FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filing Date: **2011-05-13** | Period of Report: **2011-04-03**
SEC Accession No. 0001193125-11-139663

FILER

DRUGSTORE COM INC
CIK:**1086467**| IRS No.: **043416255** | State of Incorp.:**DE** | Fiscal Year End: **1231**
Type: **10-Q** | Act: **34** | File No.: **000-26137** | Film No.: **11841863**
SIC: **5912** Drug stores and proprietary stores

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended April 3, 2011

or

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

For the transition period from to

Commission File Number 000-26137

drugstore.com, inc.

(Exact name of registrant as specified in its charter)

Delaware	**04-3416255**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

411 108th Avenue NE, Suite 1400, Bellevue, Washington 98004

(Address of principal executive offices including zip code)

(425) 372-3200

(Registrant' s telephone number, including area code)

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 preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐.

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	☐	Accelerated filer	☒
Non-accelerated filer	☐	Smaller reporting company	☐

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 May 6, 2011, the registrant had 106,873,567 shares of common stock outstanding.

DRUGSTORE.COM, INC.

FORM 10-Q

For the three months ended April 3, 2011

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PART I–FINANCIAL INFORMATION

Item 1. Financial Statements

DRUGSTORE.COM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except share and per share data)
(unaudited)

	Three Months Ended	
	April 3, 2011	April 4, 2010
Net sales	$128,439	$110,933
Costs and expenses:		
Cost of sales	92,322	77,753
Fulfillment and order processing	13,263	11,975
Marketing and sales	12,785	10,907
Technology and content	6,949	6,608
General and administrative	6,870	6,743
Total costs and expenses	132,189	113,986
Operating loss	(3,750)	(3,053)
Interest expense, net	(153)	(63)
Loss from continuing operations	(3,903)	(3,116)
Gain from discontinued operations, net of tax	720	500
Net loss	$(3,183)	$(2,616)
Basic and diluted loss from continuing operations per share	$(0.04)	$(0.03)
Basic and diluted gain from discontinued operations per share	0.01	0.00
Basic and diluted net loss per share	$(0.03)	$(0.03)
Weighted average shares outstanding	105,172,829	102,605,614

See accompanying notes to consolidated financial statements.

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DRUGSTORE.COM, INC.

CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	April 3, 2011 (unaudited)	January 2, 2011
Assets		
Current assets:		
Cash and cash equivalents	$24,730	$20,437
Marketable securities	10,986	13,094
Accounts receivable, net of allowances	12,685	13,916
Inventories	41,585	48,977
Other current assets	4,088	3,701
Assets of discontinued operations	3,260	2,440
Total current assets	97,334	102,565
Fixed assets, net	29,028	25,181
Other intangible assets, net	14,421	14,503
Goodwill	57,598	57,593
Other long-term assets	159	530
Total assets	$198,540	$200,372
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$43,901	$49,540
Accrued compensation	5,292	3,433
Accrued marketing expenses	3,547	4,108
Other current liabilities	2,373	2,397
Current portion of long-term debt obligations	250	581
Total current liabilities	55,363	60,059
Long-term debt obligations, less current portion	16,983	13,985
Deferred income taxes	4,085	4,079
Other long-term liabilities	939	920
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $.0001 par value, 10,000,000 shares authorized, no shares issued and outstanding	–	–
Common stock, $.0001 par value, stated at amounts paid in: 250,000,000 shares authorized, 107,002,667 and 106,108,096 shares issued, and 106,675,858 and 105,897,847 shares outstanding	899,866	896,378
Treasury stock, at cost, 326,809 and 210,249 shares	(792)	(344)
Accumulated other comprehensive income	60	76
Accumulated deficit	(777,964)	(774,781)
Total stockholders' equity	121,170	121,329
Total liabilities and stockholders' equity	$198,540	$200,372

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three Months Ended	
	April 3, 2011	April 4, 2010
Operating Activities:		
Net loss	$(3,183)	$(2,616)
Less gain from discontinued operations, net of tax	720	500
Loss from continuing operations	(3,903)	(3,116)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation	3,018	3,204
Amortization of intangible assets	132	48
Stock-based compensation	1,765	1,827
Other	(50)	7
Changes in, net of acquisitions:		
Accounts receivable	1,231	2,487
Inventories	7,392	3,500
Other assets	(554)	(1,032)
Accounts payable, accrued expenses and other liabilities	(4,624)	(4,982)
Net cash provided by continuing operations	4,407	1,943
Net cash provided by (used in) discontinued operations	(372)	1,052
Net cash provided by operating activities	4,035	2,995
Investing Activities:		
Purchases of marketable securities	(1,290)	(2,256)
Sales and maturities of marketable securities	3,403	4,385
Purchases of fixed assets	(6,613)	(1,973)
Purchase of Salu, less cash acquired	–	(18,069)
Purchase of intangible assets	–	(29)
Net cash used in continuing investing activities	(4,500)	(17,942)
Net cash used in discontinued investing activities	–	(366)
Net cash used in investing activities	(4,500)	(18,308)
Financing Activities:		
Proceeds from exercise of stock options	2,001	322
Borrowings from line of credit	3,500	10,000
Purchase of treasury stock	(295)	–
Principal payments on debt obligations	(448)	(83)
Net cash provided by financing activities	4,758	10,239
Net increase (decrease) in cash and cash equivalents	4,293	(5,074)
Cash and cash equivalents at beginning of period	20,437	22,175
Cash and cash equivalents at end of period	$24,730	$17,101
Supplemental Cash Flow Information:		
Common stock issued for purchase of Salu	$–	$17,362
Cash paid during the period for interest	$171	$103

See accompanying notes to consolidated financial statements.

DRUGSTORE.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Description of the Business

drugstore.com, inc. is a leading online retailer of health, beauty, clinical skincare, and vision products. We provide a convenient, private, and informative shopping experience while offering a wide assortment of products through our web stores located on the Internet as follows:

Health, Beauty & Pharmacy	OTC Partnerships
www.drugstore.com	www.medcohealthstore.com
www.Beauty.com	www.riteaidonlinestore.com
www.SkinStore.com	www.spalook.com
www.DrWeilVitaminAdvisor.com	

Microsites	Vision and Vision Partnerships
www.thenaturalstore.com	www.VisionDirect.com
www.athisbest.com	www.LensMart.com
www.sexualwellbeing.com	www.Lensworld.com
www.allergysuperstore.com	www.LensQuest.com
www.vitaminemporium.com	www.pearlevisioncontacts.com (1)
	www.lenscrafterscontacts.com (1)
	www.searsopticalcontacts.com (1)

(1) In the first quarter of 2011, we launched three branded sites for Luxottica Group, S.p.A. (Luxottica), a global leader in the design, manufacturing and distribution of fashion, luxury, and sport eyewear.

On March 23, 2011, we entered into an agreement and plan of Merger with Walgreen Co. (Walgreens) and Dover Subsidiary, Inc., a wholly-owned subsidiary of Walgreens, pursuant to which Dover Subsidiary, Inc. will merge with and into drugstore.com with drugstore.com surviving as a wholly-owned subsidiary of Walgreens. The consummation of the merger is subject to customary conditions, including approval of the transaction by drugstore.com' s stockholders and is expected to close by the end of June 2011 (see note 5).

2. Basis of Presentation and Principles of Consolidation

We have prepared the accompanying consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) and the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial reporting. These consolidated financial statements are unaudited but, in our opinion, include all adjustments, consisting of normal recurring adjustments and accruals, necessary for a fair presentation of the consolidated balance sheets, statements of operations, and statements of cash flows for the periods presented. Operating results for the periods presented are not necessarily indicative of future results for the 2011 fiscal year ending January 1, 2012 or any other interim period, due to seasonal and other factors. We have derived the consolidated balance sheet as of January 2, 2011 from audited financial statements as of that date, but we have excluded certain information and footnotes required by GAAP for complete financial statements. You should read these consolidated financial statements in conjunction with the audited consolidated financial statements and accompanying notes included in our annual report on Form 10-K for the fiscal year ended January 2, 2011.

The accompanying consolidated financial statements include those of drugstore.com, inc. and our subsidiaries. We have eliminated all material intercompany transactions and balances.

We operate using a 52/53-week retail calendar year, with each of the fiscal quarters in a 52-week fiscal year representing a 13-week period. Fiscal years 2011 and 2010 are 52-week years.

3. Significant Accounting Policies

Estimates and Assumptions

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts of assets and liabilities, revenues and expenses, and disclosure of contingent assets and liabilities at the date of the financial statements. These estimates include, but are not limited to, revenue recognition, inventories, goodwill and intangible assets, stock-based compensation, deferred taxes, and commitments and contingencies. Actual results could differ from our estimates, and these differences could be material.

Recently Issued Accounting Standards

From time to time, the Financial Accounting Standards Board (FASB) or other standard setting bodies issue new accounting pronouncements that we adopt as of the specified effective date. Unless otherwise discussed, our management believes that the impact of recently issued standards that are not yet effective will not have a material impact on our consolidated financial statements upon adoption.

4. Net Income (Loss) Per Share

We compute net income (loss) per share using the two-class method. We compute basic net income (loss) per share by dividing net income (loss) by the weighted-average number of shares outstanding during the applicable period, including outstanding participating securities when in a net income position. Participating securities include unvested restricted stock awards and restricted stock units, as holders of these securities are entitled to receive non-forfeitable dividends prior to vesting at the same rate as holders of our common stock. Because we had a net loss for the three month periods ended April 3, 2011 and April 4, 2010, none of the loss was allocated to the participating securities. In addition, 816,450 shares of common stock held in escrow in connection with the acquisition of Salu, Inc. (Salu) were also excluded from the computation of net income (loss) per share for the three month periods ended April 3, 2011 and April 4, 2010 as these shares were considered contingently issuable shares. We compute diluted earnings (loss) per share using the weighted-average number of shares determined for the basic net income (loss) per share computation plus the dilutive effect of common stock equivalents to the extent it does not create anti-dilution using the treasury stock method.

We excluded the following shares from the calculation of diluted net income (loss) per share because their inclusion would have been anti-dilutive:

	Three Months Ended	
	April 3, 2011	April 4, 2010
Stock options and stock appreciation rights	18,720,238	16,436,140
Non-vested restricted stock units	1,658,807	–
Non-vested restricted stock	1,263,991	1,768,620
Warrants	700,000	700,000
Contingently issuable shares	816,450	816,450
	23,159,486	19,721,210

5. Agreement and Plan of Merger

On March 23, 2011, drugstore.com, inc., a Delaware corporation, entered into an Agreement and Plan of Merger with Walgreen Co. (Walgreens), an Illinois corporation, and Dover Subsidiary, Inc., a Delaware corporation and wholly-owned subsidiary of Walgreens, pursuant to which Dover Subsidiary, Inc. will merge with and into drugstore.com with drugstore.com surviving as a wholly-owned subsidiary of Walgreens.

Pursuant to the terms and subject to the conditions of the merger agreement, at the effective time of the merger, each issued and outstanding share of common stock of drugstore.com, including all shares of restricted stock (whether or not vested), will be converted into the right to receive $3.80 in cash, without interest. In addition, outstanding and vested options and stock appreciation rights, in both cases that have exercise prices per share of less than $3.80, will be converted into the right to receive $3.80 in cash less the applicable exercise price, without interest. All other outstanding stock options and stock appreciation rights, and all unvested restricted stock units will be converted into options, stock appreciation rights and restricted stock units, as applicable, denominated in shares of Walgreens common stock based on formulas set forth in the merger agreement, with terms and conditions that are otherwise the same as those existing immediately prior to the consummation of the merger.

drugstore.com and Walgreens have agreed to customary representations, warranties and covenants in the merger agreement, including a “no-shop” provision prohibiting the solicitation of alternate transactions and a provision requiring drugstore.com’ s board of directors to recommend that its common stockholders adopt the merger agreement. These provisions are subject to a “fiduciary-out” exception that, under certain circumstances and prior to the time that drugstore.com receives stockholder approval for the merger, permits the drugstore.com board to provide information and participate in discussions and negotiations with respect to unsolicited alternative acquisition proposals that constitute or are reasonably expected to lead to a superior proposal.

In addition, drugstore.com has also agreed to operate its business in the ordinary course of business, consistent with past practice and the terms of certain interim operating covenants, pending consummation of the merger. The merger agreement also contains certain termination rights for both drugstore.com and Walgreens, including for drugstore.com to enter into an agreement with respect to a superior proposal if drugstore.com' s board of directors determines that the failure to do so would reasonably be expected to be inconsistent with its fiduciary duties to drugstore.com' s stockholders under applicable law. Upon termination of the merger agreement under certain circumstances, drugstore.com would be required to pay Walgreens a termination fee of approximately $15.0 million.

Consummation of the merger is subject to customary conditions, including approval of the transaction by drugstore.com' s stockholders. drugstore.com has called a special meeting of its stockholders on June 2, 2011 for purposes of approving the merger. The transaction is not subject to any financing condition. The waiting period under the U.S. Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (HSR Act), with respect to the proposed merger expired in May 2011. Accordingly, the merger closing condition with respect to the expiration or termination of the waiting period under the HSR Act has been satisfied. The boards of directors of each of drugstore.com and Walgreens have approved the merger and the merger agreement, and the parties anticipate that the merger will close by the end of June 2011.

In conjunction with the planned merger, we incurred transaction related expenses of $2.2 million during the first quarter of 2011 which are recorded in general and administrative expenses in our consolidated statements of operations.

6. Business Acquisition

On February 19, 2010, we acquired Salu for $19.4 million in cash (less approximately $1.9 million of Salu' s transaction expenses and the repayment of Salu' s outstanding debt obligation of $2.6 million paid out of the merger consideration) and 5,425,678 shares of drugstore.com common stock with a fair value of $17.3 million. Of this initial consideration, drugstore.com paid approximately $2.7 million in cash and 816,450 shares of our common stock into escrow to secure post-closing indemnification obligations of Salu' s stockholders. Additionally, certain employees of Salu are eligible to receive a performance incentive payment payable in cash over a two-year period commencing in fiscal year 2010 with an aggregate value of $2.5 million if the surviving entity achieves certain financial and other performance targets. On the acquisition date, we recorded a liability of $0.5 million which represented the fair value of the portion of the performance incentive payment that will be accounted for as additional consideration. During first quarter of 2011, we made incentive payments of approximately $0.4 million for achievement of certain 2010 targets. Any adjustments to the fair value of our initial estimate of the performance incentive payment may affect our consolidated statements of operations and could have a material impact on our financial results. In conjunction with the acquisition, we also paid $1.4 million in transaction fees in the first quarter of 2010, which are recorded in general and administrative expenses in the statements of operations.

7. Discontinued Operations

On July 30, 2010, we sold substantially all the assets of our mail-order pharmacy to BioScrip, Inc. (BioScrip) for a purchase price of $10.5 million, subject to adjustment for changes in gross profit of the business. Of this initial consideration, BioScrip paid $5.0 million in connection with closing, with $0.5 million accounting for the purchase of inventory and $4.5 million accounting for the purchase of other assets. BioScrip will pay the remaining $5.5 million of the initial consideration into escrow in installments over the 12 months following the closing. The final amount paid out of escrow will be determined after the 12-month period based on the profitability of the prescription pharmacy business during that period. We recognized $1.6 million of the contingent consideration in 2010 and $1.0 million during the first quarter of 2011. We will continue to earn all or a portion of the remaining consideration of $2.9 million over the remaining contract period in 2011. Additionally, the parties entered into a 5-year marketing agreement allowing drugstore.com pharmacy customers to continue to order as they always have through the drugstore.com web store. Under the agreement, 12 months following the closing of July 30, 2010, BioScrip will pay drugstore.com a fee to continue to market the drugstore.com pharmacy, which will be served by BioScrip. We consider the marketing service fees to be indirect cash inflows of our discontinued mail-order pharmacy segment, as the fees earned are not a significant source of ongoing future revenue.

