required under applicable NYSE Rules, the Committee may delegate to one or more officers of the Company all of its powers under the 2004 Plan other than determinations regarding awards made to employees who are subject to Section 16 of the 1934 Act, or who are, or may become, subject to the Section 162(m) compensation deductibility limit, subject to such conditions and restrictions as the Committee may establish from time to time.

The Committee may amend the 2004 Plan as it deems necessary, provided that no amendment may be made without the approval of shareholders if such amendment would increase the number of shares available for issuance under the Plan or otherwise cause the Plan to not comply with Rule 16b-3 of the 1934 Act, Section 162(m), or the New York Business Corporation Law. No such amendments may adversely affect any outstanding awards under the 2004 Plan without the consent of the holders thereof. Notwithstanding the foregoing, an amendment that constitutes a material revision, as defined by the NYSE Rules must be submitted to the Company's shareholders for approval. In addition, any revision that deletes or limits the scope of the Plan provision prohibiting repricing of options without shareholder approval will be considered a material revision and would require shareholder approval.

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The Board may terminate the Plan at any time. Upon termination of the Plan, no future awards may be granted, but previously made awards will remain outstanding in accordance with their applicable terms and conditions, and the terms of the Plan. Absent any prior termination no awards or grants can be made after January 1, 2008.

Eligibility

Any employee of the Company or of any entity which is controlled by the Company or in which the Company has a significant equity interest will be eligible to receive an award under the 2004 Plan. Awards may be granted to employees who are foreign nationals or employed outside the United States on such terms as may be necessary or desirable, in the judgment of the Committee, to assure the viability of such awards consistent with the Plan's purpose.

Types of Awards

Consistent with the 1991 Plan, the 2004 Plan provides flexibility in structuring long-term incentive awards for various groups and levels of executives and other participants. The flexibility will continue to permit the Company to grant one form of award or a combination of awards to one level of executives while using another award type or mix for others. With the exception of cash awards, all awards under the 2004 Plan will be denominated in shares, or consist of actual shares of Common Stock of the Company. Thus, the most significant components of the 2004 Plan will reward participants directly in concert with the returns realized by shareholders and increased shareholder value.

Stock Options Stock options will constitute rights entitling their holders to purchase shares of the Company's Common Stock during a specified period at a purchase price that is not less than 100% of Fair Market Value on the effective date of grant. Fair Market Value for purpose of the 2004 Plan means the average of the high and low traded prices of Common Stock on such date of grant or such average for the first preceding date on which there are trades if no trades occur on such effective grant date. Any stock option granted in the form of an incentive stock option (ISO) will be intended to comply with the requirements of Section 422 of the Internal Revenue Code of 1986, as amended. Shares purchased upon exercise of stock options must be paid for in full at the time of exercise in cash or such other method as the Committee may permit from time to time. Such payment may include tendering shares of common stock (either constructively or by attestation) or surrender of a stock award (in either case valued at the market value at the time of exercise) or surrender of a cash award, or a combination of methods. A repricing of a stock option will be allowed by the Committee only with the approval of the Company's shareholders to the extent required under the NYSE Rules. For this purpose, a repricing will be defined as described in the NYSE Rules. In addition, under no circumstances may stock option awards be made which provide for the automatic award of additional stock options upon the exercise of such awards, including, without limitation, reload options.

Stock Appreciation Rights Stock appreciation rights (SARs) entitle their recipients to receive payments in cash, shares or a combination as determined by the Committee. Any such payments will represent the appreciation in the market value of a specified number of shares from the date of grant until the date of exercise. Such appreciation will be measured by the excess of the market value at the time of exercise over the Fair Market Value of the Company's common stock on the effective date of the grant of SARs.

Stock Awards Stock awards may constitute actual shares of common stock or may be denominated in stock units. Stock awards may be subject to such restrictions and contingencies regarding vesting and eventual payment as the Committee shall from time to time determine.

Cash Awards Cash Awards may be any of the following:

(i) an annual incentive award in connection with which the Committee will establish specific performance periods (not to exceed twelve months) to provide cash awards for the purpose of motivating participants to achieve goals for the performance period. An annual incentive award shall specify the minimum, target and maximum amounts of awards for a performance period for a participant or any groups of participants, and, to the extent applicable to Covered Employees (as defined in the Plan), comply with the Plan requirements relating to performance-based awards under Section 162(m) of the Internal Revenue Code; or

(ii) a long-term award denominated in cash with the eventual payment amount subject to future service and such other restrictions and conditions as may be established by the Committee, and as set forth in the award agreement, including, but

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not limited to continuous service with the Company, achievement of specific business objectives and other measurement of individual, business unit or Company performance.

(iii) Cash Awards under this section to any single Covered Employee, including dividend equivalents in cash or shares of Common Stock payable based upon attainment of specific performance goals, may not exceed in the aggregate \$10,000,000 in the case of the Chief Executive Officer and \$5,000,000 in the case of any other participant, such limits being applicable to each twelve-month performance period established by the Committee under the Plan.

The Committee has discretion with respect to any award granted under this Plan to establish upon its grant conditions under which (i) the award may be later forfeited, cancelled, rescinded, suspended, withheld or otherwise limited or restricted; or (ii) gains realized by the grantee in connection with an award or an award's exercise may be recovered; provided that such conditions and their consequences are: (a) clearly set forth in the grant agreement or other grant document; and (b) fully comply with applicable laws. These conditions may include, without limitation, actions by the participant which constitute a conflict of interest with the Company, are prejudicial to the Company's interests, or are in violation of any non-compete agreement or obligation, any confidentiality agreement or obligation, the Company's applicable policies, its Code of Business Conduct and Ethics, or the participant's terms and conditions of employment.

Awards (other than annual incentive cash awards) will be evidenced by agreements approved by the Committee which set forth the terms and conditions of each award. Awards may be granted singly, in tandem with or in replacement or as alternatives for other awards, including awards made under other plans.

The Committee may provide that awards (other than cash awards) under the 2004 Plan earn dividend equivalents, to be paid currently or at a later date or dates, subject to such conditions as the Committee may also establish. Award payments may also be deferred as determined by the Committee. Such deferral settlements may include the crediting of (a) dividend equivalents if denominated in stock awards or (b) interest if denominated in cash.

Generally, all awards under the 2004 Plan are nontransferable except by will or in accordance with laws of descent and distribution or pursuant to a domestic relations order. During the life of the participant, awards generally can be exercised only by him or her. However, the Committee may provide that any award of non-qualified stock options may be transferable by the recipient to family members or family trusts established by the recipient. The Committee may permit a participant to designate a beneficiary to exercise or receive any rights that may exist under the 2004 Plan upon the participant's death. Awards granted, and shares issued in conjunction with the settlement of any award under the 2004 Plan may be subject to forfeiture back to the Company and/or restrictions on transferability for such periods as the Committee may determine.

Additional Information Applicable to Certain Performance-Based Awards

Performance-based awards made to certain senior executives will be made by the Committee within the time period required under Section 162(m) for the establishment of performance goals and will specify, among other things, the performance period(s) for such award (which will be not less than one year), the performance criteria and the performance targets. The performance criteria will be any one or more of the following as determined by the Committee and may differ as to type of award and from one performance period to another: earnings per share, cash flow, document processing profit, cost reduction, days sales outstanding, cash conversion cycle, cash management (including, without limitation, inventory and/or capital expenditures), total shareholder return, return on shareholders' equity, economic value added measures, return on assets, pre- or post-currency revenue, pre- or post-currency performance profit, profit before tax, profit after tax, revenues, stock price and return on sales. Payment or vesting of awards to such employees will be contingent upon satisfaction of the performance criteria and targets as certified by the Committee by resolution of the Committee. To the extent provided at the time of an award, the Committee may in its sole discretion reduce any award to any employee receiving such an award to any amount, including zero. Any performance-based awards made may include annual incentive awards and long-term awards.

Change in Control

Upon the occurrence of a change in control of the Company, as defined in the 2004 Plan, with certain exceptions, all awards outstanding under the 2004 Plan become immediately vested and are settled or paid out. The amount of cash to be paid shall be determined by multiplying the number of such awards, as the case may be, by: (i) in the case of stock awards,

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the CIC Price (as defined in the plan), (ii) in the case of SARs, the difference between the exercise price of the related option per share and the CIC Price; (iii) in the case of cash awards where the award period, if any, has not been completed upon the occurrence of a change in control, the pro rata value of such awards or such higher amount as determined by the Committee, without regard to the performance criteria, if any, applicable to such award; and (iv) in the case of cash awards where the award period, if any, has been completed on or prior to the occurrence of a change in control: (aa) where the cash award is payable in cash, the value of such award as determined in accordance with the award agreement, and (bb) where the cash award is payable in shares of Common Stock, the CIC Price.

CIC Price shall mean the higher of (a) the highest price paid for a share of the Company's Common Stock in the transaction or series of transactions pursuant to which a change in control of the Company shall have occurred, or (b) the highest price paid for a share of the Company's Common Stock during the 60-day period immediately preceding the date upon which the event constituting a change in control shall have occurred as reported in The Wall Street Journal in the New York Stock Exchange Composite Transactions or similar successor consolidated transactions reports.

Federal Tax Aspects of the 2004 Plan

The Company believes that under the present law, the following are the federal tax consequences generally arising with respect to awards granted under the 2004 Plan. The grant of an option or SAR will create no tax consequences for an optionee or the Company. The optionee will have no taxable income upon exercising an ISO (except that the alternative minimum tax may apply), and the Company will receive no deduction when an ISO is exercised. Upon exercising an option other than an ISO, the optionee must recognize ordinary income equal to the difference between the exercise price and the fair market value of the stock on the date of exercise; the Company will be entitled to a deduction for the same amount. The treatment of an optionee on a disposition of shares acquired through the exercise of an option depends on how long the shares have been held and on whether such shares were acquired by exercising an ISO or by exercising an option other than an ISO. Generally, there will be no tax consequence to the Company in connection with a disposition of shares acquired under an option except that the Company may be entitled to a deduction in the case of a disposition of shares acquired under an ISO before the applicable ISO holding periods have been satisfied. With respect to other awards granted under the 2004 Plan that are settled either in cash or in stock or other property that is either transferable or not subject to substantial risk of forfeiture, the participant must recognize ordinary income equal to the cash or the fair market value of shares or other property received; the Company will be entitled to a deduction for the same amount, assuming that, where applicable, the requirements of Section 162(m) are met. With respect to awards that are settled in stock or other property that is restricted as to transferability and subject to substantial risk of forfeiture, the participant must recognize ordinary income equal to the fair market value of the shares or other property received at the time the shares or other property become transferable or not subject to substantial risk of forfeiture, whichever occurs earlier; the Company will be entitled to a deduction for the same amount, assuming that, where applicable, the requirements of Section 162(m) are met. Different tax rules may apply with respect to participants who are subject to Section 16 of the Securities Exchange Act of 1934, as amended (1934 Act).

Additional Information

Reference is made to the following sections of this proxy statement regarding executive compensation: Summary Compensation Table, Option Grants and Option Exercises/Year-End Values beginning on page 20 for a description of options and SARs granted and exercised under the 1991 Plan and the 1998 Plan. The closing price of the Company's common stock as reported on New York Exchange Composite Transactions on February 27, 2004, was \$14.14.

To be adopted, the proposed plan must be approved by the holders of a majority of the votes cast at the meeting.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE **FOR** THE PROPOSED 2004 PERFORMANCE INCENTIVE PLAN.

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Proposal 4 Adoption of 2004 Equity Compensation Plan For Non-Employee Directors

Background

On December 10, 2003 the Board of Directors (the Board) approved and recommended for submission to the shareholders for their adoption the 2004 Equity Compensation Plan for Non-Employee Directors (the 2004 Non-Employee Director Plan).

The Board believes that the adoption of the 2004 Non-Employee Director Plan is desirable because it will advance the Company's interests and those of its shareholders by attracting and retaining qualified individuals to serve as directors of the Company and to align the long-term interests of such individuals with those of the Company's shareholders through grants of equity which directors must retain until one year after Board service termination.

If the 2004 Non-Employee Director Plan is approved by shareholders, the 1996 Non-Employee Director Stock Option Plan as amended in 1999 will be terminated and the Company will no longer provide option grants to Non-Employee Directors. After approval, the 2004 Non-Employee Director Plan will remain in effect until the earlier of the date when no additional shares are available for issuance under the Plan or the date when the Board terminates the Plan. If the 2004 Non-Employee Director Plan is not approved, the 1996 Non-Employee Director Stock Option Plan will remain in place.

The following summary of the material features of the 2004 Non-Employee Director Plan is qualified in its entirety by the complete text of the Plan, a copy of which is attached to this Proxy Statement as Exhibit VI.

Shares Subject to the 2004 Non-Employee Director Plan

Under the 2004 Non-Employee Director Plan, up to 1,000,000 shares of Common Stock, par value \$1.00, of the Company (Common Stock) will become available for issuance under the 2004 Non-Employee Director Plan. While the Board does not anticipate issuing stock options, if in the future it did, any shares issued in connection with options or stock appreciation rights (SARs) would be counted against this limit as 0.6 shares for each one (1) share issued.

In determining the number of shares available, the following will not be counted against shares available for issuance under the 2004 Non-Employee Director Plan: settlement of SARs in cash or any form other than shares; and payment in shares of dividends and dividend equivalents in conjunction with outstanding awards.

In addition, in determining shares available for issuance under the 2004 Non-Employee Director Plan, any awards granted under the 2004 Non-Employee Director Plan that are cancelled, forfeited or lapse will become eligible again for issuance under the 2004 Non-Employee Director Plan.

The Board may make adjustments as it deems appropriate in the shares available under the 2004 Non-Employee Director Plan and in outstanding grants in the event of any stock dividend, stock split, combination or exchange of shares, merger, consolidation, spin-off or other distribution (other than normal cash dividends) of Company assets to shareholders, or any other change affecting shares, provided that these actions are consistently and equitably applicable to all affected Non-Employee Directors.