We have classified the results of operations of our mail-order pharmacy segment as discontinued operations in the accompanying consolidated financial statements for all periods presented.

The following table summarizes the results of operations of our mail order pharmacy segment that we have classified as discontinued operations (in thousands).

	Three months ended	
	April 3, 2011	April 4, 2010
Net sales	$–	$7,395
Income (loss) from discontinued operations	(313)	500
Net gain from sale of mail-order pharmacy	1,033	–
Gain from discontinued operations, net of tax	$720	$500

8. Fair Value of Financial and Nonfinancial Instruments

GAAP has established a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

Level 1− Valuations based on quoted prices for identical assets and liabilities in active markets.

Level 2− Valuations based on observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, or inputs that are observable or can be corroborated by observable market data.

Level 3− Valuations based on observable inputs reflecting our own assumptions, consistent with reasonably available assumptions made by other market participants. These valuations require significant judgment.

The carrying value approximates the fair value for all financial instruments that we do not measure at fair value on the balance sheet, including accounts receivable and debt, due to the short-maturities of the instruments. We measure the fair value of money market funds based on quoted prices in active markets for identical assets. All other financial instruments measured at fair value were valued either based on recent trades of securities in inactive markets or based on quoted market prices of similar instruments and other significant inputs derived from or corroborated by observable market data.

Assets and liabilities measured at fair value consist of the following:

	April 3, 2011			
	Cost or Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses (1)	Total Fair Value
	(in thousands)			
Cash	$14,105	$ –	$ –	$14,105
Level 1 securities:				
Money market funds	7,025	–	–	7,025
Level 2 securities:				
Commercial paper	4,300	–	–	4,300
U.S. government agency obligations	8,741	3	–	8,744
Corporate notes and bonds (2)	1,541	1	–	1,542
Total cash, cash equivalents and marketable securities (3)	$35,712	$ 4	$ –	$35,716
Level 3 liabilities:				
Deferred acquisition payment				$70

	January 2, 2011			
	Cost or Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses (1)	Total Fair Value
	(in thousands)			
Cash	$11,973	$ –	$ –	$11,973
Level 1 securities:				
Money market funds	7,065	–	–	7,065
Level 2 securities:				
Commercial paper	2,727	–	–	2,727
U.S. government agency obligations	8,128	–	2	8,126
Corporate notes and bonds (2)	3,638	2	–	3,640
Total cash, cash equivalents and marketable securities	$33,531	$ 2	$ 2	$33,531
Level 3 liabilities:				
Deferred acquisition payment				$289

(1) As of April 3, 2011, there were no investments with loss positions and as of January 2, 2011 U.S. government agency obligations had unrealized losses totaling $2,000. We evaluated the nature of our investments, credit worthiness of the issuer, and the duration of any impairments to determine if an other-than-temporary decline in fair value had occurred.

(2) Corporate notes and bonds include investments in corporate institutions. No single issuer represents a significant portion of the total corporate notes and bonds portfolio.

(3) As of April 3, 2011, marketable securities including cash equivalents due within one year totaled $11.9 million and due one year through three years totaled $2.7 million.

9. Stockholders' Equity

Stock Compensation

We measure compensation cost for all stock-based awards at fair value on the date of grant and recognize it over the service period for awards expected to vest. We determined the fair value of stock options and stock appreciation rights based on the grant date fair value method using the Black-Scholes valuation model. We determined the fair value of restricted stock awards and units based on the number of shares granted and the quoted price of our common stock. We recognize such value as expense over the service period, net of estimated forfeitures, using the straight-line method. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, we will record such amounts as a cumulative adjustment in the period estimates are revised. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results and future estimates may differ substantially from our current estimates.

Stock Option and Stock Appreciation Rights Activity

The following table summarizes our stock option and stock appreciation rights (SARs) activity:

	Number of Shares	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Term
Outstanding at January 2, 2011	20,064,342	$ 2.86	
Options and SARs granted	–	$ –	
Options and SARs exercised	(743,393)	$ 2.95	
Options and SARs forfeited	(600,711)	$ 3.01	
Outstanding at April 3, 2011	18,720,238	$ 2.87	

Vested and expected to vest at April 3, 2011	16,600,122	$ 2.94	5.46
Exercisable at April 3, 2011	15,601,698	$ 2.96	5.27

Restricted Stock Awards Activity

The following table summarizes our restricted stock awards activity:

	Number of Shares	Weighted-Average Grant Date Fair Value
Outstanding at January 2, 2011	1,671,191	$ 1.26
Awards granted	–	$ –
Awards released	(394,752)	$ 1.13
Awards forfeited	(12,448)	$ 3.47
Outstanding at April 3, 2011	1,263,991	$ 1.28

Restricted Stock Units Activity

The following table summarizes our restricted stock units activity:

	Number of Shares	Weighted-Average Grant Date Fair Value
Outstanding at January 2, 2011	1,274,672	$ 2.19
Units granted	652,575	$ 1.85
Units vested	(226,660)	$ 2.13
Units forfeited	(41,780)	$ 2.00
Outstanding at April 3, 2011	1,658,807	$ 2.07

Stock-Based Compensation Expense

The following table summarizes stock-based compensation by operating function recorded in the Statements of Operations (in thousands):

	Three Months Ended	
	April 3, 2011	April 4, 2010
Fulfillment and order processing	$173	$98
Marketing and sales	434	319
Technology and content	253	205
General and administrative	905	1,205
Total	$1,765	$1,827

10. Line of Credit and Debt Obligations

In March 2011, we entered into a loan and security agreement with our existing bank, which includes a revolving three-year line of credit allowing for borrowings up to $40.0 million, which accrue interest, at the option of the borrower and dependent on achieving certain financial covenants, at LIBOR plus 2.5% - 3%, or prime plus 0% - 0.5%. This agreement replaced our two-year $25.0 million line of credit which matured in March 2011. As of April 3, 2011, $16.5 million was outstanding under the line of credit, which included the refinancing of $13.0 million under the prior line of credit, and $3.5 million of borrowings during the first quarter of 2011 related to equipment purchases to automate our New Jersey distribution center. The line of credit matures in March 2014. Availability under the line of credit is also reduced by a $541,000 letter of credit we provided to our corporate headquarters landlord. As of April 3, 2011, the available borrowings under the line of credit were approximately $23.0 million. Advances available under the revolving line of credit are limited, based on eligible inventory, accounts receivable, cash and investment balances, and balances outstanding under our line of credit. The agreement contains certain covenants that are customary in transactions of this nature, including a prohibition on other debt and liens, requirements regarding the payment of taxes, and certain restrictions on mergers and acquisitions, investments, and transactions with our affiliates, as well as certain financial covenants. The $2.2 million of transaction costs incurred in the first quarter of 2011 in connection with the merger agreement with Walgreens (see note 5) exceeded our allowable limit of one-time charges of $750,000 under the agreement. As a result, we failed our adjusted EBITDA (earnings before interest, taxes, depreciation, amortization, and adjusted for stock compensation) covenant in the first quarter of 2011, which failure the bank waived. The agreement also identifies certain events of default that are customary for transactions of this nature and subject to materiality provisions and grace periods where appropriate, including failure to pay any principal or interest under this facility or other instruments when due, the occurrence of a material adverse change, violations of any covenants, a material cross-default to our other debt, or a change of control. As of April 3, 2011, none of these events had occurred.

11. Commitments and Contingencies

Legal Proceedings

Litigation Related to the Merger. In March and April of 2011, seven putative class action lawsuits arising from the proposed acquisition of drugstore.com by Walgreen Co. (Walgreens) were filed in the Court of Chancery of the State of Delaware and the Superior Court of the State of Washington in King County, against drugstore.com, its directors, Walgreens, and Dover Subsidiary, Inc. (Merger Sub). The complaints purport to have been filed on behalf of all holders of drugstore.com common stock, and generally allege that the defendants either breached their fiduciary duties of care, loyalty, good faith, fair dealing, and full disclosure, or aided and abetted such breaches. drugstore.com, directors Dawn Lepore, Geoffrey R. Entress, Richard W. Bennet III, Jeffrey M. Killeen, William D. Savoy, and Gregory S. Stanger, and Walgreens, are named defendants in all of the complaints. Merger Sub is also named as a defendant in some of the complaints.

On April 15, 2011, defendants filed a motion to consolidate, stay, and proceed in one forum in the Washington actions. On April 15, 2011, defendants also filed a motion to proceed in one forum with the Court of Chancery in Delaware. On May 2, 2011, the Washington court entered an order consolidating the Washington actions, and referring the determination on the one forum issue to the judge assigned to the consolidated Washington actions.

On May 2, 2011, plaintiff Nicholas Hurlin filed an Amended Complaint for Breach of Fiduciary Duty (the Amended Complaint) in his Washington action. The Amended Complaint, similar to the prior Washington complaints, generally alleges that the directors breached their fiduciary duties of care, loyalty, good faith, fair dealing, and full disclosure. The Amended Complaint also contains new factual allegations concerning purported deficient disclosures and material omissions in drugstore.com's preliminary proxy filed on April 14, 2011. The Amended Complaint, similar to the prior complaints, also generally alleges that drugstore.com and Walgreens aided and abetted the directors' alleged breaches of fiduciary duties.

On May 2, 2011, plaintiffs in the Delaware actions filed a Verified Consolidated Amended Class Action Complaint (the Consolidated Amended Complaint). The Consolidated Amended Complaint, similar to the prior Delaware complaints, generally alleges that the directors breached their fiduciary duties of care, loyalty, good faith, fair dealing, and full disclosure. The Consolidated Amended Complaint also contains new factual allegations concerning purported deficient disclosures and material omissions in drugstore.com's definitive proxy filed on April 29, 2011. The Consolidated Amended Complaint also alleges that all defendants aided and abetted the directors' alleged breaches of fiduciary duties.

The relief generally sought by plaintiffs in all actions is, among other things, declaratory and injunctive relief, including an injunction of the merger and that the merger be declared unlawful and unenforceable, a rescission of the merger, to the extent it has already been consummated, and awarding plaintiffs costs, including attorneys' fees and experts' fees. The Delaware Consolidated Amended Complaint also seeks an unspecified amount of compensatory and "rescissory" damages.

On May 3, 2011, the Delaware court entered an order consolidating the Delaware actions, appointing lead plaintiffs and lead counsel for plaintiffs, and designating the Consolidated Amended Complaint as the operative complaint in the consolidated actions. Also on May 3, 2011, lead plaintiffs in the Delaware consolidated actions moved to expedite discovery on the basis that such discovery is needed to seek a preliminary injunction. On May 11, 2011, the Delaware Court conducted a status conference with the parties, at which the Court tentatively set a hearing on plaintiffs' anticipated motion for a preliminary injunction for May 31, 2011. The parties are conferring on an appropriate schedule concerning discovery and briefing and intend to submit a stipulated proposed order to Delaware Court.

On May 4, 2011, plaintiff Hurlin moved to expedite discovery in the consolidated Washington actions on the basis that such discovery is needed to seek a preliminary injunction. On May 12, 2011, the Washington Court held a hearing on defendants' s motion to proceed in one forum and plaintiff Hurlin' s motion to expedite discovery. At the hearing, the parties mutually agreed to allow the Washington plaintiffs to be included in discovery related to the Delaware consolidated actions, including the production of documents and attendance at proposed depositions.

Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of this matter. We are unable to estimate the potential damages that might be awarded if the lawsuit is successful and we were found liable, there arose a material limitation with respect to our insurance coverage, or the amount awarded were to exceed our insurance coverage. Because our liability, if any, cannot be reasonably estimated, no amounts have been accrued for this matter. An adverse outcome in this matter could have a material adverse effect on our financial position and results of operations.

Class Action Laddering Litigation. A consolidated amended complaint, which is now the operative complaint, was filed on April 19, 2002 in the U.S. District Court for the Southern District of New York. It names drugstore.com as a defendant, along with the underwriters and certain of our present and former officers and directors (the Individual Defendants), in connection with our July 27, 1999 initial public offering and March 15, 2000 secondary offering (together, the Offerings). The suit purports to be a class action filed on behalf of purchasers of our common stock during the period July 28, 1999 to December 6, 2000.

In general, the complaint alleges that the prospectuses through which we conducted the Offerings were materially false and misleading because they failed to disclose, among other things, that (i) the underwriters of the Offerings allegedly had solicited and received excessive and undisclosed commissions from certain investors in exchange for which the underwriters allocated to those investors' material portions of the restricted number of shares issued in connection with the Offerings and (ii) the underwriters allegedly entered into agreements with customers whereby the underwriters agreed to allocate drugstore.com shares to customers in the Offerings in exchange for which customers agreed to purchase additional drugstore.com shares in the after-market at predetermined prices. The complaint asserts violations of various sections of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended. The action seeks damages in an unspecified amount and other relief. The action is being coordinated with approximately 300 other nearly identical actions filed against other companies or their present and former officers and directors.

On October 9, 2002, the District Court dismissed the Individual Defendants from the case without prejudice. On December 5, 2006, the U.S. Court of Appeals for the Second Circuit vacated a decision by the District Court granting class certification in six of the coordinated cases, which are intended to serve as test, or "focus," cases. The plaintiffs selected these six cases, which do not include us. On April 6, 2007, the Second Circuit denied a petition for rehearing filed by plaintiffs, but noted that plaintiffs could ask the District Court to certify more narrow classes than those that were rejected.

The parties in the approximately 300 coordinated cases, including the parties in drugstore.com' s case, reached a settlement. The insurers for the issuer defendants in the coordinated cases will make the settlement payment on behalf of the issuers, including drugstore.com. The District Court approved the settlement on October 5, 2009. Appeals of the settlement approval are proceeding before the United States Court of Appeals for the Second Circuit. Plaintiffs have moved to dismiss the appeals.

Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of this matter. We are unable to estimate the potential damages that might be awarded if the appeal is successful and we were found liable, there arose a material limitation with respect to our insurance coverage, or the amount awarded were to exceed our insurance coverage. Because our liability, if any, cannot be reasonably estimated, no amounts have been accrued for this matter. An adverse outcome in this matter could have a material adverse effect on our financial position and results of operations.

Other. From time to time, we are subject to other legal proceedings and claims in the ordinary course of business. We are not currently aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse effect on our business prospects, financial condition, or operating results, other than those listed above.

12. Segment Information

We have two reporting segments: over-the-counter (OTC) and vision. The OTC segment is comprised of the sales and related costs of selling all non-prescription health, beauty, personal care, household, and other products. Our vision segment is comprised of sales and the related costs of selling contact lenses and other contact lens supplies. We operate and evaluate our business segments based on contribution margin results. We define contribution margin as net sales attributable to a segment, less the direct cost of these sales and the incremental (variable) costs of fulfilling, processing, and delivering the order (labor, packaging supplies, and credit card fees that are variable based on sales volume). In the second quarter of 2010, our chief operating decision makers modified our definition of variable order costs to exclude partnership-related royalty costs, which are variable in nature, but are considered more of a marketing cost since we consider our partnerships a marketing channel. We have restated prior periods to reflect this change in the definition of contribution margin. The information presented below for these segments is the information our management uses in evaluating operating performance.