Administration of the 2004 Non-Employee Director Plan

The 2004 Non-Employee Director Plan will be administered by the Board upon advice of the Board's Corporate Governance Committee. The Board has full and exclusive power, within the limitations of the 2004 Non-Employee Director Plan, to do all things necessary or desirable in connection with the administration of the 2004 Non-Employee Director Plan. This includes, but is not limited to, prescribing, amending and rescinding rules relating to the 2004 Non-Employee Director Plan, constructing the form of documentation used to evidence any grant awarded under the 2004 Non-Employee Director Plan, establishing and verifying the extent of satisfaction of any conditions to exercisability and/or receipt or vesting of awards, and interpreting and construing the 2004 Non-Employee Director Plan, any rules and regulations under the 2004 Non-Employee Director Plan and the terms and conditions of awards granted under the 2004 Non-Employee Director Plan. Furthermore, the Board has the full power and authority to determine under what circumstances an award is canceled or suspended, such as for activity by Non-Employee Directors which constitutes a conflict of interest with the Company or is in violation of Company policies.

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All determinations, interpretations, and other decisions under or with respect to the 2004 Non-Employee Director Plan are final, conclusive and binding upon the Company, all participants and any holder or beneficiary of any award under the 2004 Non-Employee Director Plan. The Board may consider such factors as it deems relevant, in its sole and absolute discretion, in making its decisions, determinations and interpretations including, without limitation, the recommendations or advice of any officer or other employee of the Company and any attorneys, consultants and accountants as it may select.

The Board may periodically amend the 2004 Non-Employee Director Plan as it deems appropriate, without further action by the Company's shareholders except to the extent required by applicable law or NYSE listing requirements. Notwithstanding the foregoing, the 2004 Non-Employee Director Plan may not be amended to materially increase the number of shares of Common Stock authorized for issuance under the 2004 Non-Employee Director Plan, unless the amendment is approved by the Company's shareholders or is a result of a reorganization or other adjustment in the stock permitted under the 2004 Non-Employee Director Plan.

Additionally, the Board may terminate the 2004 Non-Employee Director Plan at any time. Amendments or termination of the 2004 Non-Employee Director Plan will not affect the rights and obligations arising under outstanding stock options or stock grants previously awarded and then in effect without the participant's consent.

All questions pertaining to the construction, regulation, validity and effect of the 2004 Non-Employee Director Plan will be determined in accordance with the laws of the state of New York and applicable Federal law.

Eligibility

Any Non-Employee Director, defined as a member of the Board who is not at the time also an employee of the Company or any of its direct or indirect majority-owned subsidiaries, is eligible to receive an award under the 2004 Non-Employee Director Plan.

Types of Awards

The 2004 Non-Employee Director Plan provides increased flexibility in structuring long-term incentive awards for Non-Employee Directors. Part of this flexibility includes the ability to grant awards singly, in combination or in tandem so that the settlement or payment of one award automatically reduces or cancels the other. All awards will be evidenced by agreements provided by the Board which set forth the terms and conditions of each award.

While the Board currently anticipates granting awards only of deferred stock units, the following is a list of awards that may be granted, either individually or collectively, to participants pursuant to the provisions of the 2004 Non-Employee Director Plan.

Deferred Stock Units (DSUs) DSUs are a bookkeeping entry that represents the right to receive one share of Common Stock at a future date, such as retirement from the Board. Outright grants may be made as part of the Non-Employee Directors' annual compensation for services rendered or as a result of a voluntary election by Non-Employee Directors to defer cash compensation otherwise payable to Non-Employee Directors. DSUs can be structured to include the right to receive dividend equivalents which are credited in the form of additional DSUs payable in Common Stock following termination of Board service.

The Board may require or permit participants to elect to defer the issuance of shares or the settlement of awards in cash under rules and procedures established under the 2004 Non-Employee Director Plan. It may also provide that deferred settlements include the payment or crediting of interest on the deferral amounts or the payment or crediting of dividend equivalents on deferred settlements denominated in shares.

Stock Options Stock options constitute a right to purchase a specified number of shares of Common Stock during a specified period, no longer than seven years, at a purchase price not less than 100% of Fair Market Value on the effective date of grant. For purpose of the 2004 Non-Employee Director Plan, Fair Market Value is defined as of any date, as the average of the high and low trading prices of a share of Common Stock as reported in The Wall Street Journal listing of composite transactions for New York Stock Exchange issues or similar successor consolidated transaction reports for the relevant date, unless the Board specifies otherwise. Note that Fair Market Value can not be less than the par value of the Common Stock.

Participants may exercise stock option grants in whole or in installments in accordance with any vesting schedule established by the Board or upon the death of the Non-Employee Director. At the time of exercise, participants may pay the full purchase price of Common Stock in cash or shares, including tendering (either actually or by attestation) Common Stock or surrendering a stock award valued at Fair Market Value on the

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date of surrender. Lastly, under no circumstances may stock option awards be made which provide by their terms for the automatic award of additional stock options upon the exercise of such awards, including, without limitation, reload options. Notwithstanding any provision of the 2004 Non-Employee Director Plan, a repricing of a Stock Option shall not be allowed by the Board.

Stock Appreciation Rights (SARs) SARs constitute a right to receive a payment, in cash and/or Common Stock, as determined by the Board, equal to the excess of the Fair Market Value of a specified number of shares of Common Stock on the date the SAR is exercised over the Fair Market Value on the effective date of grant of the SAR as set forth in the applicable award agreement. The maximum term for SARs is seven years.

Stock Awards Stock awards are awards made in Common Stock of the Company. All or part of any stock award may be subject to conditions established by the Board and set forth in the award agreement which may include, but is not limited to, continuous service with the Company.

Generally, all awards under the 2004 Non-Employee Director Plan are nontransferable except by will or the laws of descent and distribution or pursuant to a domestic relations order. In limited circumstances, the Board may provide that an option award may be transferable by the participant to family members or family trusts established by the participant. In addition, awards under the 2004 Non-Employee Director Plan are exercisable only by the Non-Employee Director during his or her lifetime except that the Board may permit Non-Employee Directors to designate a beneficiary to exercise the rights of the director and receive any distributions upon his or her death.

Lastly, the 2004 Non-Employee Director Plan is unfunded and does not create a trust or a separate fund or funds. The 2004 Non-Employee Director Plan does not establish any fiduciary relationship between the Company and any participant or other person. To the extent any person holds any rights by virtue of a grant awarded under the 2004 Non-Employee Director Plan, these rights (unless otherwise determined by the Board) are no greater than the right of an unsecured general creditor of the Company.

Change In Control

Upon the occurrence of a change in control of the Company, as defined in the 2004 Non-Employee Director Plan, with certain exceptions, all awards outstanding under the 2004 Non-Employee Director Plan become immediately vested and are settled or paid out. The amount of cash to be paid shall be determined (i) in the case of stock options, by multiplying the number of stock options by the difference between the exercise price and the CIC Price (as defined in the 2004 Non-Employee Director Plan), (ii) in the case of DSUs, by multiplying the number of DSUs by the CIC Price and (iii) in the case of SARs, by multiplying the number of SARs by the difference between the exercise price of the related option per share and the CIC Price.

CIC Price shall mean the higher of (a) the highest price paid for a share of the company's Common Stock in the transaction or series of transactions pursuant to which a change in control of the Company shall have occurred, or (b) the highest price paid for a share of the Company's Common Stock during the 60-day period immediately preceding the date upon which the event constituting a change in control shall have occurred as reported in The Wall Street Journal in the New York Stock Exchange Composite Transactions or similar successor consolidated transactions reports.

Federal Tax Aspects of the 2004 Non-Employee Director Plan

The Company believes that under the present law, the following are the federal tax consequences generally arising with respect to awards granted under the 2004 Non-Employee Director Plan. The grant of an option or SAR will create no tax consequences for an optionee or the Company. Upon exercising an option, the optionee must recognize ordinary income equal to the difference between the exercise price and the fair market value of the stock on the date of exercise; the Company will be entitled to a deduction for the same amount. The treatment of an optionee on a disposition of shares acquired through the exercise of an option depends on how long the shares have been held. If the shares are held for more than one year, long-term capital gain or loss treatment will apply. There will be no tax consequence to the Company in connection with a disposition of shares acquired under an option.

With respect to other awards (including dividends and dividend equivalents) granted under the 2004 Non-Employee Director Plan that are settled either in cash or in stock or other property that is either transferable or not subject to substantial risk of forfeiture, the participant must recognize ordinary income equal to the cash or the fair market value of shares or other property received; the Company will be entitled to a deduction for the same amount. With respect to awards (including dividends and dividend equivalents) that are settled in stock or other property that is restricted as to transferability and subject to substantial risk of forfeiture, the participant must recognize ordinary income equal to the fair market value of the shares or other property received at the time the shares or other property become transferable or not subject to substantial risk of forfeiture, whichever occurs earlier; the Company will be entitled to a deduction for the same amount. Different tax rules may apply with

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respect to participants who are subject to section 16 of the 1934 Act.

Income that is currently recognized will be reported to directors on IRS Form 1099 for such year.

Additional Information

The closing price of the Company's Common Stock as reported on New York Exchange Composite Transactions on February 27, 2004, was \$14.14.

To be adopted, the proposed 2004 Non-Employee Director Plan must be approved by the holders of a *majority* of the votes cast at the meeting.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE **FOR** THE PROPOSED 2004 EQUITY COMPENSATION PLAN FOR NON-EMPLOYEE DIRECTORS.

OTHER MATTERS

Other Actions at Meeting

The Board of Directors does not intend to present any other matters at this meeting. The Board has not been informed that any other person intends to present any other matter for action at this meeting. If any other matters properly come before the meeting, the persons named in the accompanying proxy intend to vote the proxies in accordance with their best judgment.

Information About this Solicitation of Proxies

In addition to the solicitation of proxies by mail, certain of our employees may solicit proxies without extra remuneration. We also will request brokerage houses, nominees, custodians and fiduciaries to forward soliciting material to the beneficial owners of stock held of record and will reimburse such person for the cost of forwarding the material. We have engaged D.F. King & Co., Inc. to handle the distribution of soliciting material to, and the collection of proxies from, such entities. We will pay D.F. King & Co., Inc. a fee of \$11,500 plus reimbursement of out-of-pocket expenses for this service. We will bear the cost of all proxy solicitation.

Confidential Voting

As a matter of policy, we keep confidential proxies, ballots and voting tabulations that identify individual shareholders. Such documents are available for examination only by the inspector of election and certain of our employees and our transfer agent who are associated with processing proxy cards and tabulating the vote. The vote of any shareholder is not disclosed except in a contested proxy solicitation or as may be necessary to meet legal requirements.

Shareholder Communication With Members of the Board

Under the Corporate Governance Guidelines the Company provides a process for investors to send communications to the Board of Directors. The Corporate Governance Guidelines provide that investors desiring to communicate with the non-management Directors regarding the Company may directly contact the Chairman of the Corporate Governance Committee, Mr. Vernon E. Jordan, Jr., Senior Managing Director, Lazard Freres & Co., LLC, 30 Rockefeller Center, New York, New York 10020.

Board Members Attendance at Annual Meeting

The Company's policy generally is for all members of the Board of Directors to attend the Annual Meeting of Shareholders. The 2003 Annual Meeting was attended by all of the Company's then eight directors.

Multiple Shareholders Having the Same Address

If you and other residents at your mailing address own shares of Common Stock through a broker, you may have received a notice from the broker notifying you that your household will be sent only one Annual Report and Proxy Statement. If you did not return the "opt-out" card

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attached to such notice you were deemed to have consented to such process. The broker or other holder of record will send at least one copy of the Annual Report and Proxy Statement to your address. You may revoke your consent at any time by calling (800) 542-1061. The revocation will be effective 48 hours after receiving your telephone notification. In any event, the Company will send a copy of the Annual Report and Proxy Statement to you if you address your written request to Xerox Corporation, Shareholder Services, P.O. Box 1600, Stamford, CT 06904 or call Shareholder Services at (203) 968-4002. If you are receiving multiple copies of annual reports and proxy statements at your address and would like to receive only one copy in your household, please contact us at the foregoing address and telephone number.

Availability of Additional Information

Copies of the 2003 annual report of the Company have been distributed to shareholders (unless you have consented to electronic delivery). Additional copies and additional information, including the annual report (Form 10-K) filed with the SEC and the consolidated statistical data contained in the EEO-1 annual report to the U.S. Equal Employment Opportunity Commission are available without charge from Investor Relations, Xerox Corporation, P.O. Box 1600, Stamford, Connecticut 06904. The annual report, proxy statement and Form 10-K are also available on the Company's website at www.xerox.com/investor.

REQUIREMENTS FOR SUBMISSION OF PROXY PROPOSALS, NOMINATION OF DIRECTORS AND OTHER BUSINESS

Shareholder Proposals for 2005 Meeting

We expect to hold our 2005 Annual Meeting during the second half of May and to issue our proxy statement for that meeting during the first half of April.

Under the SEC proxy rules if a shareholder wants us to include a proposal in our proxy statement and form of proxy for the 2005 Annual Meeting of Shareholders, the proposal must be received by us at P.O. Box 1600, Stamford, Connecticut 06904, Attention: Secretary-no later than December 4, 2004.

Under our By-Laws any shareholder wishing to make a nomination for director, or wishing to introduce any business, at the 2005 Annual Meeting of Shareholders must give the Company advance notice as described in the By-Laws. To be timely, we must receive your notice for the 2005 Annual Meeting at our offices mentioned above no earlier than November 4, 2004 or later than December 4, 2004. Nominations for director must be accompanied by written consent to being named in the proxy statement as a nominee and to serving as a director if elected.