	Three Months Ended	
	April 3, 2011	April 4, 2010
	(in thousands)	
OTC:		
Net sales	$107,466	$92,992
Cost of sales	76,487	63,640
Variable order costs (a)	9,180	7,981
Contribution margin	$21,799	$21,371
Vision:		
Net sales	$20,973	$17,941
Cost of sales	15,835	14,113
Variable order costs (a)	981	821
Contribution margin	$4,157	$3,007
Consolidated:		
Net sales	$128,439	$110,933
Cost of sales	92,322	77,753
Variable order costs (a)	10,161	8,802
Consolidated contribution margin	$25,956	$24,378
Less:		
Fixed fulfillment and order processing (b)	$3,102	$3,173
Marketing and sales	12,785	10,907
Technology and content	6,949	6,608
General and administrative	6,870	6,743
Operating loss	$(3,750)	$(3,053)

(a) These amounts include all variable costs of fulfillment and order processing, including labor, packaging supplies, and those credit card fees that are variable based on sales volume. These amounts exclude depreciation, stock-based compensation, and fixed overhead costs. As we previously reported in the first quarter of 2010, we excluded partnership-related royalty costs of $660,000 from the three-month period ended April 4, 2010, as a result of the change in our definition of variable costs to exclude such marketing-related costs from contribution margin.

(b) These amounts include all fixed costs of fulfillment and order processing that are not discernable by business segment.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion and analysis in conjunction with the financial statements and accompanying notes included elsewhere in this quarterly report and in our annual report on Form 10-K for the fiscal year ended January 2, 2011.

Special Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 based on our expectations, estimates and projections as of the date of this filing. Actual results may differ materially from those expressed in forward-looking statements. All statements made in this quarterly report other than statements of historical fact, including statements regarding our future financial and operational performance, sources of liquidity and future liquidity needs, are forward-looking, including statements regarding:

- our beliefs regarding the impact of recently issued standards that are not yet effective will have on our consolidated financial statements upon adoption;
- the potential of any legal proceedings or claims to have, individually or in the aggregate, a material adverse effect on our business prospects, financial condition, or operating results;
- the affects of leveraging our capabilities in Internet marketing, merchandising, fulfillment, and customer care in the health, beauty, and wellness arena, including through our strategic partnerships and our microsite strategy, on future growth in our OTC segment;
- our beliefs regarding the adequacy of our liquidity in light of our operations and anticipated capital expenditures;
- our expectation that we will continue to evaluate and consider a wide array of potential strategic partnerships as part of our growth strategy;
- the future impact of, or the parties' performance under, our agreements with our strategic partners;
- our expectations regarding our continued marketing and merchandising strategies, including the expansion of our product offerings and the continuation of our shipping or other promotions;
- our expectations and assumptions underlying our valuation of our equity awards;
- the future launch of new or improved technology or additional websites, including for our strategic partners and in conjunction with our microsite strategy; and
- the consummation and subsequent impact of the proposed merger with Walgreen Co. (Walgreens).

Forward-looking statements are based on current expectations, and are not guarantees of future performance and involve assumptions, risks, and uncertainties. Actual performance may differ materially from those contained or implied in such forward-looking statements. Risks and uncertainties that could cause our actual results to differ significantly from management's expectations are discussed in the sections entitled *"Risk Factors"* in Part II, Item 1A of this quarterly report and Part I, Item 1A of our annual report on Form 10-K for the fiscal year ended January 2, 2011. You should not rely on a forward-looking statement as representing our views as of any date other than the date on which we made the statement. We expressly disclaim any intent or obligation to update any forward-looking statement after the date on which we make it.

Overview

drugstore.com, inc. is a leading online retailer of health, beauty, clinical skincare, and vision products. We provide a convenient, private, and informative shopping experience while offering a wide assortment of products through our web stores located on the Internet as follows:

Health, Beauty & Pharmacy	OTC Partnerships
www.drugstore.com	www.medcohealthstore.com
www.Beauty.com	www.riteaidonlinestore.com
www.SkinStore.com	www.spalook.com
www.DrWeilVitaminAdvisor.com	

Microsites	Vision and Vision Partnerships
www.thenaturalstore.com	www.VisionDirect.com
www.athisbest.com	www.LensMart.com
www.sexualwellbeing.com	www.Lensworld.com
www.allergysuperstore.com	www.LensQuest.com
www.vitaminemporium.com	www.pearlevisioncontacts.com (1)
	www.lenscrafterscontacts.com (1)
	www.searsopticalcontacts.com (1)

(1) In the first quarter of 2011, we launched three sites under our partnership with Luxottica Group, S.p.A. (Luxottica), a global leader in the design, manufacturing and distribution of fashion, luxury, and sport eyewear.

Business Segments; Growth Strategies. We operate our business in two business segments: over-the-counter or OTC and vision.

OTC. Our OTC segment includes all non-prescription products sold online through our health and beauty web stores, microsites, and our partnership web stores. We source our OTC products from various manufacturers and distributors. We also sell advertising on our primary OTC site *www.drugstore.com*. Our business strategy is to offer our customers a wide selection of health, beauty, and wellness products at competitive prices and provide a superior online shopping experience. We are able to offer a significantly broader assortment of products, with greater depth in each product category, than brick-and-mortar drugstores and provide a broad array of interactive tools and information on our websites to help consumers make informed purchasing decisions. Key drivers of our growth strategy for our OTC segment include expanding into new marketing channels and enhanced use of mobile and social media, continued ramp up of microsites, growth in partnerships, international expansion, and overall increased customer conversion from site improvements and enhancements. We will continue to enter into new marketing channels, such as Buy.com, which we launched in the fourth quarter of 2010, and ShopRunner.com and eBay.com, which we launched in the first quarter of 2011. In addition, we will continue to make investments in social media advertising and increasing our fan following population. In the first quarter of 2011, we launched new device agnostic mobile stores and plan on launching a variety of applications, or apps, in 2011. We expect continued growth from our microsites, both from the five microsites we have launched to date as well as additional microsites we plan to launch in 2011. Microsites allow us to better target specific customers with tailored marketing programs, by offering a larger assortment of niche specific SKUs and product content. We anticipate continued growth from our partnerships with Medco CHP, L.L.C. (Medco) and Rite Aid Corporation (Rite Aid) as they continue to attract new customers to the websites and generate more orders from site visitors. Finally, we plan to make improvements to site navigation and look and feel of our sites to improve customer conversion. With these initiatives, we will continue to capitalize on our leadership position in health and beauty online, and continue to expand our categories and employ our strategy of being the "when, where, and how" of health, beauty, and wellness.

Vision. Our vision segment includes contact lenses and eye accessories sold through our vision web stores. We purchase our contact lens inventory directly from various manufacturers and other distributors. We have a strategic multi-year e-commerce partnership with Luxottica, a global leader in the design, manufacturing and distribution of fashion, luxury, and sport eyewear. Through this partnership, we will develop branded contact lens e-commerce sites for Luxottica' s North American businesses such as LensCrafters, Pearle Vision, and Sears Optical. In the first quarter of 2011, we launched three Luxottica branded sites, *www.lenscrafterscontacts.com,* *www.pearlevisioncontacts.com*, and *www.searsopticalcontacts.com*. In 2011, we plan to continue to drive new customer growth through promotional offers on our owned vision sites and launch one remaining Luxottica branded site.

Agreement and Plan of Merger. On March 23, 2011, drugstore.com entered into an Agreement and Plan of Merger with Walgreen Co., an Illinois corporation (Walgreens), and Dover Subsidiary, Inc., a Delaware corporation and wholly-owned subsidiary of Walgreens, pursuant to which Dover Subsidiary, Inc. will merge with and into drugstore.com with drugstore.com surviving as a wholly-owned subsidiary of Walgreens. Pursuant to the terms and subject to the conditions of the merger agreement, at the effective time of the merger, each issued and outstanding share of common stock of drugstore.com, including all shares of restricted stock (whether or not vested), will be converted into the right to receive $3.80 in cash, without interest. In addition, outstanding and vested options and stock appreciation rights, in both cases that have exercise prices per share of less than $3.80, will be converted into the right to receive $3.80 in cash less the applicable exercise price, without interest. All other outstanding stock options and stock appreciation rights, and all unvested restricted stock units will be converted into options, stock appreciation rights and restricted stock units, as applicable, denominated in shares of Walgreens common stock based on formulas set forth in the merger agreement, with terms and conditions that are otherwise the same as those existing immediately prior to the consummation of the merger.

In addition, drugstore.com has also agreed to operate its business in the ordinary course of business, consistent with past practice and the terms of certain interim operating covenants, pending consummation of the merger. The merger agreement also contains certain termination rights for both drugstore.com and Walgreens, including for drugstore.com to enter into an agreement with respect to a superior proposal if drugstore.com' s board of directors determines that the failure to do so would reasonably be expected to be inconsistent with its fiduciary duties to drugstore.com' s stockholders under applicable law. Upon termination of the merger agreement under certain circumstances, drugstore.com would be required to pay Walgreens a termination fee of approximately $15.0 million.

Consummation of the merger is subject to customary conditions, including approval of the transaction by drugstore.com' s stockholders. drugstore.com has called a special meeting of its stockholders on June 2, 2011 for purposes of approving the merger. The transaction is not subject to any financing condition. The waiting period under the U.S. Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (HSR Act), with respect to the proposed merger expired in May 2011. Accordingly, the merger closing condition with respect to the expiration or termination of the waiting period under the HSR Act has been satisfied. The boards of directors of each of drugstore.com and Walgreens have approved the merger and the merger agreement, and the parties anticipate that the merger will close by the end of June 2011. In conjunction with the planned merger, we incurred transaction related expenses of $2.2 million during the first quarter of 2011 which are recorded in general and administrative expenses in our consolidated statements of operations.

Business Acquisition. On February 19, 2010, we acquired Salu for $19.4 million in cash (less approximately $1.9 million of Salu' s transaction expenses and the repayment of Salu' s outstanding debt obligation of $2.6 million paid out of the merger consideration) and 5,425,678 shares of drugstore.com common stock with a fair value of $17.3 million. Of this initial consideration, drugstore.com paid approximately $2.7 million in cash and 816,450 shares of our common stock into escrow to secure post-closing indemnification obligations of Salu' s stockholders. Additionally, certain employees of Salu are eligible to receive a performance incentive payment payable in cash over a two-year period commencing in fiscal year 2010 with an aggregate value of $2.5 million if the surviving entity achieves certain financial and other performance targets. On the acquisition date, we recorded a liability of $0.5 million which represented the fair value of the portion of the performance incentive payment that will be accounted for as additional consideration. During first quarter of 2011, we made incentive payments of approximately $0.4 million for achievement of certain 2010 targets. Any adjustments to the fair value of our initial estimate of the performance incentive payment may affect our consolidated statements of operations and could have a material impact on our financial results. In conjunction with the acquisition, we also paid $1.4 million in transaction fees in the first quarter of 2010, which are recorded in general and administrative expenses in the statements of operations.

Discontinued Operations. On July 30, 2010, we sold substantially all the assets of our mail-order pharmacy to BioScrip, Inc. (BioScrip) for a purchase price of $10.5 million, subject to adjustment for changes in gross profit of the business. Of this initial consideration, BioScrip paid $5.0 million in connection with closing, with $0.5 million accounting for the purchase of inventory and $4.5 million accounting for the purchase of other assets. BioScrip will pay the remaining $5.5 million of the initial consideration into escrow in installments over the 12 months following the closing. The final amount paid out of escrow will be determined after the 12-month period based on the profitability of the prescription pharmacy business during that period. We recognized $1.6 million of the contingent consideration in 2010 and $1.0 million during the first quarter of 2011. We will continue to earn all or a portion of the remaining consideration of $2.9 million over the remaining contract period in 2011. Additionally, the parties entered into a 5-year marketing agreement allowing drugstore.com pharmacy customers to continue to order as they always have through the drugstore.com web store. Under the agreement, 12 months following the closing of July 30, 2010, BioScrip will pay drugstore.com a fee to continue to market the drugstore.com pharmacy, which will be served by BioScrip. We consider the marketing service fees to be indirect cash inflows of our discontinued mail-order pharmacy segment, as the fees earned are not a significant source of ongoing future revenue. We have classified the results of operations of our mail-order pharmacy segment as discontinued operations in the accompanying consolidated financial statements for all periods presented.

We operate using a 52/53-week retail calendar year, with each of the fiscal quarters in a 52-week fiscal year representing a 13-week period. Fiscal years 2011 and 2010 are 52-week years.

Results of Operations

Customer Data

We define new and repeat customer orders as orders generated through our health and beauty web stores, microsites, and our vision web stores, excluding our partnership orders with Medco, Rite Aid, and Luxottica as well as Salu' s partnership with SpaLook.com and orders generated through Dr. Weil-related web stores. We define total orders as orders fulfilled through our distribution centers. Mixed orders across one or more of our business segments are reported to each individual segment, but are included as one order in the number of total customer orders shipped. In first quarter of 2011, orders from new customers increased year-over-year by 13% to 538,000. These increases are primarily the result of new orders generated from our acquisition of Salu, orders generated through our vision web stores, orders driven by our microsites, and expansion into new marketing channels. Orders from repeat customers as a percentage of total orders remained consistent year-over-year at 65% in the first quarter of 2011.

Net Sales

	Three Months Ended		
	April 3, 2011	% Change	April 4, 2010
	(in thousands, except per order data)		
Total net sales	$128,439	15.8 %	$110,933
Total customer orders shipped	1,988	14.6 %	1,735
Average net sales per order	$65	1.6 %	$64

Net sales include gross revenues from sales of product, shipping fees, service fees, and advertising revenues, net of discounts, provision for sales returns, and other allowances. Net sales also include consignment service fees earned from our arrangements with certain partners, under which we do not take title to the inventory and do not establish pricing. We record on a net basis consignment service fees, which constitute approximately 1% of total net sales in each period presented.

Total net sales increased year-over-year in the first quarter of 2011 as a result of increases in order volume, net sales per order, and the acquisition of Salu, Inc. on February 19, 2010, which generated $14.2 million in net sales in the first quarter of 2011 and $5.5 million of net sales in the first quarter of 2010. Order volumes increased year-over-year in the first quarter of 2011, reflecting an approximate 15% increase in orders in both our OTC and vision segments. Net sales per order increased year-over-year primarily as a result of an increase in net sales per order in our vision segment. Revenues from repeat customers, excluding partnerships, were 71% and 73% of total net sales in the first quarter of 2011 and 2010, respectively.

OTC Net Sales

	Three Months Ended		
	April 3, 2011	% Change	April 4, 2010
	(in thousands, except per order data)		
OTC net sales	$107,466	15.6 %	$92,992
Percentage of total net sales from OTC	83.7 %		83.8 %
OTC customer orders shipped	1,818	14.5 %	1,588
Average net sales per order	$59	– %	$59

Net sales in our OTC segment increased year-over-year in the first quarter of 2011 as a result of an increase in order volume. The number of orders in our OTC segment grew year-over-year in the first quarter of 2011 as a result of: (a) orders generated from our acquisition of Salu on February 19, 2010, (b) orders through new and existing marketing channels, and (c) orders driven by our microsites. The average net sales per order in our OTC segment remained consistent between the first quarter of 2011 and 2010. Net sales generated by our acquisition of Salu in the first quarter of 2011 and 2010 were $14.2 million and $5.5 million, respectively, and net sales generated by our partnerships with Medco and Rite Aid in the first quarter of 2011 and 2010 were $5.0 million and $4.6 million, respectively.

Vision Net Sales

	Three Months Ended		
	April 3, 2011	% Change	April 4, 2010
	(in thousands, except per order data)		
Vision net sales	$20,973	16.9 %	$17,941
Percentage of total net sales from vision	16.3 %		16.2 %
Vision customer orders shipped	170	14.9 %	148
Average net sales per order	$123	1.8 %	$121

Net sales in our vision segment increased year-over-year in the first quarter of 2011 as a result of an increase in orders and net sales per order. Orders in our vision segment increased year-over-year in the first quarter of 2011, primarily as a result of increased new customer orders driven by promotional offers. The year-over-year increase in average net sales per order was driven primarily by customers making larger quantity purchases, partially offset by increased use of discount and promotional offers by our customers.

Cost of Sales and Gross Margin

	Three Months Ended		
	April 3, 2011	**% Change**	**April 4, 2010**
		($ in thousands)	
Cost of sales	$92,322	18.7 %	$77,753
Gross profit dollars	$36,117	8.9 %	$33,180
Gross margin percentage	28.1 %		29.9 %

Cost of sales consists primarily of the cost of products sold to our customers, including allowances for shrinkage and damaged, slow-moving, and expired inventory; outbound and inbound shipping costs; and expenses related to promotional inventory included in shipments to customers. We net against cost of sales payments that we receive from vendors in connection with volume purchases or rebate allowances and payment discount terms.

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Total cost of sales increased year-over-year in absolute dollars in the first quarter of 2011 as a result of growth in order volume and net sales in both of our OTC and vision segments. Total gross margin percentage decreased year-over-year in the first quarter of 2011 primarily as a result of a 280 basis point decrease in our OTC segment margin due to increased promotional offers to accelerate new customer growth and downward pricing pressures resulting from increased ecommerce competition, partially offset by a 320 basis point improvement in our vision segment margins.

Shipping

	Three Months Ended		
	April 3, 2011	% Change	April 4, 2010
	($ in thousands)		
Shipping activity:			
Shipping revenue	$4,105	5.0 %	$3,909
Shipping costs	$9,818	15.0 %	$8,537
Net shipping loss	$5,713	23.4 %	$4,628
Percentage of net sales:			
Shipping revenue	3.2 %		3.5 %
Shipping costs	7.6 %		7.7 %
Net shipping loss	4.4 %		4.2 %

We include in net sales our revenues from shipping charges to customers, and we include in cost of sales outbound shipping costs. Our net shipping loss increased year-over-year in absolute dollars and as a percentage of net sales in the first quarter of 2011, primarily as a result of a decrease in shipping revenue resulting from an increase in the number of customers using free shipping offers and a reduced number of customers choosing expedited shipping methods for their orders. We expect to continue to subsidize a portion of customers' shipping costs for the foreseeable future, through certain free shipping promotions, as a strategy to attract and retain customers.

OTC Cost of Sales and Gross Margin

	Three Months Ended		
	April 3, 2011	% Change	April 4, 2010
	($ in thousands)		
OTC cost of sales	$76,487	20.2 %	$63,640
OTC gross profit dollars	$30,979	5.5 %	$29,352
OTC gross margin percentage	28.8 %		31.6 %

Cost of sales in our OTC segment increased year-over-year in absolute dollars in the first quarter of 2011, as a result of growth in order volumes and net sales generated from the acquisition of Salu, growth in net sales generated through existing and new marketing channels, and growth in net sales from microsites. Our gross margin percentage decreased year-over-year in the first quarter of 2011, as a result of promotional offers to accelerate new customer growth, downward pricing pressures resulting from increased ecommerce competition, and a decrease in vendor subsidies. These decreases were partially offset by strong year-over-year net sales growth in our higher margin total beauty business, including prestige beauty and Salu, of 29%.

Vision Cost of Sales and Gross Margin

	Three Months Ended		
	April 3, 2011	% Change	April 4, 2010
		($ in thousands)	
Vision cost of sales	$15,835	12.2 %	$14,113
Vision gross profit dollars	$5,138	34.2 %	$3,828
Vision gross margin percentage	24.5 %		21.3 %

Cost of sales in our vision segment increased year-over-year in absolute dollars in the first quarter of 2011 as a result of growth in net sales. Gross margin percentage in the first quarter of 2011 benefited year-over-year from our joint sourcing agreement with Luxottica, partially offset by discounts and promotional offers, and by an increase in cost of sales in the first quarter of 2010 due to a higher mix of higher cost inventory related to the build-up of inventory to support the move of our vision fulfillment operations from Ferndale, Washington to our distribution center in Swedesboro, New Jersey and a one-time inventory shrinkage charge related to the migration of inventory to a new perpetual inventory system.

Fulfillment and Order Processing Expenses

	Three Months Ended		
	April 3, 2011	% Change	April 4, 2010
		($ in thousands)	
Fulfillment and order processing expenses	$13,263	10.8 %	$11,975
Percentage of net sales	10.3 %		10.8 %
Fixed and variable cost information:			
Variable costs	$10,161	15.4 %	$8,802
Fixed costs	$3,102	-2.2 %	$3,173

Fulfillment and order processing expenses include payroll and related expenses for personnel engaged in purchasing, fulfillment, distribution, and customer care activities (including warehouse and vision prescription verification personnel), distribution center equipment and packaging supplies, credit card processing fees, and bad debt expenses. These expenses also include rent and depreciation related to equipment and fixtures in our distribution centers and call center facility. Variable fulfillment costs represent the incremental costs of fulfilling, processing, and delivering the orders that are variable based on sales volume.

Variable fulfillment and order processing expenses increased year-over-year in absolute dollars in the first quarter of 2011 primarily as a result of an increase in order volume in our OTC and vision segments. Fixed fulfillment and order processing expenses remained consistent year-over-year in the first quarter of 2011 as a result of a $0.4 million decrease in depreciation expense from assets being fully depreciated in 2010, partially offset by the addition of a full quarter of Salu fulfillment costs. Fulfillment and order processing expenses as a percentage of net sales improved year-over-year in the first quarter of 2011, due to the fact that our fixed fulfillment costs were spread across a higher revenue base.

Marketing and Sales Expenses

	Three Months Ended

	April 3, 2011	% Change	April 4, 2010
		($ in thousands)	
Marketing and sales expenses	$12,785	17.2 %	$10,907
Percentage of net sales	10.0 %		9.8 %

Marketing and sales expenses include advertising expenses, promotional expenditures, web analytic tools, web design, and payroll and related expenses for personnel engaged in marketing and merchandising activities. Advertising expenses include our obligations under various advertising contracts. Advertising and promotional costs were $9.5 million in the first quarter of 2011 and $8.1 million in the first quarter of 2010.

Marketing and sales expenses increased in absolute dollars and as a percentage of net sales in the first quarter of 2011 compared to the prior year. The year-over-year increase of $1.9 million in the first quarter of 2011 resulted primarily from: an increase of $1.6 million in paid search, affiliate, and portal costs, driven by order volume, growth in new customer orders, and the addition of Salu’ s online marketing costs for a full quarter; and $0.3 million in employee related costs primarily due to the addition of Salu’ s costs for a full quarter in 2011.

Marketing and sales expense per new customer, excluding partnership marketing costs and orders, was $23.50 in the first quarter of 2011 and $22 in the first quarter of 2010. The year-over-year increase in marketing cost per new customer is primarily due to a higher mix of new customer orders, which have a higher acquisition cost, and an increase in marketing investments associated with our microsites as well as a shift in marketing channel mix related to social networks and marketplaces.

Technology and Content Expenses

	Three Months Ended		
	April 3, 2011	% Change	April 4, 2010
		($ in thousands)	
Technology and content expenses	$6,949	5.2 %	$6,608
Percentage of net sales	5.4 %		6.0 %

Technology and content expenses consist primarily of payroll and related expenses for personnel engaged in developing, maintaining, and making routine upgrades and improvements to our websites. Technology and content expenses also include Internet access and hosting charges, depreciation on hardware, and technology structures, utilities, and website content and design expenses.

Technology and content expenses increased in absolute dollars but decreased as a percentage of net sales in the first quarter of 2011 compared to the prior year. The year-over-year increase of $0.3 million in the first quarter of 2011 resulted primarily from the addition of Salu’ s technology costs for a full quarter. Technology and content expenses as a percentage of net sales improved year-over-year in the first quarter of 2011 due to the fact that we spread fixed technology and content costs across a higher revenue base.

General and Administrative Expenses

	Three Months Ended		
	April 3, 2011	% Change	April 4, 2010
		($ in thousands)	
General and administrative expenses	$6,870	1.9 %	$6,743
Percentage of net sales	5.3 %		6.1 %

General and administrative expenses consist of payroll and related expenses for executive and administrative personnel, corporate facility expenses, professional service expenses, and other general corporate expenses.

General and administrative expenses remained consistent year-over-year in absolute dollars but decreased as a percentage of net sales in the first quarter of 2011. In the first quarter of 2011, we incurred $2.2 million of transaction costs related to the planned merger with Walgreens offset by $1.4 million of transaction fees related to the acquisition of Salu and a fully vested warrant with a fair value of $0.7 million issued in exchange for three years of advisory services in the first quarter of 2010. General and administrative expenses as a percentage of net sales decreased in the first quarter of 2011 as a result of fixed costs spread across a higher revenue base.

Interest Income and Expense

	Three Months Ended	
	April 3, 2011	April 4, 2010
Interest (expense) income	$ (153)	$ (63)

Interest income consists of earnings on our cash, cash equivalents, and marketable securities, and interest expense consists primarily of interest associated with debt obligations. The year-over-year increase in net interest expense in the first quarter of 2011 was primarily due to an increase in interest expense from increased borrowings on our line of credit and capital leases.

Gain from Discontinued Operations

	Three Months Ended	
	April 3, 2011	April 4, 2010
Gain from discontinued operations	$ 720	$ 500

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The gain from discontinued operations represents the gain on the sale and the operations of our discontinued mail-order pharmacy segment as a result of our sale of our mail-order pharmacy assets to BioScrip on July 30, 2010. See note 7 to our consolidated financial statements.

Income Taxes

There was no provision or benefit for income taxes for the first quarter of 2011 due to our ongoing operating losses.

Non-GAAP Measures

Adjusted EBITDA

The following table provides information regarding our adjusted EBITDA, including a reconciliation of net loss to adjusted EBITDA (in thousands):

	Three Months Ended	
	April 3, 2011	April 4, 2010
Net loss	$(3,183)	$(2,616)
Amortization of intangible assets	132	48
Stock-based compensation	1,765	1,827
Depreciation	3,018	3,204
Interest expense, net	153	63
Adjusted EBITDA	$1,885	$2,526

Ongoing Adjusted EBITDA

The following table provides information regarding our ongoing adjusted EBITDA, including a reconciliation of adjusted EBITDA to ongoing adjusted EBITDA (in thousands):

	Three Months Ended	
	April 3, 2011	April 4, 2010
Adjusted EBITDA	$1,885	$2,526
Less: Discontinued mail-order pharmacy operations	(992)	(517)
Add: Walgreens transaction related costs	2,235	–
Add: Vision migration one-time charges	–	650
Add: Salu and Luxottica transaction and integration-related costs	–	1,786
Ongoing Adjusted EBITDA	$3,128	$4,445

To supplement the consolidated financial statements presented in accordance with U.S. generally accepted accounting principles (GAAP), we use the non-GAAP measure of adjusted EBITDA, defined as earnings before interest, taxes, depreciation, and amortization of intangible assets, adjusted to exclude the impact of stock-based compensation expense. We also use the non-GAAP measure of ongoing adjusted EBITDA, defined as adjusted EBITDA excluding the impact of expenses or income from discontinued operations, certain legal actions, settlements and related costs outside our normal course of business, restructuring and severance costs, impairment charges, and certain other one-time charges and credits specifically identified in the non-GAAP reconciliation financial schedules included in this quarterly report. These non-GAAP measures are provided to enhance the user' s overall understanding of our current financial performance. Management believes that adjusted EBITDA and ongoing adjusted EBITDA, as defined, provides useful information to us and to investors by excluding certain items that may not be indicative of our core operating results. In addition, because we have historically provided adjusted EBITDA and have recently begun to provide ongoing adjusted EBITDA measures to investors, management believes that including adjusted EBITDA and ongoing adjusted EBITDA measures provides consistency in the our financial reporting. However, adjusted EBITDA and ongoing adjusted EBITDA should not be considered in isolation, or as a substitute for, or as superior to, net income/loss, cash flows, or other consolidated income/loss or cash flow data prepared in accordance with GAAP, or as a measure of our profitability or liquidity. Although adjusted EBITDA and ongoing adjusted EBITDA are frequently used as measures of operating performance, they are not necessarily comparable to other similarly titled captions of other companies due to differences in methods of calculation. Net income/loss is the closest financial measure prepared by us in accordance with GAAP in terms of comparability to adjusted EBITDA and ongoing adjusted EBITDA.

Adjusted EBITDA and ongoing adjusted EBITDA decreased year-over-year in the first quarter of 2011, primarily as a result of a decrease in our OTC segment gross profit dollars as a percentage of net sales due to increased promotional offers to accelerate new customer growth and downward pricing pressures resulting from increased ecommerce competition. The impact of this decrease was partially offset by lower fixed costs as a percentage of revenue as a result of costs being spread across a higher revenue base. The first quarters of 2011 and 2010 included $2.2 million and $1.8 million, respectively, of transaction and integration costs related to Walgreens, Salu, and Luxottica.

Significant Accounting Judgments

The preparation of financial statements in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The Securities and Exchange Commission, or SEC, has defined a company' s critical accounting policies as the ones that are most important to the portrayal of the company' s financial condition and results of operations and that require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Significant accounting policies are included in Note 1 of our consolidated financial statements included in Part I of our annual report on Form 10-K for the fiscal year ended January 2, 2011. Although we believe that our estimates, assumptions, and judgments are reasonable, they are based on information presently available. Actual results may differ significantly from these estimates under different assumptions, judgments, or conditions. In addition, any significant unanticipated changes in any of our assumptions could have a material adverse effect on our business, financial condition, and results of operations.

Off-Balance Sheet Transactions

We have not entered into any off-balance sheet transactions.

Liquidity and Capital Resources

We have an accumulated deficit of $778.0 million through April 3, 2011. To date, we have had only four profitable quarters, and we may never achieve profitability on a full-year or consistent basis.

Our primary source of cash is sales made through our websites, for which we collect cash from our customers and payments received from our fulfillment partners. Our primary uses of cash are purchases of inventory, salaries, marketing expenses, and overhead and fixed costs. Any projections of our future cash needs and cash flows are subject to substantial uncertainty for the reasons discussed in this section and in the sections entitled "*Risk Factors*," in Part II, Item 1A of this quarterly report and in Part I, Item 1A of our annual report on Form 10-K for the fiscal year ended January 2, 2011.