Corporate Governance Committee Director Nomination Process

The Corporate Governance Committee considers candidates for Board membership recommended by its members and other Board members, as well as by management and shareholders (see below). The Committee has paid a fee to a third party search firm to assist in the identification of potential candidates based upon criteria provided by the Committee. There are no specific minimum qualifications that the Committee believes must be met by candidates. The Corporate Governance Guidelines require that a substantial majority of the Board should consist of independent directors. Any management representation should be limited to top Company management. Nominees are to be selected on the basis of, among other things, broad perspective, integrity, independence of judgment, experience, expertise, diversity, ability to make independent analytical inquiries, understanding of the Company's business environment and willingness to devote adequate time and effort to Board responsibilities. Members should represent a predominance of business backgrounds and bring a variety of experiences and perspectives to the Board. The Committee evaluates nominations by shareholders in the same manner as nominations received from any of the other sources described above.

Shareholders who wish to recommend individuals for consideration by the Committee may do so by submitting a written recommendation to the Secretary of the Company, P.O. Box 1600, Stamford, Connecticut 06904. Submissions must include sufficient biographical information concerning the recommended individual, including age, employment and board memberships (if any), for the Committee to consider. The submission must be accompanied by a written consent by the nominee to stand for election if nominated by the Board of Directors and to serve if elected by the shareholders. Recommendations received by December 31, 2004 will be considered for nomination at the 2005 Annual Meeting of Shareholders. Recommendations received after December 31, 2004 will be considered for nomination at the 2006 Annual Meeting of Shareholders.

By order of the Board of Directors,

Leslie F. Varon
Secretary
April 2, 2004

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Exhibit I

Xerox Corporate Governance Guidelines
(Amended 3/19/2004)

The following Corporate Governance Guidelines have been adopted by the Board of Directors of Xerox Corporation to assist the Board in the exercise of its responsibilities. These Corporate Governance Guidelines reflect the Board's commitment to monitor the effectiveness of policy and decision making both at the Board and management level, with a view to enhancing long-term shareholder value. These Corporate Governance Guidelines shall be reviewed by the Board, through the Corporate Governance Committee, on an annual basis and are subject to modification from time to time by the Board acting by a majority of the independent directors as determined under these Guidelines. Waivers of these Corporate Governance Guidelines may be made by the Board or the Corporate Governance Committee only.

THE BOARD

The Board's Goals

The Xerox Board of Directors represents the owners' interest in the operation of a successful business, including optimizing long-term financial returns. The Board is responsible for determining that the Company is managed in such a way to ensure this result, which will also assure the company's vitality for its customers, employees and the other individuals and organizations that depend on it. This is an active, not a passive, responsibility. The Board has the responsibility to ensure that in good times, as well as difficult ones, management is capably executing its responsibilities.

The Board's responsibility is to regularly monitor the effectiveness of management policies and decisions including the creation and execution of its strategies. The Board is also responsible for monitoring the establishment and enforcement of procedures designed to ensure that the Company's management and employees operate in a legal and ethically responsible manner. When it is appropriate or necessary, it is the Board's responsibility to remove the Chief Executive Officer and to select his or her successor.

To achieve the above goals, the Board will monitor the performance of the Company (in relation to its goals, strategy and competitors) and the performance of the Chief Executive Officer and offer advice and feedback.

Role of Directors

The business of the Company is managed under the direction of the Board. Normally it is management's job to formalize, propose and implement strategic choices, and the Board's role to approve strategic direction and evaluate strategic results. However, as a practical matter, the Board and management will be better able to carry out their respective responsibilities if there is an ongoing dialogue among the Chief Executive Officer, other members of top management and Board members. To facilitate such discussions, the Board conducts an annual review of the Company's long-term strategic plans and principal issues. Periodically during the year, the Board receives strategy updates from members of senior management of the Company.

Directors are expected to spend the time and effort necessary to properly discharge their responsibilities. Accordingly, a Director is expected to regularly attend meetings of the Board and committees on which he or she sits, and to review prior to meetings material distributed in advance for such meetings. A Director who is unable to attend a Board or Committee meeting (which, it is understood will occur on occasion) is expected to notify the Secretary of the Company who will advise the Chairman of the Board and/or the Chairman of the relevant Committee. All Directors are expected to attend the Company's Annual Meeting of Shareholders.

Selection of the Chairman of the Board

The Board does not require the separation of the offices of the Chairman of the Board and the Chief Executive Officer. The Board shall be free to choose its Chairman in any way that it deems best for the Company at any given point in time.

Size of the Board

In recent years the Board has had 8-12 Directors and it is the sense of the Board that this size is about right. This range permits diversity of experience without hindering effective discussion or diminishing individual accountability.

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Independence of the Board

The Board is comprised of a substantial majority of Directors who qualify as independent Directors under the listing standards of the New York Stock Exchange (NYSE) and the more stringent standards adopted by the Board. Under these more stringent standards, members of the Company's Board of Directors will be considered independent if the sales to, and buys from, the Company are less than one percent of the revenues of companies they serve as officers, partners or of counsel. If the Company borrows from the other entity the amount must represent less than one percent of our consolidated assets or those of the other entity. Moreover, if a Director of the Company serves as an officer or director of a charitable organization, such director will be considered independent, if the Company donates less than five percent of that organization's charitable receipts.

The Corporate Governance Committee as well as the Board annually review the relationships that each Director has with the Company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the Company) to insure compliance with NYSE listing standards and requirements otherwise imposed by law or regulation. Following this review, only those Directors who the Board affirmatively determines have no material relationship with the Company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the Company) will be considered independent Directors under such standards, law or regulation.

Board Membership Criteria

The ultimate responsibility for the selection of new Directors resides with the Board. The identification, screening and recommendation process has been delegated to the Corporate Governance Committee, which reviews candidates for election as Directors and annually recommends a slate of Directors for approval by the Board and election by the shareholders.

The Board requires that a substantial majority of the Board should consist of independent Directors. Any management representation should be limited to top Xerox management. Nominees for Director are selected on the basis of, among other things, broad perspective, integrity, independence of judgment, experience, expertise, diversity, ability to make independent analytical inquiries, understanding of the Company's business environment and willingness to devote adequate time and effort to Board responsibilities. Members should represent a predominance of business backgrounds and bring a variety of experiences and perspectives to the Board.

Other Company Directorships

The Company does not have a policy limiting the number of other company boards of directors upon which a Director may sit. However, the Corporate Governance Committee shall consider the number of other company boards and other boards (or comparable governing bodies) on which a prospective nominee is a member. It is the sense of the Board that prospective Directors should simultaneously serve on no more than 2-4 other company Boards, depending on their personal circumstances.

Directors are expected to advise the Chairman of the Board and the Chairman of the Corporate Governance Committee in advance of accepting any other company directorship or any assignment to the audit committee or compensation committee of the Board of Directors of any other company.

Directors Who Change Their Present Job Responsibility

Any Director whose affiliation or position of principal employment changes substantially after election to the Board will be expected to submit a resignation as a Director for consideration by the Corporate Governance Committee and the Board. The Corporate Governance Committee will review with the Board the effects of this change upon the interests of the Company and recommend to the Board whether to accept the resignation. Directors who are also Xerox employees are expected to offer their resignation from the Board at the same time they leave active employment with the Company, which shall be subject to acceptance by the Board.

Retirement Age

It is the general policy of the Board that Directors will not stand for re-election after reaching age 70. However, the Board may determine to waive this policy in individual cases.

Term Limits

The Board does not believe it should establish term limits. While term limits could help ensure that there are fresh ideas and viewpoints available to the Board, they hold the disadvantage of losing the contribution of Directors who have been able to develop, over a period of time, increasing insight into the Company and its operations and, therefore, provide an increasing contribution to the Board as a whole.

As an alternative to term limits, the Corporate Governance Committee, in conjunction with the Chairman of the Board, will formally review each Director's continuation on the Board every five years. This will also allow each Director the opportunity to conveniently confirm his or her desire to continue as a member of the Board.

Board Compensation

A Director who is also an officer of the Company shall not receive additional compensation for such service as a Director.

The Company believes that compensation for non-employee Directors should be competitive and should encourage increased ownership of the Company's stock through the payment of a portion of Director compensation in Company stock or similar compensation. The Corporate Governance Committee will periodically review the level and form of the Company's Director compensation, including how such compensation compares to Director compensation of companies of comparable size, industry and complexity. Changes to Director compensation will be proposed to the full Board for consideration.

No member of the Audit Committee may receive, directly or indirectly, any compensation from the Company other than (a) fees paid to directors for service on the Board, (b) additional fees paid to directors for service on a committee of the Board (including the Audit Committee) and/or for serving as the chairperson of such a committee and (c) a pension or other deferred compensation for prior service that is not contingent on future services on the Board.

Board Access to Management, other Employees and Advisors

Board members have complete access to the Company's senior management and other employees. Board members have the authority to obtain advice and assistance from outside legal, accounting or other advisors of their own choosing, at the expense of the Company.

Board Interaction with Investors, Analysts, Press and Customers

The Board believes that management generally should speak for the Company. Any interested parties desiring to communicate with the non-management Directors regarding the Company may directly contact the Chairman of the Corporate Governance Committee, Mr. Vernon E. Jordan, Jr., Senior Managing Director, Lazard Freres & Co., LLC, 30 Rockefeller Center, New York, New York 10020.

Board Orientation and Continuing Education

The Company has an orientation process for new Directors to familiarize them with the Company's business, strategic plans, significant financial, accounting and risk management issues, compliance programs, conflicts policies, code of business conduct and business ethics and corporate governance guidelines. This process includes review of background materials, meetings with senior management and visits to Company facilities. Each Director is expected to participate in continuing educational programs in order to maintain the necessary level of expertise to perform his or her responsibilities as a Director.

Self-Evaluation by the Board

The Corporate Governance Committee will sponsor an annual self-assessment of the Board's performance as well as the performance of each committee of the Board, the results of which will be discussed with the full Board and each committee. The assessment will include a review of any areas in which the Board or management believes the Board can make a better contribution to the Company. The Corporate Governance Committee will also utilize the results of this self-evaluation process in assessing and determining the characteristics and critical skills required of prospective candidates for election to the Board and making recommendations to the Board with respect to assignments of Board members to

various committees.

BOARD MEETINGS

Frequency of Meetings

There are 6 regularly scheduled meetings of the Board each year with at least one regularly scheduled meeting of the Board held each quarter.

Selection of Agenda Items for Board Meetings

The Chairman of the Board annually prepares a Board of Directors Master Agenda. This Master Agenda sets forth a general agenda of items to be considered by the Board at each of its regular meetings during the year. Thereafter, the Chairman of the Board may adjust the agenda to include special items not contemplated during the initial preparation of the annual Master Agenda. Board members are invited to suggest inclusion of items on the agenda and are free to raise, at any Board meeting, subjects that are not specifically on the agenda.

Executive Sessions of Outside Directors

Each regularly scheduled Board meeting includes an executive session of all Directors and the CEO and, a separate executive session of just the Directors who are independent as determined under these Guidelines. The Chairmen of the Governance Committee and the Compensation Committee will rotate responsibility to preside over non-management executive sessions and will be responsible for providing appropriate feedback to the CEO.

Attendance of Senior Management Personnel at Board Meetings

The Board expects the regular attendance at each of its meetings of non-Board members who are in the most senior management positions of the Company. In addition, the General Counsel and Corporate Secretary regularly attend Board meetings. Should the Chief Executive Officer want to add additional people as attendees on a regular basis, it is expected that this suggestion would be made to the Board for its concurrence.

Board Materials Distributed in Advance

Information and materials that are important to the Board's understanding of the agenda items and other topics to be considered at a Board meeting are distributed sufficiently in advance of the meeting to permit prior review by the Directors. The Directors are expected to review such material prior to the meeting. In the event of a pressing need for the Board to meet on short notice or on occasions where the subject matter is too sensitive to be put on paper, certain proposals will be discussed at the meeting.

COMMITTEE MATTERS

Number and Names of Board Committees

The Company has 4 standing committees: Audit, Compensation, Corporate Governance and Finance. The purpose and responsibilities for each of these committees is outlined in committee charters adopted by the Board. The Board may, from time to time, form a new committee or disband a current committee depending on circumstances. In addition, the Board may determine to form ad hoc committees from time to time, and determine the composition and areas of competence of such committees.

Independence of Board Committees

Each of the Audit, Compensation, Corporate Governance and Finance Committees are composed entirely of independent Directors satisfying applicable legal, regulatory and stock exchange requirements necessary for an assignment to any such committee.

Assignment and Rotation of Committee Members

The Corporate Governance Committee is responsible, after consultation with the Chairman of the Board, for making recommendations to the Board with respect to the assignment of Board members to various committees. After reviewing the Corporate Governance Committee's

recommendations, the Board is responsible for appointing the Chairman and members to the committees on an annual basis.

The Corporate Governance Committee annually reviews the Committee assignments and considers the rotation of the Chairman and members with a view toward balancing the benefits derived from continuity against the benefits derived from the diversity of experience and viewpoints of the various Directors.

Committee Meetings

The Chairman of each committee, in consultation with the committee members, will determine the frequency and length of the committee meetings consistent with any requirements set forth in the committee's charter. The Chairman of each committee, in consultation with the appropriate members of the committee and management, will develop the committee's agenda. The schedule for each committee will be furnished to all Directors.

LEADERSHIP DEVELOPMENT

Selection of the Chief Executive Officer

The Board is responsible for identifying potential candidates for, and selecting, the Company's Chief Executive Officer. In identifying potential candidates for and selecting the Company's Chief Executive Officer, the Board considers, among other things, a candidate's experience, understanding of the Company's business environment, leadership qualities, knowledge, skills, expertise, integrity, and reputation in the business community.

Evaluation of Chief Executive Officer

The Compensation Committee is responsible for overseeing the evaluation process for the Chief Executive Officer.

The process is intended to formally assess the Chief Executive Officer's past performance as well as to help the Board determine future developmental needs for the Chief Executive Officer. Consequently, there are two types of measures: 1) Financial Performance Measures (such as cash, profit and revenue) which track accountability for past performance, and 2) Leadership Effectiveness Measures (such as employee morale, strategic leadership, and enterprise guardianship) which single out the key objectives that will assure the future success of the company.