Our principal sources of liquidity are our cash, cash equivalents, and marketable securities. Historically, our principal liquidity requirements have been to meet our working capital and capital expenditure needs. Until required for other purposes, our cash and cash equivalents are maintained in deposit accounts or highly liquid investments with remaining maturities of 90 days or less at the time of purchase. Our marketable securities, which include commercial paper, U.S. government agency obligations, and corporate notes and bonds, are considered short-term as they are available to fund current operations. In addition, in March 2011, we entered into a new three-year line of credit agreement with our existing bank, which replaced our existing two-year $25.0 million line of credit, allowing for borrowings of up to $40.0 million in the aggregate through March 2014, which is available to fund operations, capital expenditures, or finance acquisitions, as needed. As of April 3, 2011, $16.5 million was outstanding under the line of credit, which included the refinancing of $13.0 million under the prior line of credit, and $3.5 million of borrowings during the first quarter of 2011 related to equipment purchases to automate our New Jersey distribution center. The available borrowings under the three-year line of credit were approximately $23.0 million as of April 3, 2011. In the event we are not in compliance with certain financial covenants contained in the line of credit agreement, and are unable to obtain a waiver from the bank, our ability to borrow under the line of credit may be temporarily suspended until such time the covenant violations are remediated. The $2.2 million of transaction costs incurred in the first quarter of 2011, in connection with the merger agreement with Walgreens (see note 5 to our consolidated financial statements), exceeded our allowable limit of one-time charges of $750,000 under the agreement. As a result, we failed our adjusted EBITDA covenant in the first quarter of 2011, which was waived by the bank.

As of April 3, 2011, our cash and money market funds include $5.0 million that serves as collateral on a contract. The contract is cancelable with 30-days written notice and therefore the cash equivalent is considered readily available within 30 days.

We believe that our cash and marketable securities on hand plus our sources of cash will be sufficient to fund our operations and anticipated capital expenditures. However, any projections about our future cash needs and cash flows are subject to substantial uncertainty. As a result, we may need to raise additional monies to fund our operating activities or for strategic flexibility (if, for example, we decide to pursue business or technology acquisitions or invest in additional distribution centers) or if our expectations regarding our operations and anticipated capital expenditures change. We have assessed in the past, and will continue to assess, opportunities for raising additional funds by selling equity, equity-related or debt securities, obtaining additional credit facilities, or obtaining other means of financing for strategic reasons or to further strengthen our financial position. Under the merger agreement with Walgreens, we generally would be prohibited from issuing equity or debt securities without Walgreens consent, and we cannot ensure that Walgreens would approve of any such issuance. In addition, we cannot be certain that additional financing will be available to us on acceptable terms when required, or at all. Furthermore, if we were to raise additional funds through the issuance of securities, such securities may have rights, preferences, or privileges senior to those of the rights of our common stock and our stockholders may experience additional dilution.

Discussion of Cash Flows

The following table provides information regarding our cash flows for the three-month periods ended April 3, 2011 and April 4, 2010:

	Three Months Ended		
	April 3, 2011	$ Change	April 4, 2010
		(in thousands)	
Net cash provided by (used in)			
Continuing operations	$4,407	$2,464	$1,943
Discontinued operations	$(372)	$(1,424)	$1,052
Continuing investing activities	$(4,500)	$13,442	$(17,942)
Discontinued investing activities	$−	$366	$(366)
Financing activities	$4,758	$(5,481)	$10,239
Net increase (decrease) in cash and cash equivalents	$4,293	$9,367	$(5,074)

Cash provided by (used in) operating activities. Our operating cash flows result primarily from cash received from our customers, fulfillment partners, and advertising and other service revenue, offset by cash payments we make for products and services, employee compensation, payment processing and related transaction costs, and interest payments on our debt obligations. Cash received from customers and other activities generally corresponds to our net sales, and because our customers primarily use credit cards to buy from us, our receivables from customers settle quickly. Working capital at any specific point in time is subject to many variables, including seasonality, inventory management and category expansion, the timing of cash receipts and payments, vendor payment terms, and valuation of cash equivalents and marketable securities.

In the first quarter of 2011, net cash provided by continuing operations reflects non-cash expenses of $4.9 million and cash generated from working capital of $3.4 million, partially offset by a loss from continuing operations of $3.9 million. In the first quarter of 2010, net cash provided by continuing operations reflects non-cash expenses of $5.1 million, partially offset by a loss from continuing operations of $3.1 million. Net cash provided by continuing operations, net of acquisitions, increased year-over-year in the first quarter of 2011 as a result of cash generated from working capital, primarily due to a decrease in inventory and accounts receivable, partially offset by an increase in net loss from continuing operations. In the first quarter of 2011, net cash used in discontinued operations reflects expenses incurred from discontinued operations of our mail-order pharmacy segment and the first quarter of 2010 reflects mail-order pharmacy operations and cash provided by the settlement of assets and liabilities. Net cash used in discontinued operations decreased year-over-year in the first quarter of 2011 as a result of the sale of the mail-order pharmacy assets in the third quarter of 2010.

Cash provided by (used in) investing activities. Our net cash flows used in investing activities include the purchase of marketable securities, the acquisition of fixed assets and intangible assets, and the acquisition of Salu, partially offset by the net proceeds received from the sales and maturities of marketable securities.

In the first quarter of 2011, net cash used in continuing investing activities reflects $6.6 million of fixed asset purchases, including $3.5 million related to equipment purchased for the automation of our New Jersey distribution center, and $1.3 million of purchases of marketable securities, partially offset by $3.4 million from sales and maturities of marketable securities. In the first quarter of 2010, net cash used in continuing investing activities reflects $18.0 million of cash used to acquire Salu, net of $1.4 million of cash acquired, $2.0 million used to purchase fixed assets and intangible assets, and $2.3 million used to purchase marketable securities, partially offset by $4.4 million from sales and maturities of marketable securities. Net cash used in continuing investing activities decreased year-over-year in the first quarter of 2011 primarily as a result of the purchase of Salu in the first quarter of 2010, partially offset by the increase in fixed asset purchases. Net cash used in discontinued investing activities in the first quarter of 2010 represents the software development costs related to the systems integration between our mail-order pharmacy and BioScrip in conjunction with the sale of the mail-order pharmacy in the third quarter of 2010.

Cash provided by (used in) financing activities. Our net cash flows from financing activities represent cash provided from borrowings under our revolving bank line of credit to fund capital expenditures, acquisitions, and operations, and the exercise of options, partially offset by payments on our debt obligations and purchases of treasury stock.

In the first quarter of 2011, net cash provided by financing activities represents $3.5 million of proceeds received from the line of credit to fund asset purchases related to the automation of our New Jersey distribution center and $2.0 million of stock option exercises, partially offset by $0.7 million of payments on debt obligations and treasury stock purchases. In the first quarter of 2010, net cash provided by financing activities represents $10.0 million of proceeds received from the line of credit for the Salu acquisition, and $0.3 million received from the exercise of stock options. Net cash provided by financing activities decreased year-over-year in the first quarter of 2011 primarily due to less borrowings on the line of credit and increases in proceeds from the exercise of stock options.

Until required for other purposes, our cash and cash equivalents are maintained in deposit accounts or highly liquid investments with remaining maturities of 90 days or less at the time of purchase. Our marketable securities, which include corporate notes and bonds, commercial paper, and U.S. government agency obligations, are considered short-term as they are available to fund current operations.

Contractual Cash Requirements and Commitments

In March 2011, we entered into a loan and security agreement with our existing bank, which includes a revolving three-year line of credit allowing for borrowings up to $40.0 million, which accrue interest, at the option of the borrower and dependent on achieving certain financial covenants, at LIBOR plus 2.5% – 3%, or prime plus 0% – 0.5%. This agreement replaced our two-year $25.0 million line of credit which matured in March 2011. As of April 3, 2011, $16.5 million was outstanding under the line of credit, which included the refinancing of $13.0 million under the prior line of credit, and $3.5 million of borrowings during the first quarter of 2011 related to equipment purchases to automate our New Jersey distribution center. The line of credit matures in March 2014. Availability under the line of credit is also reduced by a $541,000 letter of credit we provided to our corporate headquarters landlord. As of April 3, 2011, the available borrowings under the line of credit were approximately $23.0 million. Advances available under the revolving line of credit are limited, based on eligible inventory, accounts receivable, cash and investment balances, and balances outstanding under our line of credit. The agreement contains certain covenants that are customary in transactions of this nature, including a prohibition on other debt and liens, requirements regarding the payment of taxes, and certain restrictions on mergers and acquisitions, investments, and transactions with our affiliates, as well as certain financial covenants. The $2.2 million of transaction costs incurred in the first quarter of 2011, in connection with the merger agreement with Walgreens (see note 5 to our consolidated financial statements), exceeded our allowable limit of one-time charges of $750,000 under the agreement. As a result, we failed our adjusted EBITDA (earnings before interest, taxes, depreciation, amortization, and adjusted for stock compensation) covenant in the first quarter of 2011, which was waived by the bank. The agreement also identifies certain events of default that are customary for transactions of this nature and subject to materiality provisions and grace periods where appropriate, including failure to pay any principal or interest under this facility or other instruments when due, the occurrence of a material adverse change, violations of any covenants, a material cross-default to our other debt, or a change of control. As of April 3, 2011, none of these events had occurred.

As of April 3, 2011, we did not have any future material noncancelable commitments to purchase goods or services.

Except as discussed above, there have been no material changes to our contractual commitments as disclosed in our annual report on Form 10-K for the fiscal year ended January 2, 2011.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We have assessed our vulnerability to certain market risks, including interest rate risk associated with marketable securities, accounts receivable, accounts payable, capital lease obligations, and cash and cash equivalents. Due to the short-term nature of these investments and our investment policies and procedures, we have determined that the risk associated with interest rate fluctuations related to these financial instruments is not material to us.

Our financing facilities expose our net earnings to changes in short-term interest rates because interest rates on the underlying obligations are variable. Borrowings outstanding under the variable interest-bearing financing facilities totaled $16.5 million at April 3, 2011, and the highest interest rate attributable to this outstanding balance was 3.25% at April 3, 2011. A change in net earnings resulting from a hypothetical 10% increase or decrease in interest rates would not be material.

We have investment risk exposure arising from our investments in marketable securities due to the volatility of the bond market in general, company-specific circumstances, and changes in general economic conditions. As of April 3, 2011, we had $11.0 million of securities classified as "marketable securities." We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that declines in the fair value of such assets below our accounting basis are other-than-temporary.

Item 4. Controls and Procedures

Under the supervision of and with the participation of our management, including our chief executive officer, chief accounting officer, and general counsel, we performed an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act). Based on that evaluation, our management, including our chief executive officer, chief accounting officer, and general counsel, concluded that, as of April 3, 2011, our disclosure controls and procedures were effective to provide reasonable assurance that all material information required to be disclosed in reports filed or submitted by us under the Exchange Act is made known to management in a timely fashion.

There were no changes in our internal control over financial reporting during the most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

The certifications required by Section 302 of the Sarbanes-Oxley Act of 2002 are filed as exhibits 31.1 and 31.2, respectively, in this Form 10-Q.

PART II–OTHER INFORMATION

Item 1. Legal Proceedings

See Note 11 of our consolidated financial statements, " *Commitments and Contingencies–Legal Proceedings* ," included in Part I, Item 1 of this quarterly report, for a discussion of the material legal proceedings to which we are a party.

Item 1A. Risk Factors

You should carefully consider the following risks and uncertainties associated with our company and ownership of our securities. If any of the following risks actually occurs, our business, financial condition, or operating results could be materially adversely affected. This could cause the trading price of our common stock to decline, and you could lose all or part of your investment. Some statements in this quarterly report (including some of the following risk factors) are forward-looking statements. See the section entitled "Special Note Regarding Forward-Looking Statements" in Part I, Item 2 of this quarterly report.

The announcement and pendency of our agreement to be acquired by Walgreens could adversely affect our business, financial results and operations.

On March 23, 2011, drugstore.com, inc., a Delaware corporation, entered into an Agreement and Plan of Merger with Walgreen Co. (Walgreens), an Illinois corporation, and Dover Subsidiary, Inc., a Delaware corporation and wholly-owned subsidiary of Walgreens, pursuant to which Dover Subsidiary, Inc. will merge with and into drugstore.com with drugstore.com surviving as a wholly-owned subsidiary of Walgreens.

The announcement and pendency of the merger and the related litigation described in note 11 to our consolidated financial statements could cause disruptions in and create uncertainty surrounding our business, including affecting our relationships with our customers, vendors, and employees, which could have an adverse effect on our business, financial results, and operations. In particular, we could lose important personnel as a result of the departure of employees who decide to pursue other opportunities in light of the proposed merger. We could potentially lose customers or suppliers, or customer orders could be delayed or decreased. The sales cycles for our products may lengthen due to the uncertainty related to the proposed merger. In addition, we have diverted, and will continue to divert, significant management resources in an effort to complete the merger, which could adversely affect our business and results of operations. We may also experience increased competition if our competitors target our customers as a result of the uncertainty associated with our proposed acquisition by Walgreens.

We are subject to prohibitions contained in the merger agreement on soliciting, initiating, knowingly facilitating, or knowingly encouraging alternative acquisition proposals. If violated, these restrictions could potentially result in the termination of the merger agreement by Walgreens. We are also subject to restrictions contained in the merger agreement on the conduct of our business prior to the completion of the merger. These restrictions could result in our inability to respond effectively to competitive pressures, industry developments, and future opportunities or may otherwise harm our business, financial results, and operations.

The failure to complete the merger could adversely affect our business and the market price of our common stock and could result in substantial termination costs.

There is no assurance that the merger with Walgreens or any other transaction will occur. Consummation of the merger is subject to various conditions, including the approval by our stockholders and certain other conditions. If the proposed merger, or a similar transaction, is not completed, the share price of our common stock may change to the extent that the current market price of our common stock reflects an assumption that a transaction will be completed. We will have incurred significant costs, including the diversion of management resources, for which we will have received little or no benefit. In addition, under circumstances defined in the merger agreement, we may be required to pay Walgreens a termination fee of approximately $15 million. Furthermore, a failed transaction may result in negative publicity and a negative impression of us in the investment community.

Certain of our directors and executive officers have interests in the merger that may be different from, or in addition to, the interests of our stockholders.

Our executive officers negotiated the terms of the merger agreement under the direction of our board of directors. The board unanimously adopted, approved, and declared advisable the merger agreement and the transactions contemplated by the merger agreement, declared it in the best interest of our stockholders for us to enter into the merger agreement and consummate the transactions contemplated by the merger agreement, declared the terms of the merger fair to our stockholders and recommended that our stockholders vote in favor of the merger agreement. These directors and executive officers may have interests in the merger that are different from, or in addition to, or may be deemed to conflict with those of our stockholders. These interests may include the continued employment of certain of our executive officers by the combined company and the indemnification of former directors and officers by the combined company. With respect to these directors and executive officers, these interests also include the treatment in the merger of employment agreements, severance policies, change of control arrangements, restricted stock, restricted stock units, stock options, stock appreciation rights, and other rights held by these directors and executive officers.

We face significant competition from both traditional and online retailers.