The following steps are utilized to carry out this review:

The Compensation Committee reviews performance measures and targets and submits these for Board approval on or before the start of the first meeting of the fiscal year.

The Chief Executive Officer provides a self-evaluation to the Board within one-month of the end of the fiscal year.

The non-management Directors will provide their individual assessments of the Chief Executive Officer's performance. These assessments should include the Director's appraisal of the Financial Performance Measures and the Leadership Performance Measures approved by the Board as well as any other aspect of the Chief Executive Officer's performance that the non-management Director deems relevant. In addition, non-management Directors should identify any future developmental needs they deem necessary for the Chief Executive Officer.

The Compensation Committee synthesizes this information and recommends annual incentive compensation of the Chief Executive Officer based on the evaluation. The Board will do this in executive session.

After agreement by the non-management Directors to the evaluation, the chairs of the Compensation Committee and the Corporate Governance Committee will meet with the Chief Executive Officer to discuss the Board's assessment of performance and developmental needs for the Chief Executive Officer. The Chief Executive Officer may then take the opportunity to discuss his or her reaction to the evaluation.

Succession Planning

The Board shall plan for the succession to the position of the Chief Executive Officer. To assist the Board, the Chief Executive Officer shall conduct an annual succession planning session with the Board at which an assessment of senior managers will be conducted including their potential to succeed the Chief Executive Officer and other senior management positions.

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Management Development

The Board shall determine that a satisfactory system is in effect for education, development, and orderly succession of senior and mid-level managers throughout the Company.

POLICIES AND GUIDELINES

Copies of the current version of these Corporate Governance Guidelines, the Company's Code of Business Conduct and Ethics for Members of the Board of Directors, the Company's Ethics Policy and Finance Code of Conduct for employees and officers and the charter of each key committee of the Board shall be posted on the Company's website.

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Exhibit II

Audit Committee Charter (Amended 2/12/2004)

Purpose

The purpose of the Audit Committee (the "Committee") of the Board of Directors (the "Board") of Xerox Corporation (the "Company") shall be to assist in Board oversight of (1) the integrity of the Company's financial statements, (2) the Company's compliance with legal and regulatory requirements, (3) the independent auditors' qualifications and independence, (4) the performance of the Company's independent auditors (the "Auditors") and internal audit function (5) the Company's code of business conduct and ethics; and to prepare the audit committee report that the rules of the Securities and Exchange Commission (the "SEC") require to be included in the Company's annual proxy statement.

Duties and Responsibilities of the Committee

The Committee's function is one of oversight. The Company's management is responsible for preparing the Company's financial statements and, along with the internal auditors, for developing and maintaining systems of internal accounting and financial controls, while the Auditors will assist the Committee and the Board in fulfilling their responsibilities for their review of these financial statements and internal controls. The Committee expects the Auditors to call to their attention any accounting, auditing, internal accounting control, regulatory or other related matters that they believe warrant consideration or action. The Committee recognizes that the financial management and the internal and outside auditors have more knowledge and information about the Company than do Committee members. Consequently, in carrying out its oversight responsibilities, the Committee does not provide any expert or special assurance as to the Company's financial statements or internal controls or any professional certification as to the Auditors' work.

The Committee shall undertake the following activities in carrying out its oversight responsibilities:

Internal and External Audit Responsibilities

1. The Committee shall have the sole authority to directly appoint, retain, compensate, evaluate and, where appropriate, replace the Auditors (subject, if appropriate, to ratification by a vote of the shareholders of the Company). The Auditors shall report directly to the Committee. The Committee must be directly responsible for oversight of the independent auditors, including resolution of disagreements between management and the Auditors.
- 2.

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Review and pre-approve all the audit services to be performed, including the Auditors' engagement letter for the annual audit of the Company in accordance with U.S. generally accepted auditing standards and the proposed fees in connection with such audit. Any additional services that management chooses to hire the independent auditors to perform must be approved individually by the Committee, prior to the independent auditors engagement. The authority for such pre-approval may be delegated to one or more members of the Committee; the decisions of any member to whom pre-approval authority is delegated shall be presented to the full Committee at the next Committee meeting. Additionally, the Committee can establish pre-approval policies and procedures with respect to the engagement of the Company's independent accountant's for non-audit services. Such policies and procedures would allow management to engage the Company's independent accountant's for non-audit services, provided the pre-approval policies and procedure are detailed as to the particular service and the Committee is informed of each service and such policies and procedures do not include delegation of the Committee's responsibilities under the Securities Exchange Act of 1934 to management. Engagement letters with respect to the services to be performed, whether audit or non-audit, approved in accordance with the foregoing may be signed on behalf of the Committee by its Chairman and on behalf of the Company by the Chief Financial Officer, Controller or Chief Accounting Officer of the Company.

3. Examine and make recommendations, if any, with respect to the audit scope, plans for (including staffing and budgeting), and the results of, the annual audit conducted by the Auditors and the internal auditors.

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4. Receive and review periodic written reports from the Auditors regarding the Auditors independence and discuss such reports with the Auditor. Annually, obtain and review a report by the Auditors describing their internal quality-control procedures, any material issues raised by the most recent internal quality-control review or peer review, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, with respect to any independent audit carried out by the firm. Such report shall also detail steps taken to resolve any issues raised in the above reviews, inquiries or investigations and all relationships between the independent auditor and the Company, including the matters covered by Independence Standards Board Standard Number 1. The Committee shall review and discuss with the Auditors any relationships or services that may impact the objectivity and independence of the Auditors and take appropriate action in response to the Auditors' report to satisfy itself of the Auditors' independence. This review shall include an evaluation of the lead partner of the Auditors. The Committee shall insure that the lead audit partner is rotated at least every five years to the extent required by the Securities Exchange Act of 1934, as amended by the Sarbanes Oxley Act of 2002 (the "Act"), and shall consider whether there should be regular rotation of the Auditors. The Committee shall present its findings from this report to the Board.
5. The Committee shall establish clear policies with respect to the hiring of employees or former employees of the Auditors.
6. The Committee shall ensure that none of the individuals serving in the positions of chief executive officer, chief financial officer, corporate controller, chief accounting officer, or any person serving in an equivalent position participated in any capacity in the audit of the Company as an employee of the Auditors during the 1-year period preceding the date of initiation of any audit being performed by the Auditors.
7. Review with the Auditors the matters required to be discussed by Statement on Auditing Standards No. 61 relating to communications with audit committees ("SAS 61"), all alternative accounting treatments of financial information discussed with management (including the ramifications of using such alternative disclosures and treatments and the Auditors' preferences) and all material written communications with management.
8. Review the activities, organization, resources and qualifications of the Director of Worldwide Audit and of the internal audit organization.
9. At least annually, review the progress made with respect to executing the approved internal audit plan as well as any modifications made to the plan during the year.
10. Review with the Auditors and the internal auditors any audit problems or difficulties and disagreements with management encountered in the course of the audit, management's response thereto and the related effects on audit scope and procedures. The Committee is responsible for resolving any disagreements between management and the Auditors or internal auditors regarding financial reporting.
11. Examine and review with the Auditors, the internal auditors and the Company's chief financial and accounting officers the comments and recommendations contained in the Auditors', and the internal auditors', summary audit management reports, as presented to the Committee, and management's response to those reports, and advise the Board with respect thereto.

System of Internal Controls

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12. At least quarterly, the Committee shall meet with management, the internal auditors and the Auditors in separate executive sessions.
13. Review with the management, the Auditors and the internal auditors the quality and adequacy of internal controls that could significantly affect the Company's financial statements.
14. Discuss with management and the Auditors the Company's major financial risk exposures, the Company's policies with respect to risk assessment and risk management and the steps management has taken to monitor and control these exposures.
15. Review and make recommendations to the Board concerning the Company's policies with regard to affiliate/related party transactions.

Financial Reporting Process and Financial Statements

16. Discuss with management and the Auditors the quality and adequacy of the Company's disclosure controls and procedures, and review disclosures made by the Company's principal executive officer and principal financial officer in the Company's periodic reports filed with the SEC regarding compliance with their certification obligations.
17. Prior to each quarterly earnings release, the Committee shall discuss with management and the Auditors the earnings press release, as well as financial information and earnings guidance to be provided to investors, analysts or rating agencies. Discuss with management the Company's policies with respect to the types of information and type of presentation to be used in earnings releases and in providing financial information and earnings guidance to the public.
18. Review and discuss with management and the Auditors the Company's quarterly financial reports and Management Discussion and Analysis prior to filing on Forms 10-Q.
19. Review and discuss with management and the Auditors the annual audited financial statements, including the, management discussion and analysis portion thereof, changes in accounting policies and practices, financial reporting practices and significant reporting issues, critical accounting policies and significant estimates and judgments made in connection with the preparation of such audited financial statements.
20. Review with management and the Auditors the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the Company's financial statements.
21. Review with, and make a recommendation to, the Board with respect to the inclusion of the audited financial statements, including the management discussion and analysis portion thereof, in the Company's Annual Report to Shareholders and in the Company's Form 10-K to be filed with the SEC.
22. Prepare the report from the Audit Committee required by the rules of the SEC to be included in the Company's annual proxy statement.

Compliance with Laws and Regulations

23. Review with the Company's General Counsel legal matters that may have a material impact on the financial statements, the Company's compliance policies and any material reports or inquiries received from regulators or government agencies.

Compliance with the Company's Codes of Conduct

24. Ensure that the Company's Ethics Policy and Finance Code of Conduct (the ethics codes) are in writing and have annually been distributed to applicable Company employees, Directors and other individuals covered by its contents.
25. Review at least annually with the Company's Ethics Compliance Officer the process for monitoring compliance with the ethics codes and obtain regular updates from management regarding compliance. Establish procedures for reviewing, granting and, to the extent required by

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law, regulation or NYSE listing standards, promptly disclosing any waivers of the ethics codes for directors and executive officers.

26. Establish and maintain a procedure for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters. Additionally, establish and maintain procedures for the confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters.

Reporting and other Responsibilities

27. Annually review and reassess the adequacy of the Committee's purpose and responsibilities as herein set forth and recommend any proposed changes to the Board for approval.
28. The Committee has the authority, without having to seek Board approval, and appropriate funding to obtain advice and assistance, as appropriate, from outside legal, accounting and other advisers, as it determines necessary to carry

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out its duties. The Committee may also conduct or authorize investigations into or studies of matters within the Committee's scope of responsibilities.

29. The Committee shall review at least quarterly with the Board any issues that arise with respect to the quality or integrity of the Company's financial statements, the Company's compliance with legal or regulatory requirements, the performance and independence of the Auditors, or the performance of the internal audit function.
30. The Committee shall perform, at least annually, an evaluation of its own performance, and submit that evaluation, including any recommended changes to the Committee's membership, charter or procedures, to the Board for review and discussion.
31. The Chairman of the Committee shall report to the Board at each meeting of the Board the deliberations, actions and recommendations of the Committee since the last Board meeting and such other matters as the Board shall from time to time specify.

Composition and Qualifications

The Committee shall be comprised of three or more directors, the exact number to be determined from time to time by resolution of the Board. Each member of the Committee shall (1) be independent as required by NYSE listing standards and any other legal requirements as shall from time to time be in effect, including, without limitation Rule 10A-3(b)(i) under the Act, subject to the exemptions provided in Rule 10A-3(c), and (2) have such financial/accounting literacy or expertise as required by NYSE listing standards and/or rules adopted by the SEC pursuant to the Act. The Board of Directors shall, in the exercise of business judgment, determine the independence and financial literacy, financial expertise, or accounting and related financial management expertise of directors for this purpose. At least one member of the Committee must have accounting or related financial management expertise, as the Board interprets such qualification in its business judgment. A person who satisfies the definition of audit committee financial expert set out in Item 401(e) of Regulation S-K has accounting and related financial management expertise.

No Director may serve as a member of the Committee if such Director serves on the audit committee of more than two other public companies, unless the Board determines that such simultaneous service would not impair the ability of such Director to effectively serve on the Committee. Any such determination shall be disclosed in the Company's annual proxy statement.

No affiliated person of the Company (including its subsidiaries) shall serve on the Committee in accordance with such definitions and rules as shall be adopted by SEC pursuant to the Act.

No member of the Committee may receive, directly or indirectly, any compensation from the Company other than (a) fees paid to directors for service on the Board, (b) additional fees paid to directors for service on a committee of the Board (including the Committee) and/or for serving as the chairperson of such a committee and (c) a pension or other deferred compensation for prior service that is not contingent on future service on the Board.

The Chairman of the Committee shall be designated by a majority vote of the entire Board.

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Members of the Committee shall be designated annually by a majority vote of the entire Board (after considering any recommendations of the Corporate Governance Committee) at the organizational meeting of the Board held in connection with the annual meeting of shareholders.

Vacancies on the Committee shall be filled by a majority vote of the entire Board. By a majority vote of the entire Board, a member of the Committee may be removed.

Structure and Operation

1. Three members of the Committee shall constitute a Quorum. The act of a majority of the members present at a meeting at which a quorum is present shall be the act of the Committee.
2. The Secretary of the Company, or in the absence of the Secretary such person as may be designated by the Chairman of the Committee, shall act as secretary and keep the minutes of all meetings of the Committee.

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3. The Committee shall meet in person or telephonically at least seven times a year at such times and places determined by the Chairman of the Committee, with further meetings to occur, or actions to be taken by unanimous written consent, when deemed necessary or desirable by the Committee or its Chairman.
4. The Committee may request that any directors, officers or employees of the Company, or other persons whose advice and counsel are sought by the Committee, attend any meeting of the Committee to provide such pertinent information as the Committee requests.
5. The Committee may form and delegate authority to subcommittees when appropriate.
6. Except as expressly provided in this Charter, the By-laws of the Company, or the Company's Corporate Governance Guidelines, or as required by law, regulation or NYSE listing standards, the Committee shall establish its own rules of procedure.