The market segments in which we compete are rapidly evolving and intensely competitive, and we have many competitors in different industries, including both the retail and e-commerce services industries. These competitors include chain drugstores, mass-market retailers, warehouse clubs, supermarkets, specialty retailers, major department stores, insurers and health care providers, national optical chains, eye care professionals, Internet portals and online service providers that feature shopping services, and various online stores that offer products within one or more of our product categories. Many of our current and potential competitors have longer operating histories, larger customer bases, greater brand recognition, and significantly greater financial, marketing, and other resources than we have. They may be able to secure merchandise from vendors on more favorable terms, operate with a lower cost structure, adopt more aggressive pricing policies, or devote more resources to technology development and marketing than we do. To the extent we can respond with more aggressive discounts, shipping rates, or other promotions, we cannot ensure that these will be successful and in any event, our margins will be negatively affected. In addition, other companies in the retail and e-commerce service industries may enter into business combinations or alliances that would strengthen their competitive positions and prevent them, their affiliated companies, or their strategic partners from entering into relationships with us.

As various Internet market segments obtain large, loyal customer bases, participants in those segments may expand into the market segments in which we operate. In addition, new and expanded Web technologies may further intensify the competitive nature of online retail and allow our competitors to duplicate many of the products, services, and content offered on our site. We believe that the Internet facilitates entry into the retail market and comparison shopping and renders it inherently more competitive than conventional retailing formats. We expect competition in the e-commerce channel to intensify, and this increased competition may reduce our ability to grow and, as a result, reduce our revenue, increase our operating expenses, or both, and harm our business.

Our revenue growth and profitability depends on the continued growth of demand for the products we offer.

Demand for many of our products, and, therefore, our business, is affected by changes in consumer preferences, general economic and business conditions, and world events. For example, macro-economic trends in the United States and abroad, threatened or actual terrorist attacks or armed hostilities (or the resulting security concerns), or natural disasters could create economic and consumer uncertainty and delays in and increased costs of product shipments to and from us, which may decrease demand. A softening of demand, for whatever reason, may result in decreased revenue or growth, which could prevent us from achieving or sustaining profitability. Revenue growth or profitability may not be sustainable and our company-wide and by-segment percentage growth rates may decrease in the future.

Our revenues and operating results may vary significantly from quarter to quarter due to a number of factors, including:

- our ability to retain and increase sales to existing customers, attract new customers, and satisfy our customers' demands;
- the frequency and size of customer orders and the quantity and mix of products our customers purchase;
- changes in consumer acceptance and usage of the Internet, online services, and e-commerce;
- the price we charge for our products and for shipping those products, or changes in our pricing policies or the pricing policies of our competitors;
- the extent to which we offer our customers, and our customers take advantage of, free shipping or other promotional discounts;
- our ability to acquire merchandise, manage inventory, and fulfill orders;
- technical difficulties, system downtime, or interruptions;
- timing and costs of upgrades and developments in our systems and infrastructure;
- timing and costs of marketing and other investments;
- disruptions in service by shipping carriers;
- the introduction by our competitors of websites, products, or services;
- changes in the mix of products purchased by our customers (for example, if our OTC net sales do not grow as much as we anticipate or the proportion of OTC net sales compared to net sales in vision segments is lower than we anticipate, our margins will be lower than we currently plan);

- the effects of strategic alliances, potential acquisitions, and other business combinations, and our ability to successfully and timely integrate them into our business; and
- changes in government regulation.

In addition, our operating expenses are largely based on anticipated revenue trends and a high percentage of our expenses are fixed in the short term. As a result, a delay in generating or recognizing revenue for any reason could result in substantial additional operating losses.

A portion of our revenues is also seasonal in nature. Traditional retail seasonality affects our OTC business, resulting in higher revenues in the fourth quarter of each year as compared to other quarters. We may be unable to manage the increased sales effectively, and increases in inventory in anticipation of holiday sales could negatively affect our cash flow. In addition, sales of some health and beauty products are driven, to some extent, by seasonal purchasing patterns and seasonal product changes, such as diet products, cold and flu medications, and products with holiday-specific varieties. Consumer fads and other changes in consumer trends may also cause shifts in purchasing patterns, resulting in significant fluctuations in our operating results from one quarter to the next.

Our evolving business model and the unpredictability of our industry make it difficult for us to forecast accurately the level or source of our revenues and our rate of growth. We believe that, because of these factors, historical trends and quarter-to-quarter comparisons of our operating results are not necessarily meaningful and should not be relied on as an indicator of our future performance. In the past, our operating results have sometimes been, and it is likely that in some future quarter or quarters they will be, below the expectations of investors and securities analysts. In that event, the price of our common stock may fall substantially, and stockholders may lose all or a part of their investment.

If our marketing efforts are not effective at attracting and retaining customers at an acceptable cost, we will be unable to achieve consistent profitability.

If we do not maintain our brand and continue to increase awareness of our products and services, we may not build a critical mass of customers. Promoting and positioning our brand depends largely on the success of our marketing efforts and our ability to provide consistent, high quality customer experiences. We believe that, because we are a small company with low public brand awareness in an increasingly competitive market, achieving significant market awareness will require significant marketing expense. To promote our brand and our products and services, we have incurred and expect to continue to incur substantial expense in our marketing efforts both to attract and to retain customers. Our promotional activities may not be effective at building our brand awareness and customer base to the extent necessary to generate sufficient revenue to become consistently profitable. Search engine and other online marketing initiatives comprise a substantial part of our marketing efforts, and our success depends in part on our ability to manage costs associated with these initiatives, or to find other channels to acquire and retain customers cost-effectively. The demand for and cost of online advertising has been increasing and may continue to increase. An inability to acquire and retain customers at a reasonable cost would increase our operating costs and prevent us from maintaining profitability.

If we fail to integrate, maintain or enhance our strategic relationships to help promote our website and expand our product offerings, our development could be hindered.

We have entered, or expect to enter, into a number of strategic partnerships to build, host, and market websites and to process and fulfill orders with Rite Aid Corporation, Medco CHP, L.L.C., Luxottica Group S.p.A., and BioScrip Pharmacy Services, Inc. We believe that our relationships with these and other strategic partners, Internet portals, third-party distributors, and manufacturers are critical to attract customers, to facilitate broad market acceptance of our products and the drugstore.com brands, and to enhance our sales and marketing capabilities. We expect to continue to evaluate and consider a wide array of potential strategic partnerships as part of our growth strategy. Any of these transactions could be material to our financial condition and results of operations. If we are unable to develop or maintain key relationships, our ability to attract customers would suffer and our business would be adversely affected. The process of integrating and maintaining strategic partnerships may create unforeseen operating difficulties and expenditures and is itself risky. Such risks include a diversion of management time, as well as a shift of focus from operating the businesses, to issues related to integration and administration of the strategic partnerships; partners' having interests, strategies or goals inconsistent with ours; business decisions or other actions of our partners that may result in harm to our reputation or adversely affect the value of our investment in the partnership. Such partnerships require a significant investment of time and resources, and we may not generate sufficient revenues to offset this investment. We may incur additional operating losses and expenses as a result of the operations of the strategic partners or the partnerships. In addition, we are subject to many risks beyond our control that influence the success or failure of our strategic partners or partnerships, including their ability to perform according to our partners' and our expectations. Our business could be harmed if any of our strategic partners were to experience financial or operational difficulties or if other corporate developments adversely affect their performance under their agreements with us.

Our future growth strategy may depend in part on our ability to acquire complementary or strategic businesses. Any such acquisitions could result in dilution, operating difficulties, difficulties in integrating acquired businesses, and other harmful consequences.

We have acquired, and may in the future acquire, complementary or strategic businesses, technologies, services, and products as part of our strategy to increase our net sales and customer base. The process of integrating acquisitions into our business and operations has resulted in, and may in the future result in:

- unforeseen operating difficulties and expenditures;
- disruption of our ongoing business, including loss of management focus on existing businesses and resources that would otherwise be available for operation, ongoing development and expansion of our business;

problems retaining key personnel of the businesses that we acquire;

additional operating losses and expenses of the businesses we acquired or in which we invested;

the potential impairment of tangible assets, such as inventory, and intangible assets and goodwill acquired in the acquisitions;

the potential impairment of customer and other relationships of the business that we acquired or in which we invested or our own customers as a result of any integration of operations;

the difficulty of incorporating acquired technology and rights into our offerings and unanticipated expenses related to such integration;

the difficulty of integrating a new company’ s accounting, financial reporting, management, information, human resource and other administrative systems to permit effective management, and the lack of control if such integration is delayed or not implemented; and

the difficulty of implementing at companies we acquire the controls, procedures and policies appropriate for a larger public company.

To the extent we miscalculate our ability to integrate and properly manage acquired businesses, technologies, services, and products, or we depend on the continued service of acquired personnel who choose to leave, we may have difficulty in achieving our operating and strategic objectives. In addition, we may not realize the anticipated benefits of any acquisition.

We may be subject to unanticipated problems and liabilities of acquired companies. While we attempt in our acquisitions to determine the nature and extent of any pre-existing liabilities, and to obtain indemnification rights from the previous owners for acts or omissions arising prior to the date of acquisition, resolving issues of liability between the parties could involve a significant amount of time, manpower and expense. If we or any of our subsidiaries were to be unsuccessful in a claim for indemnity from the seller of a business that we acquire, the liability imposed on us or our subsidiary could have a material adverse effect on us. We may not be able to assimilate successfully the additional personnel, operations, acquired technology or products or services into our business. Further, the physical expansion in facilities that could occur as a result of any acquisition may result in disruptions that could seriously impair our business. In addition, due to the recent disruptions in the global financial markets, valuations supporting our acquisitions could change rapidly, and we could determine that such valuations have experienced impairments which could adversely impact our financial results.

We may be unable to identify suitable acquisition opportunities or to negotiate and complete acquisitions on favorable terms, or at all. In addition, any future acquisitions may require substantial capital resources, and, to the extent it is available, we may need to obtain additional capital or financing, from time to time, to fund these activities. This could result in potentially dilutive issuances of equity securities or the incurrence of debt, contingent liabilities, or amortization or impairment expenses related to goodwill and other intangible assets, any of which could harm our business, financial condition, and results of operation. Sufficient capital or financing may not be available to us on satisfactory terms, or at all.

In connection with our acquisition of Salu, Inc., now Salu Beauty, Inc., we have entered a new line of business – clinical skincare and spa products – with greater targeted international operations. We cannot assure you that our expansion into this business line will succeed.

We recently entered the clinical skincare and spa products business with our acquisition of Salu, Inc., now Salu Beauty, Inc. We cannot assure that our expansion into these businesses will succeed. We have limited experience in the sale of clinical skincare and spa products, particularly to targeted international markets. While we have operations in Canada, we have not previously had operations outside of North America. Our entry into this area will require us to devote substantial financial, technical, managerial and other resources. As noted above, international expansion comes with substantial risks. We may not be able to successfully integrate the additional personnel, operations, acquired technology or products or services of Salu into our business and there is no guarantee that key personnel of Salu will continue to work for us.

In addition, in connection with the acquisition, certain senior management employees of Salu will be eligible to receive performance incentive payments in cash for each of the 2010 and 2011 fiscal years with an aggregate value of up to $2.5 million if certain financial performance targets are achieved. These bonuses may limit our cash available to make future acquisitions and operate our business, and may affect our ability to obtain alternative financing. It is uncertain whether we will benefit financially from this acquisition.

We are expanding into international markets, causing our business to be increasingly susceptible to international business risks and challenges that could affect our profitability.

Through our contract with FiftyOne, Inc. and certain operations of our newly acquired subsidiary, Salu, Inc., now Salu Beauty, Inc., we sell certain OTC products in international markets and expect to expand into international markets more aggressively in the future. To date, our international business activities have been limited. Our lack of a track record outside the United States increases the risks described below. In addition, our experience in the United States may not be relevant to establishing a business outside the United States. Accordingly, our international expansion strategy is subject to significant execution risk, and we cannot assure that our strategy will be successful. International sales are subject to inherent risks that could adversely affect our operating results, including:

the risk that our marketing strategies will not translate well to international markets and that we will need to expend resources to adapt those strategies for a variety of new markets;

the need to develop new supplier and manufacturer relationships;

the need to comply with additional U.S. and foreign laws and regulations to the extent applicable, including but not limited to, restrictions on advertising practices, regulations governing online services, restrictions on importation of specified or proscribed items, importation quotas, consumer protection laws, enforcement of intellectual property rights, laws dealing with consumer and data protection, privacy, encryption, and restrictions on pricing or discounts;

unexpected changes in international regulatory requirements and tariffs, and geopolitical events such as war and terrorist attacks;

managing fluctuations in currency exchange rates;

difficulties in staffing and managing foreign operations;

greater difficulty in accounts receivable collection from overseas customers;

potential adverse tax consequences in the U.S. and in foreign jurisdictions; and

uncertain political and economic climates.

To the extent we generate significant international sales, any negative impact on our international operations could negatively affect our revenues and operating results. In addition, it is costly to establish, develop, and maintain international operations and websites that promote our brand internationally, which could further harm our revenues and operating results.

If the recent global economic crisis has a disproportionate impact on our business or that of our significant partners and suppliers, our business and results of operations would be harmed.

Deterioration in the U.S. and global credit markets and the financial services industry could negatively affect our business or that of our significant partners and suppliers. Tightening of credit and the recent decline in the housing market has led to a lack of consumer confidence and a reduction in business activity generally, which could significantly harm our revenues and operating results. In addition, our vendors could experience serious cash flow or other financial or operational problems due to the current economic conditions. As a result, our vendors may attempt to increase prices, alter payment terms, or seek other relief in order to offset these problems. Vendors may further be forced to reduce production, shut down operations or file for bankruptcy protection, which in some cases could have a significant impact on our ability to serve the market' s needs. In addition, access to credit from financial institutions may not be available. We do not expect the current economic conditions to improve significantly in the near future, and any continuation and/or worsening of the economic environment could intensify the adverse affects of these difficult market conditions.

We may be unable to obtain the additional capital we need in the future to support our growth.

Our available funds may not be sufficient to meet all of our long-term business development requirements, and we may seek to raise additional funds through public or private debt or equity financings. Pending the closing of the proposed merger with Walgreens, we generally are prohibited from any such financings without the consent of Walgreens, and we cannot ensure they would approve any such financing. In addition, due to the recent tightening of the credit and equity markets, any additional financing that we may need may not be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, our strategic flexibility or ability to develop and grow our business may be significantly limited. In March 2011, we entered into a loan and security agreement with our existing bank, which includes a revolving three-year line of credit allowing for borrowings up to $40.0 million, which accrue interest at LIBOR plus 2.5% – 3%, or prime plus 0% – 0.5%. This agreement replaced our two-year $25.0 million line of credit that matured in March 2011. As of April 3, 2011, $16.5 million was outstanding under the line of credit, which included the refinancing of $13.0 million under the prior line of credit, and $3.5 million of borrowings during the first quarter of 2011 related to equipment purchases to automate our New Jersey distribution center.