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Exhibit III

Compensation Committee Charter

Purpose

The purpose of the Compensation Committee (the "Committee") of the Board of Directors (the "Board") of Xerox Corporation (the "Company") is to discharge the responsibilities of the Board relating to compensation of the Company's officers, to oversee the evaluation of the Chief Executive Officer and other members of management, to oversee the administration of the Company's executive compensation plans and to produce an annual report on executive compensation for inclusion in the Company's proxy statement, in accordance with applicable rules and regulations of the Securities and Exchange Commission ("SEC"); to consult with the Chief Executive Officer and advise the Board with respect to senior management succession planning; and shall have such other powers and perform such other duties as the Board may from time to time delegate to it in accordance with Article III, Section 4 of the By-Laws of the Company.

Duties and Responsibilities

1. Review and make recommendations to the Board with respect to executive compensation and executive retirement plans. Executive compensation plans include cash and/or equity payments earned in the short term and/or long term.
2. Annually, review and approve performance goals and objectives with respect to the compensation of the Chief Executive Officer and all other officers consistent with approved compensation plans.

3. Annually, oversee the performance evaluation of the Chief Executive Officer and all other officers against approved goals and objectives.
4. Based on the evaluation, set the compensation of the Chief Executive Officer and all other officers (including annual base salary level, annual incentive level, long-term incentive level and any special or supplemental benefits).
5. Review and approve employment, severance, change-in-control, termination and retirement arrangements for all officers.
6. Consult with the Chief Executive Officer and advise the Board with respect to senior management succession planning.
7. Sole authority to retain and terminate the consulting firms engaged to assist the Committee in the evaluation of the compensation of the Chief Executive Officer and senior management. The Committee may also conduct or authorize investigations into or studies of matters within the Committee's scope of responsibilities and may retain, at the Company's expense, such independent counsel or other advisers as it deems necessary.
8. Administer and interpret executive compensation plans to the extent required by the terms of such plans.
9. In consultation with senior management of the Company, oversee regulatory compliance with respect to compensation matters, including overseeing the Company's policies on structuring compensation programs to preserve tax deductibility and, as and when required, establishing performance goals and certifying that performance goals have been attained for purposes of Section 162(m) of the Internal Revenue Code of 1986, as amended.
10. Prepare the executive compensation report from the compensation committee required by the rules of the SEC to be included in the Company's annual proxy statement.
11. The Committee shall annually conduct an evaluation of its own performance and, in light of this, consider changes in its membership, charter or procedures. The Committee shall report to the Board the results of its evaluation, including recommended charter, membership and other changes.

Composition and Qualifications

The Committee shall be comprised of three or more directors, the exact number to be determined from time to time by resolution of the Board. Each member of the Committee shall be independent as required by NYSE listing standards and any other legal requirements as shall from time to time be in effect. The Board of Directors shall, in the exercise of business judgment, determine the independence of directors for this purpose.

Members of the Committee shall also qualify as non-employee directors within the meaning of Rule 16b-3 promulgated under the Securities Exchange Act of 1934, as amended, and outside directors within the meaning of Section 162(m) of the Internal Revenue Code of 1986, as amended.

The Chairman of the Committee shall be designated by a majority vote of the entire Board.

Members of the Committee shall be designated annually by a majority of vote of the entire Board (after considering any recommendations of the Corporate Governance Committee) at the organizational meeting of the Board of Directors held in connection with the annual meeting of shareholders.

Vacancies on the Committee shall be filled by a majority vote of the entire Board. By a majority vote of the entire Board, a member of the Committee may be removed.

In selecting the members of the Committee from time to time, the Board shall consider the following qualifications for membership: prior service on the Committee or a compensation committee of another public company or service with a public company which involved executive compensation matters.

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The Chairman of the Committee is responsible for the orientation of new members regarding compensation matters.

The Committee shall be fully independent, accountable, and vigorous in taking primary responsibility for all aspects of executive compensation including employment, retention, and severance agreements.

Structure and Operation

1. Two members of the Committee shall constitute a quorum. When more than two members are present, the act of a majority of the members present at a meeting at which a quorum is present shall be the act of the Committee, and when only two members are present, the unanimous vote of the two members shall constitute the act of the Committee.
2. The Committee may form and delegate authority to subcommittees when appropriate.
3. Such person as may be designated by the Chairman of the Committee shall act as secretary and keep the minutes of all meetings of the Committee.
4. The Committee shall meet in person or telephonically, at least three times a year at such times and places determined by the Chairman of the Committee, with further meetings to occur, or actions to be taken by unanimous written consent, when deemed necessary or desirable by the Committee or its Chairman.
5. The Committee shall meet in executive session without the presence of any members of management as often as it deems appropriate.
6. The Committee may request that any directors, officers or employees of the Company, or other persons whose advice and counsel are sought by the Committee, attend any meeting of the Committee to provide such pertinent information as the Committee requests.
7. The Chairman of the Committee shall report to the Board at each meeting of the Board the deliberations, actions and recommendations of the Committee since the last Board meeting
8. Except as expressly provided in this Charter, the By-laws of the Company or the Company's Corporate Governance Guidelines, or as required by law, regulations or NYSE listing standards, the Committee shall establish its own rules of procedure.

Corporate Governance Committee Charter

Purpose

The purpose of the Corporate Governance Committee (the "Committee") of the Board of Directors (the "Board") of Xerox Corporation (the "Company") is to identify individuals qualified to become Board members; to recommend to the Board individuals to serve as directors of the Company and on committees of the Board; to advise the Board with respect to Board composition, procedures and committees; to develop, recommend to the Board and annually review a set of corporate governance principles applicable to the Company; to evaluate and make recommendations to the Board with respect to the compensation of Directors; to oversee the evaluation of the Board; and to have such other powers and perform such other duties as the Board may from time to time delegate to it in accordance with Article III, Section 4 of the By-Laws of the Company.

Duties and Responsibilities

A. Board Candidates and Nominees

The Committee shall have the following duties and responsibilities with respect to Board candidates and nominees:

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- (a) To develop and recommend to the Board director qualification criteria and establish procedures for evaluating the suitability of potential director nominees. Such criteria shall include the possession of such knowledge, experience, skills, expertise and diversity so as to enhance the Board's ability to manage and direct the affairs and business of the Company, including, when applicable, to enhance the ability of committees of the Board to fulfill their duties and/or to satisfy any independence requirements imposed by law, regulation or NYSE listing standards. The Committee shall also consider the number of other public company boards on which director candidates and nominees sit in determining eligibility for election.
- (b) To actively identify and attract candidates for director and to review potential nominees proposed by management, shareholders or others.
- (c) To recommend to the Board the director nominees for election by the shareholders or for appointment by the Board, as the case may be, pursuant to the By-Laws of the Company, which recommendations shall be consistent with the Board's criteria for selecting new directors.
- (d) To review the suitability for continued service as a director of each Board member when his or her term expires and when he or she has a significant change in status, including but not limited to an employment change, and to recommend whether or not the director should be re-nominated.
- (e) To review and make recommendations to the Board with regard to length of Board service, director compensation and a retirement policy for members of the Board.
- (f) To review and oversee any orientation programs for newly elected members of the Board and continuing director education programs and to assist the Board in the implementation of such programs.

B. Board Composition and Procedures

The Committee shall have the following duties and responsibilities with respect to the composition and procedures of the Board as a whole:

- (a) To review annually with the Board the composition of the Board as a whole and to recommend, if necessary, measures to be taken so that the Board reflects the appropriate balance of knowledge, experience, skills, expertise and diversity required for the Board as a whole and contains at least the minimum number of independent directors required by NYSE listing standards.
- (b) To review periodically the size of the Board and to recommend to the Board any appropriate changes.

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- (c) To make recommendations on the frequency, content and structure of Board meetings.
- (d) To make recommendations concerning any other aspect of the procedures of the Board that the Committee considers warranted, including but not limited to procedures with respect to the waiver by the Board of any Company rule, guideline, procedure or corporate governance principle.

C. Board Committees

The following shall be the duties and responsibilities of the Committee with respect to the committee structure of the Board:

- (a) To make recommendations to the Board regarding the size and composition of each standing committee of the Board, including the identification of individuals qualified to serve as members of a committee, including the Committee, and to recommend individual directors to fill any vacancy that might occur on a committee, including the Committee.
- (b) To monitor the functioning of the committees of the Board and to make recommendations for any changes, including the creation and elimination of committees.
- (c)

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To review annually committee assignments and the policy with respect to the rotation of members of the committees and/or chairpersons, and to report any recommendations to the Board.

- (d) To recommend that the Board establish such special committees as may be desirable or necessary from time to time in order to address ethical, legal or other matters that may arise. The Committee's power to make such a recommendation under this Charter shall be without prejudice to the right of any other committee of the Board, or any individual director, to make such a recommendation at any time.

D. Corporate Governance

The following shall be the duties and responsibilities of the Committee with respect to corporate governance:

- (a) To develop and review periodically, and at least annually, the Corporate Governance Guidelines adopted by the Board to assure that they are appropriate for the Company and comply with the requirements of the NYSE, and to recommend any desirable changes to the Board.
- (b) To consider any other corporate governance issues that arise from time to time, and to develop appropriate recommendations for the Board.
- (c) To review significant shareholder relations issues, corporate political contributions and the Company's charitable contributions.

E. Evaluation of the Board

The Committee shall be responsible for overseeing the evaluation of the Board as a whole and its committees. The Committee shall establish procedures to allow it to exercise this oversight function.

F. Investigations and Studies; Outside Advisers

The Committee may conduct or authorize investigations into or studies of matters within the Committee's scope of responsibilities, and may retain, at the Company's expense, such independent counsel or other advisers as it deems necessary. The Committee shall have the sole authority to retain or terminate any firm to be used to identify director candidates and evaluate director compensation, including sole authority to approve a search firm's fees and other retention terms, such fees to be borne by the Company.

G. Performance Evaluation

The Committee shall annually conduct an evaluation of its own performance and, in light of this, consider changes in its membership, charter or procedures. The Committee shall report to the Board the results of its evaluation, including recommended charter, membership and other changes.

Composition and Qualifications

The Committee shall be comprised of three or more directors, the exact number to be determined from time to time by resolution of the Board.

Each member of the Committee shall be independent as required by NYSE listing standards and any other legal requirements as shall from time to time be in effect. The Board of Directors shall, in the exercise of business judgment, determine the independence of directors for this purpose.

The Chairman of the Committee shall be designated by a majority vote of the entire Board.

Members of the Committee shall be designated annually by a majority vote of the entire Board (after considering any recommendations of the Committee) at the organizational meeting of the Board of Directors held in connection with the annual meeting of shareholders.

Vacancies on the Committee shall be filled by majority vote of the entire Board. By a majority vote of the entire Board, a member of the Committee may be removed.

Structure and Operation

1. Two members of the Committee shall constitute a quorum. When more than two members are present, the act of a majority of the members present at a meeting at which a quorum is present shall be the act of the Committee, and when only two members are present, the unanimous vote of the two members shall constitute the act of the Committee.
2. The Committee may form and delegate authority to subcommittees when appropriate.
3. The Secretary of the Company, or in the absence of the Secretary such person as may be designated by the Chairman of the Committee, shall act as secretary and keep the minutes of all meetings of the Committee.
4. The Committee shall meet in person or telephonically at least three times a year at such times and places determined by the Chairman of the Committee, with further meetings to occur, or actions to be taken by unanimous written consent, when deemed necessary or desirable by the Committee or its Chairman.
5. The Committee may request that any directors, officers or employees of the Company, or other persons whose advice and counsel are sought by the Committee, attend any meeting of the Committee to provide such pertinent information as the Committee requests.
6. The Chairman of the Committee shall report to the Board at each meeting of the Board the deliberations, actions and recommendations of the Committee since the last Board meeting.
7. Except as expressly provided in this Charter, the By-laws of the Company or the Company's Corporate Governance Guidelines, or as required by law, regulation or NYSE listing standards, the Committee shall establish its own rules of procedure.

Exhibit V

**Xerox Corporation
2004 Performance Incentive Plan**

1. Purpose

The purpose of the Xerox Corporation 2004 Performance Incentive Plan (the "2004 Plan" or the "Plan") is to advance the interests of Xerox Corporation (the "Company") and to increase shareholder value by providing officers and employees of the Company, its subsidiaries and its Affiliates (as hereinafter defined) with a proprietary interest in the growth and performance of the Company and with incentives for current or future service with the Company, its subsidiaries and Affiliates. The Plan is a successor plan to (i) the Xerox Corporation 1991 Long-Term Incentive Plan, (ii) the Xerox Corporation 1998 Employee Stock Option Plan, (iii) the Xerox Executive Performance Incentive Insurance Plan, (iv) the Xerox Mexicana, S.A. de C.V. Executive Rights Plan and (v) the Xerox Canada Inc. Executive Rights Plan, any or all of which may be referred to as a "Predecessor Plan".

2. Effective Date and Term

The Plan shall be effective as of May 20, 2004, subject to the approval of the Company's shareholders at the 2004 annual meeting. No awards or grants can be made after January 1, 2008 unless terminated sooner pursuant to Section 13 by the Company's Board of Directors (the "Board"). Effective May 20, 2004, no further awards shall be made under a Predecessor Plan, but outstanding awards under any Predecessor Plan shall remain outstanding in accordance with their applicable terms and conditions.

3. Plan Administration

The independent Compensation Committee of the Board, or such other independent committee as the Board shall determine, comprised of not less than three members shall be responsible for administering the Plan (the "Compensation Committee"). To the extent specified by the Compensation Committee it may delegate its administrative responsibilities to a subcommittee of the Compensation Committee comprised of not less than three members (the Compensation Committee and such subcommittee being hereinafter referred to as the "Committee"). The

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Compensation Committee or such subcommittee members, as appropriate, shall be qualified to administer the Plan as contemplated by (a) Rule 16b-3 under the Securities Exchange Act of 1934 (the "1934 Act") or any successor rule, (b) Section 162(m) of the Internal Revenue Code of 1986, as amended, and the regulations thereunder ("Section 162(m)"), and (c) any rules and regulations of a stock exchange on which Common Stock (as defined in Section 5) of the Company is listed. The Committee, and such subcommittee to the extent provided by the Committee, shall have full and exclusive power to interpret, construe and implement the Plan and any rules, regulations, guidelines or agreements adopted hereunder and to adopt such rules, regulations and guidelines for carrying out the Plan as it may deem necessary or proper. These powers shall include, but not be limited to, (i) determination of the type or types of awards to be granted under the Plan; (ii) determination of the terms and conditions of any awards under the Plan; (iii) determination of whether, to what extent and under what circumstances awards may be settled, paid or exercised in cash, shares, other securities, or other awards, or other property, or cancelled, forfeited or suspended; (iv) adoption of such modifications, amendments, procedures, subplans and the like as are necessary to enable participants employed in other countries in which the Company may operate to receive advantages and benefits under the Plan consistent with the laws of such countries, and consistent with the rules of the Plan; (v) subject to the rights of participants, modification, change, amendment or cancellation of any award to correct an administrative error and (vi) taking any other action the Committee deems necessary or desirable for the administration of the Plan. All determinations, interpretations, and other decisions under or with respect to the Plan or any award by the Committee shall be final, conclusive and binding upon the Company, any participant, any holder or beneficiary of any award under the Plan and any employee of the Company. Except for the power to amend the Plan as provided in Section 13 and except for determinations regarding employees who are subject to Section 16 of the 1934 Act or certain key employees who are, or may become, as determined by the Committee, subject to the Section 162(m) compensation deductibility limit (the "Covered Employees"), and except as may otherwise be required under applicable New York Stock Exchange rules, the Committee may delegate any or all of its duties, powers and authority under the Plan pursuant to such conditions or limitations as the Committee may establish to any officer or officers of the Company.

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4. Eligibility

Any employee of the Company shall be eligible to receive an award under the Plan. For purposes of this Section 4, "Company" shall include any entity that is directly or indirectly controlled by the Company or any entity in which the Company has a significant equity interest, as determined by the Committee ("Affiliate").

5. Shares of Stock Subject to the Plan

A total number of 10.0 million (10,000,000) shares of common stock¹, par value \$1.00 per share, of the Company ("Common Stock") shall become available for issuance under the Plan, provided that any shares issued in connection with options or SARs shall be counted against this limit as 0.6 shares for each one (1) share issued. Any shares available for grant under any Predecessor Plan on the Effective Date not subject to outstanding awards shall become available for issuance under the Plan. (As of May 20, 2004, approximately 15.7 million shares² are expected to be available for issuance under Predecessor Plans.) Thus, the total number available for grant under the 2004 Plan is expected to be 25.7 million (25,700,000)³. In addition, any shares underlying awards outstanding on May 20, 2004 under any Predecessor Plan that are cancelled, are forfeited, or lapse shall become available for issuance under the Plan.

For purposes of the preceding paragraph, the following shall not be counted against shares available for issuance under the Plan: (i) settlement of stock appreciation rights ("SAR") in cash or any form other than shares and (ii) payment in shares of dividends and dividend equivalents in conjunction with outstanding awards. Any shares that are issued by the Company, and any awards that are granted by, or become obligations of, the Company, through the assumption by the Company or an affiliate of, or in substitution for, outstanding awards previously granted by an acquired company shall not be counted against the shares available for issuance under the Plan.

In determining shares available for issuance under the Plan, any awards granted under the Plan that are cancelled, are forfeited, or lapse shall become eligible again for issuance under the Plan. In addition, shares withheld to pay taxes pursuant to Section 14, and shares tendered to exercise stock options, shall be treated as shares again eligible for issuance under the Plan.

In no event, however, except as subject to adjustment as provided in Section 6, shall more than (a) 10.0 million (10,000,000) shares of Common Stock be available for issuance pursuant to the exercise of incentive stock options ("ISOs") awarded under the Plan; and (b) 15.0 million (15,000,000) shares of Common Stock be made the subject of awards under any combination of awards under Sections 7(a), 7(b) or 7(c) of the Plan to any single individual, of which no more than 10.0 million (10,000,000) may be shares of restricted stock. SARs whether settled in cash or shares of Common Stock shall be counted against the limit set forth in (b).

Any shares issued under the Plan may consist in whole or in part, of authorized and unissued shares or of treasury shares, and no fractional shares shall be issued under the Plan. Cash may be paid in lieu of any fractional shares in settlements of awards under the Plan.

6. Adjustments and Reorganizations

The Committee may make such adjustments as it deems appropriate to meet the intent of the Plan in the event of changes that impact the Company's share price or share status, provided that any such actions are consistently and equitably applicable to all affected participants.

In the event of any stock dividend, stock split, combination or exchange of shares, merger, consolidation, spin-off or other distribution (other than normal cash dividends) of Company assets to shareholders, or any other change affecting shares,

¹10.0 million reflects the number of shares if all grants were made in whole value shares (e.g., restricted stock or performance shares). If all grants were made in the form of options or SARs, the number available is 16.7 million.

²15.7 million reflects the number of shares if all grants were made in whole value shares (e.g., restricted stock or performance shares). If all grants were made in the form of options or SARs, the number available is 26.1 million.

³25.7 million reflects the number of shares if all grants were made in whole value shares (e.g., restricted stock or performance shares). If all grants were made in the form of options or SARs, the total number available is 42.8 million.

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such adjustments, if any, as the Committee in its discretion may deem appropriate to reflect such change shall be made with respect to (i) the aggregate number of shares that may be issued under the Plan; (ii) the number of shares subject to awards of a specified type or to any individual under the Plan; and/or (iii) the price per share for any outstanding stock options, SARs and other awards under the Plan.

Notwithstanding anything to the contrary in this Section 6 or any other provision of the Plan, the Committee may increase the maximum aggregate number of shares that may be issued under the Plan only to the extent necessary to reflect a change in the number of outstanding shares of Common Stock, such as a stock dividend or stock split.

7. Awards

The Committee shall determine the type or types of award(s) to be made to each participant under the Plan and shall approve the terms and conditions governing such awards in accordance with Section 12. Awards may include but are not limited to those listed in this Section 7. Awards may be granted singly, in combination or in tandem so that the settlement or payment of one automatically reduces or cancels the other. Awards may also be made in combination or in tandem with, in replacement of, as alternatives to, or as the payment form for, grants or rights under any other employee or compensation plan of the Company, including the plan of any acquired entity. However, under no circumstances may stock option awards be made which provide by their terms for the automatic award of additional stock options upon the exercise of such awards, including, without limitation, reload options.

- (a) Stock Option is a grant of a right to purchase a specified number of shares of Common Stock during a specified period. The purchase price of each option shall be not less than 100% of Fair Market Value (as defined in Section 10) on the effective date of grant. A Stock Option may be exercised in whole or in installments, which may be cumulative. A Stock Option may be in the form of an ISO which complies with Section 422 of the Internal Revenue Code of 1986, as amended, and the regulations thereunder at the time of grant. The price at which shares of Common Stock may be purchased under a Stock Option shall be paid in full at the time of the exercise in cash or such other method as provided by the Committee at the time of grant or as provided in the form of agreement approved in accordance herewith, including tendering (either constructively or by attestation) Common Stock, surrendering a stock award valued at market value at the time of surrender, surrendering a cash award, or any combination thereof. Notwithstanding any provision of the Plan, a repricing of a Stock Option shall be allowed by the Committee only with the approval of the Company's shareholders to the extent required under the rules of the New York Stock Exchange. For this purpose, a repricing shall be defined as described in the New York Stock Exchange rules.
- (b) Stock Appreciation Right (SAR) is a right to receive a payment, in cash and/or Common Stock, as determined by the Committee, equal to the excess of the market value of a specified number of shares of Common Stock at the time the SAR is exercised over the Fair Market Value on the effective date of grant of the SAR as set forth in the applicable award agreement.
- (c) Stock Award is an award made in stock or denominated in units of stock. All or part of any Stock Award may be subject to conditions established by the Committee, and set forth in the award agreement, which may include, but are not limited to, continuous service with the Company, achievement of specific business objectives, and other measurements of individual, business unit or Company performance. A restricted stock award made pursuant to this Section 7(c) shall be subject to a vesting schedule of no less than three (3) years unless such

award is performance based, in which case vesting shall be no less than one (1) year.

(d) Cash Award may be any of the following:

- (i) an annual incentive award in connection with which the Committee will establish specific performance periods (not to exceed twelve months) to provide cash awards for the purpose of motivating participants to achieve goals for the performance period. An annual incentive award shall specify the minimum, target and maximum amounts of awards for a performance period for a participant or any groups of participants, and, to the extent applicable to Covered Employees, comply with the requirements of Section 23; or
- (ii) a long-term award denominated in cash with the eventual payment amount subject to future service and such other restrictions and conditions as may be established by the Committee, and as set forth in the award agreement, including, but not limited to, continuous service with the Company, achievement of specific business objectives, and other measurement of individual, business unit or Company performance.

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- (iii) Cash Awards under this Section 7(d) to any single Covered Employee, including dividend equivalents in cash or shares of Common Stock payable based upon attainment of specific performance goals, may not exceed in the aggregate \$10,000,000 in the case of the Chief Executive Officer and \$5,000,000 in the case of any other participant, such limits being applicable to each twelve-month performance period established by the Committee under this Section 7(d) or under Section 23.

The Committee shall have the discretion with respect to any award granted under the Plan to establish upon its grant conditions under which (i) the award may be later forfeited, cancelled, rescinded, suspended, withheld or otherwise limited or restricted; or (ii) gains realized by the grantee in connection with an award or an award's exercise may be recovered; provided that such conditions and their consequences are: (a) clearly set forth in the grant agreement or other grant document; and (b) fully comply with applicable laws. These conditions may include, without limitation, actions by the participant which constitute a conflict of interest with the Company, are prejudicial to the Company's interests, or are in violation of any non-compete agreement or obligation, any confidentiality agreement or obligation, the Company's applicable policies, its Code of Business Conduct and Ethics, or the participant's terms and conditions of employment.

8. Dividends and Dividend Equivalents

The Committee may provide that awards denominated in stock earn dividends or dividend equivalents. Such dividend equivalents may be paid currently in cash or shares of Common Stock or may be credited to an account established by the Committee under the Plan in the name of the participant. In addition, dividends or dividend equivalents paid on outstanding awards or issued shares may be credited to such account rather than paid currently. Any crediting of dividends or dividend equivalents may be subject to such restrictions and conditions as the Committee may establish, including reinvestment in additional shares or share equivalents.

9. Deferrals and Settlements

Payment of awards may be in the form of cash, stock, other awards, or in such combinations thereof as the Committee shall determine at the time of grant, and with such restrictions as it may impose. The Committee may also require or permit participants to elect to defer the issuance of shares or the settlement of awards in cash under such rules and procedures as it may establish under the Plan. It may also provide that deferred settlements include the payment or crediting of interest on the deferral amounts or the payment or crediting of dividend equivalents on deferred settlements denominated in shares.

10. Fair Market Value

Fair Market Value for all purposes under the Plan shall mean the average of the high and low prices of Common Stock as reported in The Wall Street Journal in the New York Stock Exchange Composite Transactions or similar successor consolidated transactions reports for the relevant date, or if no sales of Common Stock were made on said exchange on that date, the average of the high and low prices of Common Stock as reported in said composite transaction report for the preceding day on which sales of Common Stock were made on said exchange. Under no circumstances shall Fair Market Value be less than the par value of the Common Stock.

11. Transferability and Exercisability

Except as otherwise provided in this Section 11, all awards under the Plan shall be nontransferable and shall not be assignable, alienable, saleable or otherwise transferable by the participant other than by will or the laws of descent and distribution except pursuant to a domestic relations order entered by a court of competent jurisdiction. Notwithstanding the preceding sentence, the Committee may provide that any award of non-qualified Stock Options may be transferable by the recipient to family members or family trusts established by the recipient. The Committee may also provide that, in the event that a participant terminates employment with the Company to assume a position with a governmental, charitable, educational or similar non-profit institution, a third party, including but not limited to a blind trust, may be authorized by the Committee to act on behalf of and for the benefit of the respective participant with respect to any outstanding awards. Except as otherwise provided in this Section 11, during the life of the participant, awards under the Plan shall be exercisable only by him or her except as otherwise determined by the Committee. In addition, if so permitted by the Committee, a participant may designate a beneficiary or beneficiaries to exercise the rights of the participant and receive any distributions under the Plan upon the death of the participant.

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12. Award Agreements; Notification of Award

Awards under the Plan (other than annual incentive awards described in Section 7(d)(i)) shall be evidenced by one or more agreements approved by the Committee that set forth the terms and conditions of and limitations on an award, except that in no event shall the term of any Stock Option exceed a period of ten years from the date of its grant. The Committee need not require the execution of any such agreement by a participant in which case acceptance of the award by the respective participant will constitute agreement to the terms of the award. In the case of an annual incentive cash award, the participant shall receive notification of such award in such form as the Committee may determine.

13. Plan Amendment and Termination

The Compensation Committee may amend the Plan as it deems necessary or appropriate, except that no such amendment which would cause the Plan not to comply with the requirements of (i) Section 162(m) with respect to performance-based compensation, (ii) the Code with respect to ISOs or (iii) the New York Business Corporation Law as in effect at the time of such amendment shall be made without the approval of the Company's shareholders. No such amendment shall adversely affect any outstanding awards under the Plan without the consent of all of the holders thereof.

Notwithstanding the foregoing, an amendment that constitutes a material revision, as defined by the rules of the New York Stock Exchange, shall be submitted to the Company's shareholders for approval. In addition, any revision that deletes or limits the scope of the provision in Section 7 prohibiting repricing of options without shareholder approval will be considered a material revision.