Advances available under the revolving line of credit are limited, based on eligible inventory, accounts receivable, cash and investment balances, and balances outstanding under our line of credit. The agreement contains certain covenants that are customary in transactions of this nature, including a prohibition on other debt and liens, requirements regarding the payment of taxes, and certain restrictions on mergers and acquisitions, investments, and transactions with our affiliates, as well as certain financial covenants. The agreement identifies certain events of default that are customary for transactions of this nature and subject to materiality provisions and grace periods where appropriate, including failure to pay any principal or interest under this facility or other instruments when due, the occurrence of a material adverse change, violations of any covenants, a material cross-default to our other debt, or a change of control. In the event we are not in compliance with certain financial covenants contained in the line of credit agreement, and are unable to obtain a waiver from the bank, borrowing available under the line of credit may be suspended until such time the covenant violations are remediated.

There are risks associated with our indebtedness.

At April 3, 2011, we had $17.2 million of debt obligations outstanding, as well as $23.0 million of available borrowing capacity under our existing three-year line of credit. We may incur additional indebtedness in the future, including under our revolving line of credit, through additional capital leases, or through public or private offerings of debt securities. Our outstanding indebtedness and any additional indebtedness we incur may have important consequences, including, without limitation, the following:

- we will be required to use cash to pay the principal of and interest on our indebtedness;
- our indebtedness and leverage may increase our vulnerability to adverse changes in general economic and industry conditions, as well as to competitive pressure;
- our ability to obtain additional financing for working capital, capital expenditures and for general corporate and other purposes may be limited; and
- our flexibility in planning for, or reacting to, changes in our business and our industry may be limited.

Our ability to make payments of principal of and interest on our indebtedness depends upon our future performance, which will be subject to general economic conditions, industry cycles and financial, business and other factors affecting our consolidated operations, many of which are beyond our control. If we are unable to generate sufficient cash flow from operations in the future to service our debt, we may be required to, among other things:

- seek additional financing in the debt or equity markets;
- refinance or restructure all or a portion of our indebtedness;
- sell selected assets;
- reduce or delay planned capital expenditures; or
- reduce or delay planned operating expenditures.

Such measures might not be sufficient to enable us to service our debt. In addition, any such financing, refinancing or sale of assets might not be available on economically favorable terms or at all.

If people or property are harmed by the products we sell, product liability claims could damage our business and reputation.

Some of the products we sell may expose us to product liability claims relating to personal injury, death, or property damage caused by these products and may require us to take actions such as product recalls. Any such product liability claim or product recall may result in adverse publicity regarding us and the products we sell, which may harm our reputation. If we are found liable under product liability claims, we could be required to pay substantial monetary damages. Further, even if we successfully defend ourselves against this type of claim, we could be forced to spend a substantial amount of money in litigation expenses, our management could be required to spend valuable time in the defense against these claims, and our reputation could suffer, any of which could harm our business. Some of our vendors do not indemnify us against product liability. Further, our liability insurance may not be adequate to protect us from all liability that may be imposed as a result of these claims, and we cannot be certain that insurance will continue to be available to us on economically reasonable terms, or at all. Any imposition of product liability that is not covered by vendor indemnification or our insurance could harm our business, financial condition, and operating results.

Most of our fulfillment operations and owned inventory are located in a limited number of distribution facilities, and any significant disruption of this center’s operations would hurt our ability to make timely delivery of our products.

We conduct most of our fulfillment operations from our distribution facility in Swedesboro, New Jersey. Our distribution center in Swedesboro, our inventory storage facility in nearby Logan Township, New Jersey, and inventory held by a third-party fulfillment partner in Columbus, Ohio house our entire owned product inventory other than a small amount held by Salu’s Australian subsidiary. In January 2010, we closed our Ferndale, Washington facility and transferred our vision inventory to our distribution facility in Swedesboro, New Jersey. We recently entered into an agreement with GSI Commerce Solutions, Inc. (“GSI Commerce”) by which GSI Commerce will fulfill orders for us from a distribution center in the Western United States beginning later in 2011. Additionally, BioScrip Pharmacy Services, Inc., fulfills all prescription orders through our website from its mail-order distribution center in Columbus, Ohio. A natural disaster or other catastrophic event, such as an earthquake, fire, flood, severe storm, break-in, server or systems failure, terrorist attack, or other comparable event at our New Jersey facilities or our fulfillment partners’ Ohio facilities would cause interruptions or delays in our business and loss of inventory and could render us unable to process or fulfill customer orders in a timely manner, or at all. Further, we have no formal disaster recovery plan, and our business interruption insurance may not adequately compensate us for losses that may occur. In the event that a significant part of our New Jersey facilities or our fulfillment partners’ Ohio facilities were destroyed or our operations were interrupted for any extended period of time, our business, financial condition, and operating results would be harmed.

We are dependent on a limited number of fulfillment and distribution partners. If we are unable to obtain shipments of product from our vendors and deliver merchandise to our customers in a timely and cost-effective manner, our business and results of operations would be harmed.

We cannot control all of the various factors that might affect our timely and cost-effective procurement of products from our vendors and delivery of products to our customers. We use a third-party fulfillment partner in Columbus, Ohio to fulfill Salu orders. We also rely on a limited number of third-party carriers for shipments of products to and from our distribution facilities and those of our third-party fulfillment partners and to customers. We are therefore subject to the risks, including increased fuel costs, security concerns, labor disputes, union organizing activity, and inclement weather, associated with our carriers' ability to provide product fulfillment and delivery services to meet our distribution and shipping needs. Failure to procure and deliver merchandise, either to us or our fulfillment partners or to our customers, in a timely and accurate manner would harm our reputation, the drugstore.com brands, our business, and our results of operations. In addition, any increase in fulfillment costs and expenses could adversely affect our business and operating results.

Our plans to automate our New Jersey distribution center, to have GSI Commerce to fulfill orders for us from a west coast distribution facility or to expand to a third distribution center in the Midwest may be delayed or result in greater costs or business interruption than we anticipate, interfering with our ability to deliver merchandise to our customers in a timely and cost-effective manner, and our business and results of operations would be harmed.

We have recently entered into an agreement with GSI Commerce to fulfill orders for us from a distribution center in the Western United States. We have also begun the process of upgrading the automation of our New Jersey distribution center. In addition, we have recently begun to explore strategies to expand our fulfillment operations to include a third distribution facility in the Midwestern United States. These initiatives will require significant capital resources as well as attention from our management team and may require us to divert those resources from the operation of our primary businesses. In addition, unexpected delays or increased costs of these initiatives could cause interruptions or delays in our business, and disruption in our inventory processes while we build out these facilities could render us unable to process or fulfill customer orders in a timely manner, or at all and our business, financial condition, and operating results would be harmed.

If we are unable to optimize management of our distribution centers, we may be unable to meet customer demand.

Our ability to meet customer demand may be significantly limited if we do not successfully operate our distribution centers, including in connection with any plans for new distribution centers or our plans to move our Salu fulfillment operations to our own distribution centers. Because it is difficult to predict sales volume, we may be unable to manage our facilities in an optimal way, which may result in excess or insufficient inventory, warehousing, fulfillment, or distribution capacity. In addition, failure to control product damage and shrinkage effectively through security measures and inventory management practices could adversely affect our operating margins. Our margins and revenues may also be affected if we are unable to obtain products from manufacturers and wholesalers timely and on favorable terms. In addition, if we need to increase our distribution capacity sooner than anticipated, including in connection with any plans to move our Salu fulfillment operations, that expansion would require additional financing that may not be available to us on favorable terms when required, or at all.

Under our distribution agreement with GNC, and consignment arrangements with other partners, we maintain inventory of third parties' products in our primary distribution center, thereby increasing the complexity of tracking inventory in, and the operation of, our distribution center. Our failure to properly handle third party inventory that we hold would result in unexpected costs and other harm to our business and reputation.

We need to manage changing and expanding operations.

Over the past several years, we have significantly expanded our operations, including through Salu, and we anticipate that we will continue to expand. Our past growth has placed, and we expect that our anticipated future operations and expansion will continue to place, a significant strain on our managerial, operational, financial, and other resources. Some of the administrative and operational challenges we have faced in the past as a result of our expansion and seasonal growth include the management of an expanded number of product offerings; the assimilation of systems and technologies of acquired companies; increased pressure on our senior management; and increased demand on our systems and internal controls. Our ability to manage our operations and expansion effectively depends on the continued development and implementation of plans, systems, and controls that meet our operational, financial, and management needs. If we are unable to develop or implement these plans, systems, or controls or otherwise manage our operations and growth effectively, we will be unable to increase gross margins or achieve consistent profitability, and our business will be harmed.

The seasonality of our business places increased strain on our operations.

We expect the largest amount of our net sales to occur during our fourth quarter. If we do not stock or restock popular products in sufficient amounts such that we fail to meet customer demand, it could significantly affect our revenue and our future revenue. If we overstock products, we may be required to take significant inventory markdowns or write-offs, which could reduce our gross margins. We may experience an increase in our shipping cost due to complimentary upgrades, split-shipments, and additional long-zone shipments necessary to ensure timely delivery for the holiday season. If our systems and processes are not prepared to address peak volumes during high demand seasons, holidays, and events, we may experience system interruptions that make our websites unavailable or prevent us from efficiently fulfilling orders, which may reduce the volume of goods we sell and the attractiveness of our products and services. In addition, we may be unable to staff our distribution centers adequately during these peak periods, and delivery companies may be unable to meet the seasonal demand.

A disruption in our operations could materially and adversely affect our business, results of operations and financial condition.

Any disruption to our operations, including system, network, telecommunications, software or hardware failures, and any damage to our physical locations, could materially and adversely affect our business, results of operations and financial condition.

Our operations are subject to the risk of damage or interruption from:

fire, flood, earthquake or other natural disasters;

power losses and interruptions;

Internet, telecommunications or data network failures;

physical and electronic break-ins or security breaches;

computer viruses;

acts of terrorism; and

other similar events.

If any of these events occur, it could result in interruptions, delays or cessations in service to customers of our partners' e-commerce businesses and adversely impact our partners' e-commerce businesses. These events could also prevent us from fulfilling orders for our partners' e-commerce businesses. Our partners might seek significant compensation from us for their losses. Even if unsuccessful, this type of claim likely would be time-consuming and costly for us to address and damaging to our reputation.

Our primary data centers are located at the facilities of a third-party hosting company. We do not control the security, maintenance or operation of these facilities, which are also susceptible to similar disasters and problems. Further, we have no formal disaster recovery plan, and our insurance policies may not cover us for losses related to these events, and even if they do, they may not adequately compensate us for any losses that we or our partners' may incur. Any system failure that causes an interruption of the availability of our partners' e-commerce businesses could reduce the attractiveness of our partners' e-commerce businesses to consumers and result in reduced revenues, which could materially and adversely affect our business, results of operations and financial condition.

We have significant inventory risk.

We must maintain sufficient inventory levels to operate our business successfully, including meeting the inventory needs of our strategic partners and the expectations of our customers and those of our strategic partners that we will have the products they order in stock. However, we must also guard against the risk of accumulating excess inventory. This risk would be further exacerbated by our proposed expansion to a second and third distribution center. We are exposed to significant inventory risks as a result of rapid changes in product cycles, changes in consumer tastes, uncertainty of success of product launches, seasonality, manufacturer backorders, and other vendor-related problems. In order to be successful, we must accurately predict these trends and events, which we may be unable to do, and avoid over- or under-stocking products. Our ability to stock products properly also depends on our strategic partners' ability to predict and to keep us timely informed of these trends and events in their businesses. In addition, demand for products can change significantly between the time product inventory is ordered and the time it is available for sale. When we begin selling a new product, it is particularly difficult to forecast product demand accurately. A failure to optimize inventory would increase our expenses if we have too much inventory, and would harm our margins by requiring us to make split shipments for backordered items or pay for expedited delivery from the manufacturer if we had insufficient inventory. In addition, we may be unable to obtain certain products for sale on our websites as a result of general shortages (for example, in the case of some medications), manufacturer policies (for example, in the case of some contact lenses and prestige beauty items), manufacturer or distributor problems, or popular demand. Failure to have inventory in stock when a customer orders it could cause us to lose that order or that customer. The acquisition of some types of inventory, or inventory from some of our sources, may require significant lead time or prepayment, and this inventory may not be returnable. We carry a broad selection of products and significant inventory levels of a substantial number of products, and we may be unable to sell this inventory in sufficient quantities or during the relevant selling seasons. The occurrence of one or more of these inventory risks may adversely affect our business and operating results.

Our vendor relationships subject us to a number of risks.

We have significant vendors that are important to our sourcing of merchandise. We do not have long-term arrangements with most of our vendors to guarantee availability of merchandise, particular payment terms, or extension of credit limits. If our current vendors were to stop selling merchandise to us on acceptable terms, we may not be able to acquire merchandise from other vendors in a timely and efficient manner and on acceptable terms, or at all.

If we do not attract and retain qualified personnel, or if our key employees fail to perform, our ability to execute our business strategy will be impaired.

We are dependent on our key personnel, and our success depends in large part on our ability to attract and retain qualified personnel. All of our employees, including our executive officers, can terminate their employment with us at any time. If we experience significant turnover or difficulty in recruiting new personnel, or if our key employees fail to perform as expected, our ability to execute our business strategy will be impaired.

Changes in our senior management may have an adverse effect on our ability to execute our business strategy.

Our success depends largely on the efforts and abilities of our senior management to execute our business plan. Changes in our senior management may be disruptive to our business and may adversely affect our operations. For example, when we have changes in senior management positions, we may elect to adopt different business strategies or plans. Any new strategies or plans, if adopted, may not be successful and if any new strategies or plans do not produce the desired results, our business may suffer.

Any errors in filling or packaging the contact lenses we dispense may expose us to liability and negative publicity.

Errors relating to our contact lens dispensing process may result in liability for us that our insurance may not cover. Because we distribute contact lenses directly to the consumer, we are one of the most visible participants in the distribution chain and therefore have increased exposure to liability claims. Our general liability, product liability, and professional liability insurance may not cover potential claims of this type or may not be adequate to protect us from all liabilities that may be imposed if any such claims were to be successful.

Errors by either us or our competitors may also produce significant adverse publicity either for us or for the online vision industry in general. Because of the significant amount of press coverage on Internet retailing, we believe that we are subject to a higher level of media scrutiny than other prescription product channels. The amount of negative publicity that we or the online vision industry receives as a result of prescription processing errors could be disproportionate in relation to the negative publicity received by other eye care professionals making similar mistakes. We have no control over the practices of our competitors, and we cannot ensure that our prescription processing operates completely without error. We believe customer acceptance of our online shopping experience is based in large part on consumer trust, and errors by us or our competitors and related negative publicity could erode this trust or prevent it from growing. This could result in an immediate reduction in the amount of orders we receive, adversely affect our revenue growth, and harm our business and operating results.

Governmental regulation of our business could require significant expenditures, and failure to comply with regulations could result in civil and criminal penalties.

Our business is subject to extensive federal, state and local regulations. For example:

- the sale, advertisement, and promotion of, among other things, contact lenses, OTC and homeopathic medications, dietary supplements, medical devices, cosmetics, foods, and other consumer products that we sell are subject to regulation by the Food and Drug Administration, or FDA, the Federal Trade Commission, or FTC, the Consumer Product Safety Commission, and state regulatory authorities, as the case may be; and
- our vision business is also subject to the Fairness to Contact Lens Consumers Act and related regulations of the FTC, which requires all patients to renew their contact lens prescriptions annually and requires third-party contact lens sellers, like Vision Direct, to verify these prescriptions in accordance with specified procedures.