The Board may terminate the Plan at any time. Upon termination of the Plan, no future awards may be granted, but previously-made awards shall remain outstanding in accordance with their applicable terms and conditions, and the terms of the Plan.

14. Tax Withholding

The Company shall have the right to deduct from any settlement of an award made under the Plan, including the delivery or vesting of shares, an amount sufficient to cover withholding required by law for any federal, state or local taxes or to take such other action as may be necessary to satisfy any such withholding obligations. The Committee may permit shares to be used to satisfy required tax withholding and such shares shall be valued at the fair market value as of the settlement date of the applicable award.

15. Other Company Benefit and Compensation Programs

Unless otherwise determined by the Committee, settlements of awards received by participants under the Plan shall not be deemed a part of a participant's regular, recurring compensation for purposes of calculating payments or benefits from any Company benefit plan, severance program or severance pay law of any country.

16. Unfunded Plan

Unless otherwise determined by the Committee, the Plan shall be unfunded and shall not create (or be construed to create) a trust or a separate fund or funds. The Plan shall not establish any fiduciary relationship between the Company and any participant or other person. To the extent any person holds any rights by virtue of a grant awarded under the Plan, such right (unless otherwise determined by the Committee) shall be no greater than the right of an unsecured general creditor of the Company.

17. Future Rights

No person shall have any claim or right to be granted an award under the Plan, and no participant shall have any right by reason of the grant of any award under the Plan to continued employment by the Company or any subsidiary of the Company.

18. General Restriction

Each award shall be subject to the requirement that, if at any time the Committee shall determine, in its sole discretion, that the listing, registration or qualification of any award under the Plan upon any securities exchange or under any state or federal law, or the consent or approval of any government regulatory body, is necessary or desirable as a condition of,

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or in connection with, the granting of such award or the exercise settlement thereof, such award may not be granted, exercised or settled in whole or in part unless such listing, registration, qualification, consent or approval shall have been effected or obtained free of any conditions not acceptable to the Committee.

19. Governing Law

The validity, construction and effect of the Plan and any actions taken or relating to the Plan shall be determined in accordance with the laws of the state of New York and applicable Federal law.

20. Successors and Assigns

The Plan shall be binding on all successors and permitted assigns of a participant, including, without limitation, the estate of such participant and the executor, administrator or trustee of such estate, or any receiver or trustee in bankruptcy or representative of such participant's creditors.

21. Rights as a Shareholder

A participant shall have no rights as a shareholder until he or she becomes the holder of record of Common Stock.

22. Change in Control

Notwithstanding anything to the contrary in the Plan, the following shall apply to all awards granted and outstanding under the Plan:

A. Definitions

The following definitions shall apply to this Section 22:

A **Change in Control**, unless otherwise defined by the Compensation Committee, shall be deemed to have occurred if (a) any person, as such term is used in Section 13(d) and 14(d) of the 1934 Act, other than (1) the Company, (2) any trustee or other fiduciary holding securities under an employee benefit plan of the Company, (3) any company owned, directly or indirectly, by the shareholders of the Company in substantially the same proportions as their ownership of stock of the Company, or (4) any person who becomes a beneficial owner (as defined below) in connection with a transaction described in clause (1) of subparagraph (c) below, is or becomes the beneficial owner (as defined in Rule 13d-3 under the 1934 Act), directly or indirectly, of securities of the Company (not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 20 percent or more of the combined voting power of the Company's then outstanding voting securities; (b) the following individuals cease for any reason to constitute a majority of the directors then serving; individuals who on May 20, 2004 constitute the Board and any new director (other than a director whose initial assumption of office is in connection with an actual or threatened election contest, including but not limited to a consent solicitation, relating to the election of directors of the Company) whose appointment or election by the Board or nomination for election by the Company's shareholders was approved or recommended by a vote of at least two-thirds of the directors then still in office who were directors on May 20, 2004, or whose appointment, election or nomination for election was previously so approved or recommended; (c) there is consummated a merger or consolidation of the Company or any direct or indirect subsidiary of the Company with any other corporation, other than (1) a merger or consolidation which results in the directors of the Company immediately prior to such merger or consolidation continuing to constitute at least a majority of the board of directors of the Company, the surviving entity or any parent thereof or (2) a merger or consolidation effected to implement a recapitalization of the Company (or similar transaction) in which no person is or becomes the beneficial owner, directly or indirectly, of securities of the Company

(not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 20% or more of the combined voting power of the Company's then outstanding securities; or (d) the shareholders of the Company approve a plan of complete liquidation or dissolution of the Company or there is consummated an agreement for the sale or disposition by the Company of all or substantially all of the Company's assets, other than a sale or disposition by the Company of all or substantially all of the Company's assets to an entity, at least 50% of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the Company immediately prior to such sale.

CIC Price shall mean the higher of (a) the highest price paid for a share of the Company's Common Stock in the transaction or series of transactions pursuant to which a Change in Control of the Company shall have occurred, or (b) the highest price paid for a share of the Company's Common Stock during the 60 day period immediately preceding the date upon which the event constituting a Change in Control shall have occurred as reported in The Wall Street Journal in the New York Stock Exchange Composite Transactions or similar successor consolidated transactions reports.

B. Acceleration of Vesting and Payment of SARs, Stock Awards, Cash Awards, and Dividends and Dividend Equivalents.

Upon the occurrence of an event constituting a Change in Control, all SARs, stock awards, stock options (to the extent the CIC Price exceeds the exercise price), cash awards, dividends and dividend equivalents outstanding on such date shall become 100% vested and shall be paid in cash as soon as may be practicable. Upon such payment, such awards and any related stock options shall be cancelled.

The amount of cash to be paid shall be determined by multiplying the number of such awards, as the case may be, by: (i) in the case of stock awards, the CIC Price; (ii) in the case of SARs, the difference between the exercise price of the related option per share and the CIC Price; (iii) in the case of cash awards where the award period, if any, has not been completed upon the occurrence of a Change in Control, the pro-rata target value of such awards or such higher amount as determined by the Committee, without regard to the performance criteria, if any, applicable to such award; and (iv) in the case of cash awards where the award period, if any, has been completed on or prior to the occurrence of a Change in Control: (aa) where the cash award is payable in cash, the value of such award as determined in accordance with the award agreement, and (bb) where the cash award is payable in shares of Common Stock, the CIC Price.

C. Notwithstanding the foregoing, any SARs and any stock-based award held by an officer or director subject to Section 16 of the 1934 Act which have been outstanding less than six months (or such other period as may be required by the 1934 Act) upon the occurrence of an event constituting a Change in Control shall not be paid in cash until the expiration of such period, if any, as shall be required pursuant to such Section, and the amount to be paid shall be determined by multiplying the number of SARs, stock awards, or unexercised shares under such stock options, as the case may be, by the CIC Price determined as though the event constituting the Change in Control had occurred on the first day following the end of such period.

23. Certain Provisions Applicable to Awards to Covered Employees

Performance-based awards made to Covered Employees shall be made by the Committee within the time period required under Section 162(m) for the establishment of performance goals and shall specify, among other things, the performance period(s) for such award (which shall be not less than one year), the performance criteria and the performance targets. The performance criteria shall be any one or more of the following as determined by the Committee and may differ as to type of award and from one performance period to another: earnings per share, cash flow, document processing profit, cost reduction, days sales outstanding, cash conversion cycle, cash management (including, without limitation, inventory and/or capital expenditures), total shareholder return, return on shareholders' equity, economic value added measures, return on assets, pre- or post-currency revenue, pre- or post-currency performance profit, profit before tax, profit after tax, revenues, stock price and return on sales. Payment or vesting of awards to Covered Employees shall be contingent upon satisfaction of the performance criteria and targets as certified by the Committee by resolution of the Committee. To the extent provided at the time of an award, the Committee may in its sole discretion reduce any award to any Covered Employee to any amount, including zero. Any performance-based awards made pursuant to this Section 23 may include annual incentive awards and long-term awards.

Xerox Corporation
2004 Equity Compensation Plan for Non-Employee Directors

1. Purpose

The purpose of the Xerox 2004 Equity Compensation Plan for Non-Employee Directors (the *Plan*) is to provide the means whereby Xerox Corporation (the *Company*) may include the Company's equity in the total compensation of non-employee members of the Company's Board of Directors (the *Board*).

2. Effective Date and Term of Plan

This Plan shall be effective as of May 20 2004, subject to the approval of the Company's shareholders at the 2004 annual meeting and remain in effect until the earlier of: (i) the date when no additional shares are available for issuance under the Plan; or (ii) the date when the Board terminates the Plan in accordance with Section 10.

3. Eligibility

Any person who is a Non-Employee Director of the Company shall be eligible to receive an Award under the Plan (each a *Participant*). For purposes of the Plan, Non-Employee Director shall mean a member of the Board who is not at the time also an employee of the Company or any of its direct or indirect majority-owned subsidiaries (regardless of whether such subsidiary is organized as a corporation, partnership or other entity).

4. Administration of the Plan

The Plan shall be administered by the Board of Directors of the Company upon advice of the Board's Governance Committee. Subject to the express provisions of the Plan, the Board shall have full and exclusive power to do all things necessary or desirable in connection with the administration of the Plan, including, without limitation: (a) to prescribe, amend and rescind rules relating to the Plan and to define terms not otherwise defined herein; (b) to approve the form of documentation used to evidence any grant awarded hereunder, including providing for such terms as it considers necessary or desirable; (c) to establish and verify the extent of satisfaction of any conditions to exercisability applicable to stock options and stock appreciation rights (the *SARs*) or to receipt or vesting of stock grants; (d) to determine whether, and the extent to which, adjustments are required pursuant to Section 8 hereof; and (e) to interpret and construe the Plan, any rules and regulations under the Plan and the terms and conditions of any stock option or stock grant awarded hereunder, and to make exceptions to any procedural provisions in good faith and for the benefit of the Company.

All determinations, interpretations, and other decisions under or with respect to the Plan shall be final, conclusive and binding upon the Company, all Participants and any holder or beneficiary of any Award, as hereinafter defined, under the Plan. The Board may consider such factors as it deems relevant, in its sole and absolute discretion, in making such decisions, determinations and interpretations including, without limitation, the recommendations or advice of any officer or other employee of the Company and such attorneys, consultants and accountants as it may select.

All questions pertaining to the construction, regulation, validity and effect of the Plan shall be determined in accordance with the laws of the state of New York and applicable Federal law and the relevant rules of the New York Stock Exchange, Inc. (the *NYSE*).

5. Shares Subject to the Plan

A total number of 1,000,000 shares of Common Stock¹, par value \$1.00, as presently constituted, subject to adjustment as provided in Section 8, of the Company shall become available for issuance under the Plan. Provided, however, that any shares issued in connection with options or SARs shall be counted against this limit as 0.6 shares for each one (1) share issued.

¹1,000,000 reflects the number of shares if all grants were made in whole value shares (e.g. deferred stock units). If all grants were made in the form of options or SARs, the number available is 1,666,667.

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For purposes of the preceding paragraph, the following shall not be counted against shares available for issuance under the Plan: (i) settlement of SARs in cash or any form other than shares and (ii) payment in shares of dividends and dividend equivalents in conjunction with outstanding awards.

In determining shares available for issuance under the Plan, any Awards that are cancelled, forfeited or lapse shall become eligible again for issuance under the Plan. Upon exercise of SARs, only the shares issued shall be counted against the available share limit.

Any shares issued under the plan may consist in whole or in part, of authorized and unissued shares or of treasury shares, and no fractional shares shall be issued under the Plan. Cash may be paid in lieu of any fractional shares in settlements of Awards under the Plan.

6. Awards

The Board shall determine the type of award(s) to be made to each Non-Employee Director under the Plan and shall approve the terms and conditions governing such awards through the issuance of an award agreement. Awards may be granted singly, in combination, or in tandem so that the settlement or payment of one automatically reduces or cancels the other. However, under no circumstances may stock option awards be made which provide by their terms for the automatic award of additional stock options upon the exercise of such awards, including, without limitation, reload options.

The following is a list of awards that may be granted, either individually or collectively, to Participants pursuant to the provisions of the Plan (Awards).

(a) Deferred Stock Unit (DSU) is a bookkeeping entry that represents the right to receive one share of Common Stock at a future date, such as termination of Board service. Outright grants may be made as part of the Non-Employee Director's annual compensation for services rendered or as a result of a voluntary election by the Non-Employee Director to defer cash compensation otherwise payable to him or her. DSUs will include the right to receive dividend equivalents which are credited in the form of additional DSUs payable in Common Stock following termination of Board service.

(b) Stock Option is a grant of a right to purchase a specified number of shares of Common Stock during a specified period no longer than seven years. The purchase price of each option shall not be less than 100% of Fair Market Value on the effective date of grant. The price at which shares of Common Stock may be purchased under a Stock Option shall be paid in full at the time of the exercise in cash or shares, including tendering (either actually or by attestation) Common Stock or surrendering a Stock Award valued at Fair Market Value, as defined herein, on the date of surrender. A Stock Option may be exercised in whole or in installments on the earliest of: i) the vesting schedule established by the Board; or ii) the death of the Non-Employee Director.

Notwithstanding any provision of the Plan, a repricing of a Stock Option shall not be allowed by the Board.

Fair Market Value for all purposes under the Plan shall mean the average of the high and low prices of Common Stock as reported in the Wall Street Journal in the New York Stock Exchange Composite Transactions or similar successor consolidated transactions report for the relevant date, or if no sales of Common Stock were made on said exchange on that date, the average of the high and low prices of Common Stock as reported in said composite transaction report for the preceding day on which sales of Common Stock were made on said exchange. Under no circumstance shall Fair Market Value be less than the par value of the Common Stock.

(c) Stock Appreciation Right (SAR) is a right to receive a payment, in cash and/or Common Stock, as determined by the Board, equal to the excess of the Fair Market Value of a specified number of shares of Common Stock on the date the SAR is exercised over the Fair Market Value on the effective date of grant of the SAR as set forth in the applicable award agreement. The maximum term for SARs under the Plan is seven years.

(d) Stock Award is an Award made in stock. All or part of any Stock Award may be subject to conditions established by the Board and set forth in the award agreement which may include, but is not limited to, continuous service with the Company.

7. Dividend and Dividend Equivalents

At the Board's discretion, Awards denominated in Common Stock may earn dividends or dividend equivalents paid currently in cash or shares of Common Stock or credited to an account established by the Board in the name of the Non-Employee Director and converted into additional DSUs. Any crediting of dividends or dividend equivalents may be

subject to such restrictions and conditions as the Board may establish, including reinvestment in additional shares or share equivalents.

8. Adjustments and Reorganizations

In the event of any stock dividend, stock split, combination or exchange of shares, merger, consolidation, spin-off or other distribution (other than normal cash dividends) of Company assets to shareholders, or any other change affecting shares, such adjustments, if any, as the Board in its sole discretion may deem appropriate to reflect such change shall be made with respect to (i) the aggregate number of shares that may be issued under the Plan; (ii) the number of shares subject to outstanding Awards of a specified type or to any individual Participant under the Plan; and/or (iii) the price per share of any outstanding Stock Options or SARs under the Plan.

9. Transferability and Exercisability

Except as otherwise provided herein, all Awards under the Plan shall be nontransferable and shall not be assignable, alienable, saleable or otherwise transferable by the Non-Employee Director other than by will or the laws of descent and distribution except pursuant to a domestic relations order entered by a court of competent jurisdiction. Notwithstanding the preceding sentence, the Board may provide that any Stock Option Award may be transferable by the Participant to family members or family trusts established by the Participant.

Except as otherwise provided herein, during the life of the Non-Employee Director, Awards under the Plan shall be exercisable only by him or her except as otherwise determined by the Board. In addition, if so permitted by the Board, Non-Employee Directors may designate a beneficiary to exercise the rights of the Non-Employee Director and receive any distributions under the Plan upon the death of the Non-Employee Director.

10. Amendment and Termination of Plan

The Board may periodically amend the Plan as it deems appropriate, without further action by the Company's shareholders, except to the extent required by applicable law. Notwithstanding the foregoing, and subject to adjustment pursuant to Section 8, the Plan may not be amended to materially increase the number of shares of Common Stock authorized for issuance under the Plan, unless any such amendment is approved by the Company's shareholders.

Notwithstanding the foregoing, an amendment that constitutes a material revision, as defined by the rules of the NYSE, shall be submitted to the Company's shareholders for approval. In addition, any revision that deletes or limits the scope of the provision in Section 6 prohibiting repricing of options will be considered a material revision.

The Plan may be terminated at such time as the Board may determine. Amendments or termination of the Plan will not affect the rights and obligations arising under Stock Options or other Stock Awards theretofore granted and then in effect without the Participant's consent.

11. Term of Award

The term of each Award is determined by the Board; provided, however, that the term of any Stock Option or SAR shall not be greater than seven years from the effective date of grant.

12. Cancellation or Suspension of an Award

The Board shall have the full power and authority to determine under what circumstances any Award shall be canceled or suspended (e.g., activity by Non-Employee Directors which constitutes a conflict of interest with the Company or is in violation of Company policies).

13. Deferred Settlement

The Board may require or permit Participants to elect to defer the issuance of shares or the settlement of Awards in cash under such rules and procedures as it may establish under the Plan. It may also provide that deferred settlements include the payment or crediting of interest on the deferral amounts or the payment or crediting of dividend equivalents on deferred settlements denominated in shares.

14. Unfunded Plan

Unless otherwise determined by the Board, the Plan shall be unfunded and shall not create (or be construed to create) a trust or a separate fund or funds. The Plan shall not establish any fiduciary relationship between the Company and any Participant or other person. To the extent any person holds any rights by virtue of a grant awarded under the Plan, such right (unless otherwise determined by the Board) shall be no greater than the right of an unsecured general creditor of the Company.

15. General Restriction

Each award shall be subject to the requirement that, if at any time the Board shall determine, in its sole discretion, that the listing, registration or qualification of any Award under the Plan upon any securities exchange or under any state or federal law, or the consent or approval of any government regulatory body, is necessary or desirable as a condition of, or in connection with, the granting of such Award or the exercise settlement thereof, such Award may not be granted, exercised or settled in whole or in part unless such listing, registration, qualification, consent or approval shall have been effected or obtained free of any conditions not acceptable to the Board.

16. Governing Law

The validity, construction and effect of the Plan and any actions taken or relating to the Plan shall be determined in accordance with the laws of the state of New York and applicable Federal law.

17. Successors and Assigns

The Plan shall be binding on all successors and permitted assigns of a Participant, including, without limitation, the estate of such Participant and the executor, administrator or trustee of such estate, or any receiver or trustee in bankruptcy or representative of such Participant's creditors.

18. Rights as a Shareholder

A Participant shall have no rights as a shareholder until he or she becomes the holder of record of Common Stock.

19. Change in Control

Notwithstanding anything to the contrary in the Plan, the following shall apply to all awards granted and outstanding under the Plan:

A. Definitions

The following definitions shall apply to this Section 22:

A "Change in Control", unless otherwise defined by the Board, shall be deemed to have occurred if (a) any "person", as such term is used in Section 13(d) and 14(d) of the 1934 Act, other than (1) the Company, (2) any trustee or other fiduciary holding securities under an employee benefit plan of the Company, (3) any company owned, directly or indirectly, by the shareholders of the Company in substantially the same proportions as their ownership of stock of the Company, or (4) any person who becomes a "beneficial owner" (as defined below) in connection with a transaction described in clause (1) of subparagraph (c) below, is or becomes the "beneficial owner" (as defined in Rule 13d-3 under the 1934 Act), directly or indirectly, of securities of the Company (not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 20 percent or more of the combined voting power of the Company's then outstanding voting securities; (b) the following individuals cease for any reason to constitute a majority of the directors then serving; individuals who on May 20, 2004 constitute the Board and any new director (other than a director whose initial assumption of office is in connection with an actual or threatened election contest, including but not limited to a consent solicitation, relating to the election of directors of the Company) whose appointment or election by the Board or nomination for election by the Company's shareholders was approved or recommended by a vote of at least two-thirds of the directors then still in office who were directors on May 20, 2004, or whose appointment, election or nomination for election was previously so approved or recommended; (c) there is consummated a merger or consolidation of the Company or any direct or indirect subsidiary of the Company with any other corporation, other than (1) a merger

or consolidation which results in the directors of the Company immediately prior to such merger or consolidation continuing to constitute at least a majority of the board of directors of the Company, the surviving entity or any parent thereof or (2) a merger or consolidation effected to

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implement a recapitalization of the Company (or similar transaction) in which no person is or becomes the beneficial owner, directly or indirectly, of securities of the Company (not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 20% or more of the combined voting power of the Company's then outstanding securities; or (d) the shareholders of the Company approve a plan of complete liquidation or dissolution of the Company or there is consummated an agreement for the sale or disposition by the Company of all or substantially all of the Company's assets, other than a sale or disposition by the Company of all or substantially all of the Company's assets to an entity, at least 50% of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the Company immediately prior to such sale.

CIC Price shall mean the higher of (a) the highest price paid for a share of the Company's Common Stock in the transaction or series of transactions pursuant to which a Change in Control of the Company shall have occurred, or (b) the highest price paid for a share of the Company's Common Stock during the 60 day period immediately preceding the date upon which the event constituting a Change in Control shall have occurred as reported in The Wall Street Journal in the New York Stock Exchange Composite Transactions or similar successor consolidated transactions report.

B. Acceleration of Vesting and Payment of Stock Options, SARs, DSUs and Dividend Equivalents

Upon the occurrence of an event constituting a Change in Control, all stock options and SARs (to the extent the CIC Price exceeds the exercise price), DSUs and dividend equivalents outstanding on such date shall become 100% vested and shall be paid in cash as soon as may be practicable. Upon such payment, such awards and any related stock options shall be cancelled.

The amount of cash to be paid shall be determined (i) in the case of stock options by multiplying the number of stock options by the difference between the exercise price and the CIC Price, (ii) in the case of DSUs by multiplying the number of DSUs by the CIC Price and (iii) in the case of SARs, the difference between the exercise price of the related option per share and the CIC Price.

C. Notwithstanding the foregoing, any stock option and SARs held by a director subject to Section 16 of the Securities Exchange Act of 1934, as amended (1934 Act), which have been outstanding less than six months (or such other period as may be required by the 1934 Act) upon the occurrence of an event constituting a Change in Control shall not be paid in cash until the expiration of such period, if any, as shall be required pursuant to such Section, and the amount to be paid shall be determined by multiplying the number of SARs, stock options, or unexercised shares under such stock options, as the case may be, by the CIC Price determined as though the event constituting the Change in Control had occurred on the first day following the end of such period.

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THE DOCUMENT COMPANY

C/O EQUISERVE TRUST COMPANY N.A.

P.O. BOX 8694

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Your vote is important. Please vote immediately.

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<http://www.eproxyvote.com/xrx>

Call toll-free
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(1-877-779-8683)

If you vote over the Internet or by telephone, please do not mail your card.

DETACH HERE IF YOU ARE RETURNING YOUR PROXY CARD BY MAIL

X

Please mark
votes as in
this example.

2980

Unless marked otherwise, this voting instruction and proxy card will be voted FOR Proposals 1, 2, 3 and 4.

The Board of Directors recommends a vote FOR proposals 1, 2, 3 and 4.

1. Election of Directors nominated by the Board.

(01) Glenn A. Britt, (02) Richard J. Harrington, (03)
William Curt Hunter, (04) Vernon E. Jordan, Jr.,
(05) Hilmar Kopper, (06) Ralph S. Larsen, (07)
Anne M. Mulcahy, (08) N.J. Nicholas, Jr., (09)
John E. Pepper, (10) Ann N. Reese, and (11)
Stephen Robert

FOR AGAINST ABSTAIN

2. Ratification
of
Auditors.

£

£

£

3. Adopt the 2004
Performance
Incentive Plan.

FOR AGAINST ABSTAIN

£

£

£

FOR
ALL
NOMINEES

£

£

WITHHELD
AUTHORITY
FROM ALL
NOMINEES

4. Adopt the 2004
Equity Compensation
Plan for Non-
Employee Directors

£

£

£

For all nominees, except vote withheld as noted
above

MARK BOX AT RIGHT IF YOU PLAN TO ATTEND THE ANNUAL MEETING.
A TICKET WILL BE SENT TO YOU.

£

MARK BOX AT RIGHT FOR AN ADDRESS CHANGE AND NOTE
AT LOWER LEFT.

£

Please sign below exactly as name appears hereon. Joint owners should each sign. When signing as attorney, executor, administrator, trustee or guardian, please give full title as such. If signing in the name of a corporation or partnership, please sign full corporate or partnership name and indicate title of authorized signatory.

Signature: _____ Date: _____ Signature: _____ Date: _____

**XEROX CORPORATION
ELECTION TO OBTAIN PROXY MATERIALS
ELECTRONICALLY INSTEAD OF BY MAIL**

Xerox Corporation shareholders may elect to receive the Company's future annual reports and proxy statements and to vote their shares through the Internet instead of receiving copies through the mail. Xerox is offering this service to provide added convenience to its shareholders and to reduce annual report printing and mailing costs.

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To take advantage of this option, shareholders must subscribe to one of the various commercial services that offer access to the Internet World Wide Web. Costs normally associated with electronic access, such as usage and telephone charges, will be borne by the shareholder.

To elect this option, go to website <http://www.econsent.com/xrx>. Shareholders who elect this option will be notified each year by e-mail how to access the proxy materials and how to vote their shares on the Internet.

If you consent to receive the Company's future proxy materials electronically, your consent will remain in effect unless it is withdrawn by revoking your consent at www.econsent.com/xrx. Also, if while this consent is in effect you decide you would like to receive a hard copy of the proxy materials, you may call, write or e-mail our Transfer Agent, at: 1-800-828-6396; P.O. Box 43010, Providence, RI 02940-3010; <http://www.equiserve.com>.

YOU MAY ACCESS THE XEROX CORPORATION ANNUAL REPORT AND PROXY STATEMENT AT:
<http://www.xerox.com/investor>

IF YOU VOTE BY PHONE OR INTERNET, PLEASE DO NOT MAIL BACK YOUR PROXY CARD. DETACH HERE IF MAILING.

VOTING INSTRUCTION AND PROXY CARD

XEROX CORPORATION

**ANNUAL MEETING OF SHAREHOLDERS
10:00 A.M. THURSDAY, MAY 20, 2004
PARK HYATT PHILADELPHIA AT THE BELLEVUE
BROAD AND WALNUT STREETS
PHILADELPHIA, PENNSYLVANIA**

**THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS
FROM SHAREHOLDERS OF COMMON STOCK**

The undersigned appoints VERNON E. JORDAN, JR., HILMAR KOPPER and ANNE M. MULCAHY and each of them (or if more than one are present, a majority of those present), as proxies for the undersigned, with full power of substitution, to represent the undersigned and to vote the shares of Common Stock of the Company which the undersigned is entitled to vote at the above annual meeting and at all adjournments thereof, (a) in accordance with the following ballot, and (b) in accordance with their best judgment in connection with such other business as may come before the meeting.

NOTICE TO PARTICIPANTS IN THE EMPLOYEE STOCK OWNERSHIP PLAN

This card also constitutes voting instructions for participants in the Xerox Corporation Employee Stock Ownership Plan. A Participant who signs below hereby instructs State Street Bank & Trust Company, Trustee, to vote the shares of stock allocated to his or her Stock Account and a proportion of the shares held in the ESOP Trust for which no instructions have been received in accordance with the following direction.

**SEE REVERSE
SIDE**

IMPORTANT - TO BE SIGNED AND DATED ON REVERSE SIDE

**SEE REVERSE
SIDE**