As we expand our product and service offerings and more non-pharmaceutical products become subject to FDA, FTC, and other regulation, more of our products and services may become subject to regulation. In addition, regulatory requirements to which our business is subject may expand over time, and some of these requirements may have a disproportionately negative effect on Internet retailers. For example, the federal government and a majority of states now regulate the retail sale of OTC products containing pseudoephedrine that might be used as precursors in the manufacture of illegal drugs. As a result, we are currently unable to sell these products to customers residing in states that require retailers to obtain a physical form of identification or maintain a signature log. In addition to regulating the claims made for specific types of products, the FDA and the FTC may attempt to regulate the content included on websites that market products to consumers. Complying with regulations is time-consuming, burdensome, and expensive and could delay our introduction of new products or services.

As our website is accessible over the Internet in multiple states and other countries, and if and when we expand our marketing strategies to other countries, we may be subject to their laws and regulations or may be required to qualify to do business in those locations. Our failure to qualify in a state or country in which we are required to do so could subject us to taxes and penalties and we could be subject to legal actions and liability in those jurisdictions. The restrictions or penalties imposed by, and costs of complying with, these laws and regulations could harm our business, operating results, and financial condition. Our ability to enforce contracts and other obligations in states and countries in which we are not qualified to do business could be hampered, which could harm our business.

The laws and regulations applicable to our business often require subjective interpretation, and we cannot be certain that our efforts to comply with these regulations will be deemed sufficient by the appropriate regulatory agencies. Violations of any regulations could result in various civil and criminal penalties, including suspension or revocation of our licenses or registrations, seizure of our inventory, or monetary fines, any of which could harm our business, financial condition, or operating results. Compliance with new laws or regulations could increase our expenses or lead to delays as we adjust our websites and operations.

Restrictions imposed by, and costs of complying with, governmental regulation of the Internet and data transmission over the Internet could harm our business.

We are subject to the same federal, state, and local laws generally applicable to businesses, as well as those directly applicable to companies conducting business online, including consumer protection laws, user privacy laws, and regulations prohibiting unfair and deceptive trade practices. Further, the growth of online commerce could result in more stringent consumer protection laws that impose additional compliance burdens on us. Today there are an increasing number of laws specifically directed at the conduct of business on the Internet. Moreover, due to the increasing use of the Internet, many additional laws and regulations relating to the Internet are being debated at the state and federal levels. These laws and regulations could cover issues such as freedom of expression, pricing, user privacy, fraud, quality of products and services, taxation, advertising, intellectual property rights, and information security. Applicability of existing laws to the Internet relating to issues such as property ownership, copyrights and other intellectual property issues, taxation, libel, obscenity, and personal privacy could also harm our business. For example, U.S. and international laws regulate our ability to use customer information and to develop, buy, and sell mailing lists. The vast majority of these laws were adopted before the advent of the Internet, and do not contemplate or address the unique issues raised by the Internet. Those laws that do reference the Internet, such as the Digital Millennium Copyright Act, are only beginning to be interpreted by the courts, and their applicability and reach are therefore uncertain. The restrictions imposed by, and the costs of complying with, current and possible future laws and regulations related to businesses conducted on the Internet could harm our business, operating results, and financial condition.

Healthcare reform measures and related changes in applicable federal and state laws could adversely affect our business.

The efforts of governmental and third-party payers to contain or reduce the costs of healthcare may adversely affect our business, operating results, and financial condition. Recently, there have been, and we expect that there will continue to be, a number of legislative and regulatory proposals aimed at changing the healthcare system, including for example, restructuring the tax benefits available through flexible spending accounts and/or health savings accounts by limiting the eligibility of non-prescription products. If the laws or regulations are changed to limit further the tax benefits through these accounts, such a change could have an adverse effect on our business by reducing revenues and eroding our margins.

We are subject to a number of risks related to payments we accept and process for third parties.

We accept payments by a variety of methods, including credit cards, gift certificates, and third-party payors such as Pay Pal, Google Checkout, and Bill Me Later. In addition, we serve as a payment processing service provider for certain of our strategic partners. As we offer new payment options to our customers and processing services to our strategic partners, we may be subject to additional regulations, compliance requirements, and fraud. For credit card payments and other third-party payors, we pay interchange and other fees, which may increase over time, raising our operating costs and lowering our profit margins. In addition, we have additional contractual obligations to our strategic partners regarding the payment processing services we provide them, and conversely depend on our strategic partners to meet their obligations to us and to the third-party payors, and any failure of us or our partners to meet those obligations could expose us to additional fees and expenses. We are also subject to payment card association operating rules and certification requirements, both as a merchant and as a service provider, which could change or be reinterpreted to make compliance difficult or impractical. If we fail to comply with these rules or requirements, we may be subject to fines and higher transaction fees and lose our ability to accept credit card payments from our customers and those of our strategic partners or to facilitate other types of online payments, and our business and operating results could be adversely affected.

If we are required to collect sales and use taxes on the products we sell in additional jurisdictions, we may be subject to liability for past sales and our future sales may decrease.

Currently, decisions of the U.S. Supreme Court restrict the ability of states to collect state and local sales and use taxes with respect to sales made by companies lacking a physical presence in the state. Based on this case law, we have historically only collected and remitted sales and use taxes in the states of Washington and New Jersey where our corporate offices and distribution centers have been located. However, a number of states have passed or are considering passing initiatives that could test the Supreme Court' s position regarding sales and use taxes on Internet sales. The operation of our distribution centers, the operations of any future distribution centers, our drop-shipping agreements with vendors, our arrangements with marketing affiliates, and other aspects of our evolving business, however, may result in additional sales and use tax collection obligations. In addition, one or more other states may successfully assert that we should collect and remit sales and use or other taxes on the sale of our products in that state. One or more states or the federal government may seek, either through unilateral action or through federal legislation, to impose sales or other tax collection obligations on out-of-jurisdiction companies that engage in electronic commerce as we do.

Effective July 2008, New York imposed such a sales tax obligation requirement on on-line retailers that use New York residents to directly or indirectly refer potential customers, via a link on an Internet Website or otherwise, to the online retailer. As a result, we began collecting and remitting sales tax in New York in July 2008. Since then, other states have enacted legislation similar to New York' s, including Rhode Island in June 2009, North Carolina in August 2009, and Illinois in March 2011. In response to recently imposed state sales tax requirements for online retailers, we have suspended certain marketing affiliate relationships with persons and entities residing in Rhode Island and North Carolina, which may cause our sales to decline. Other states are considering similar laws, and if such laws become effective, we may have to change or limit our marketing activities in those states or face additional sales tax collection and remittance obligations, either of which could have a negative effect on our sales.

Because our newly acquired subsidiary, Salu, is located in California and has distribution activities in Ohio, we also collect sales tax in both California and Ohio on its sales. In conjunction with our fulfillment agreement with GSI Commerce, we will be required to collect sales tax in Nevada. If we proceed with our plans to open a Midwest distribution center, we will likely be required to collect in the state where it is located as well.

In addition, one or more states could begin to impose sales taxes on sales of prescription products, which are not generally taxed at this time. While we believe we are in compliance with existing laws and regulations, we could be subject to significant fines or other payments for any unintentional past failure to comply with tax regulations. This could result in substantial tax liabilities for our past sales, decrease our ability to compete with traditional retailers, and otherwise harm our business, financial condition, and operating results.

Pending an authoritative reconciliation of these initiatives with the common law, and potentially for years into the future if any challenge to these initiatives resulted in a reversal by the courts of the long-standing restriction on states' ability to tax out-of-state sellers, we could be required to collect and remit sales and use taxes in states other than Washington, New York, New Jersey, California, Ohio, and Nevada. The imposition of additional tax obligations on our business by state and local governments could create significant administrative burdens for us, decrease our future sales, and harm our cash flow and operating results.

We may be unable to increase the migration of consumers of health, beauty, clinical skincare, and vision products from brick-and-mortar stores to our online solution, which would harm our revenues and prevent us from becoming profitable.

If we do not continue to attract and retain higher volumes of online customers to our Internet stores at a reasonable cost, we will not be able to increase our revenues or achieve consistent profitability. Our success depends on our ability to continue to convert a large number of customers from traditional shopping methods to online shopping for health, beauty, wellness, vision, and pharmacy products. Specific factors that could prevent widespread customer acceptance of our online solution include:

- shipping charges, which do not apply to purchases made at a brick-and-mortar store;
- delivery time associated with Internet orders, as compared to the immediate receipt of products at a brick-and-mortar store;
- delays in deliveries to customers;
- lack of consumer awareness of our websites;
- additional steps and delays in verifying prescriptions for prescription products;
- regulatory restrictions or reform at the state and federal levels that could affect our ability to serve our customers;
- customer concerns about the security of online transactions, identity theft, or the privacy of their personal information;
- product damage from shipping or shipments of wrong or expired products from us or other vendors, resulting in a failure to establish, or loss of, customers' trust in buying drugstore items online;
- delays in responses to customer inquiries;
- difficulties or delays in returning or exchanging orders; and
- activity that diminishes a user's online experience or subjects online shoppers to security risks, such as viruses, spam, spyware, phishing (spoofing e-mails directed at Internet users), "denial of service" attacks directed at Internet service providers and online businesses, and breaches of data security.

Expanding the breadth and depth of our product and service offerings is expensive and difficult, and we may receive no benefit from our expansion.

We intend to continue to expand the breadth and depth of our product and service offerings by promoting new or complementary products or sales formats. Expansion of our offerings in this manner could require significant additional expenditures and could strain our management, financial, and operational resources. For example, we have launched our microsites in an initiative to design separate web stores dedicated to specific categories of products and certain mobile platforms to expand the availability of our site to mobile telephone and other device users. Additionally, we may need to incur significant marketing expenses, develop relationships with new fulfillment partners or manufacturers, or comply with new regulations. We may be unable to expand our product and service offerings or sales formats in a cost-effective or timely manner, and any new offerings or formats may not generate satisfactory revenues to offset the costs involved. Furthermore, any new product or service offering or sales format that is not favorably received by consumers could damage the reputation of our brand. A lack of market acceptance of our efforts or our inability to generate sufficient revenues to offset the cost of expanded offerings could harm our business.

Increasing concern about privacy, spam, and the use and security of customer information could restrict our marketing efforts and harm our business.

Internet retailers are also subject to increasing regulation and scrutiny relating to privacy, spam, and the use and security of personal user information. These regulations, along with increased governmental or private enforcement (for example, by Internet service providers), may increase the cost of growing our business. Current and proposed regulations and enforcement efforts may restrict our ability to collect and use demographic and personal information from users and send promotional e-mails, which could be costly or harm our marketing efforts. For example, if one or more Internet service providers were to block our promotional e-mails to customers, our ability to generate orders and revenue could be harmed. Further, any violation of privacy, anti-spam, or data protection laws or regulations may subject us to fines, penalties, and damages and may otherwise have a material adverse effect on our business, results of operations, and financial condition.

Our network and communications systems are vulnerable to system interruption and damage, which could harm our operations and reputation.

Our ability to receive and fulfill orders promptly and accurately is critical to our success and largely depends on the efficient and uninterrupted operation of our computer and communications hardware and software systems. We experience periodic system interruptions that impair the performance of our transaction systems or make our websites inaccessible to our customers. These systems interruptions may prevent us from efficiently accepting and fulfilling orders, sending out promotional e-mails and other customer communications in a timely manner, introducing new products and features on our website, promptly responding to customers, or providing services to third parties. Frequent or persistent interruptions in our services could cause current or potential customers to believe that our systems are unreliable, which could cause them to avoid our websites, drive them to our competitors, and harm our reputation. To minimize future system interruptions, we need to continue to add software and hardware and to improve our systems and network infrastructure to accommodate increases in website traffic and sales volume, to replace aging hardware and software, and to make up for several years of underinvestment in technology. We may be unable to promptly and effectively upgrade and expand our systems and integrate additional functionality into our existing systems. Any unscheduled interruption in our services, especially during the holiday shopping season, could result in fewer orders, additional operating expenses, or reduced customer satisfaction, any of which would harm our revenues and operating results and could delay or prevent our becoming consistently profitable. In addition, the timing and cost of upgrades to our systems and infrastructure may substantially affect our ability to maintain profitability.

Our systems and operations, and those of our suppliers and Internet service providers, are vulnerable to damage or interruption from fire, flood, earthquakes, power loss, server failure, telecommunications and Internet service failure, acts of war or terrorism, computer viruses and denial-of-service attacks, physical or electronic break-ins, sabotage, and similar events. Any of these events could lead to system interruptions, service delays, and loss of critical data for us, our suppliers, or our Internet service providers, and could prevent us from accepting and fulfilling customer orders. Any significant interruption in the availability or functionality of our websites or our customer processing, distribution, or communications systems, for any reason, could seriously harm our business, financial condition, and operating results. While we do have backup systems for some aspects of our operations, we do not have fully redundant backup systems or a formal disaster recovery plan. Our business interruption insurance may be inadequate to compensate for all losses that may occur.

Security breaches could damage our reputation, expose us to liability, or otherwise harm our business.

Although we have developed systems and processes that are designed to protect customer information and prevent fraudulent transactions, data loss and other security breaches, failure to prevent or mitigate such breaches may adversely affect our operating results. To succeed, we must provide a secure transmission of confidential information over the Internet and protect the confidential customer and patient information we retain, such as credit card numbers and prescription records. A third party who compromises or breaches the physical and electronic security measures we use to protect transaction data and customer records could misappropriate proprietary information, cause interruptions in our operations, damage our computers or those of our customers, or otherwise harm our business. Any of these could harm our reputation and expose us to a risk of loss or litigation and possible liability. We may need to expend significant resources to protect against security breaches or to address problems caused by breaches, and our insurance may not be adequate to reimburse us for losses caused by security breaches.

If we do not respond to rapid technological changes, our services could become obsolete and our business would be seriously harmed.

As the Internet and online commerce industry evolve, we must license technologies useful in our business, enhance our existing services, develop new services and technologies that address the increasingly sophisticated and varied needs of our prospective customers and respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis. We may not be able to successfully implement new technologies or adapt our web stores, proprietary technology, and transaction-processing systems to meet customer requirements or emerging industry standards. Failure to successfully and timely do so could adversely affect our ability to build the drugstore.com brand and attract and retain customers.

We may be unable to protect our intellectual property, and we may be found to infringe proprietary rights of others, which could harm our business, brand, and reputation.

Our success depends in substantial part on our proprietary rights, including our technology, copyrights, trademarks, service marks, trade dress, trade secrets, and similar intellectual property. We rely on a combination of patent, trademark, trade secret, and copyright law, as well as contractual restrictions to protect our proprietary rights. Despite our efforts to protect our proprietary rights, however, unauthorized parties may attempt to copy, obtain, and use technology or information that we regard as proprietary, such as our sales formats, the technology used to operate our website, our website content, and our trademarks. In addition, the laws of many countries do not protect our proprietary rights to the same extent as the laws of the United States.

We own a number of domain names, hold nine patents, and have registered several trademarks and filed applications for a number of other trademarks in the United States and several other countries. We may be unable to secure the trademark registrations or patents for which we have applied, which could negatively affect our business. Our competitors or others may adopt marks or service names similar to ours, which could impede our ability to build brand identity and lead to customer confusion, and owners of other registered trademarks or trademarks that incorporate variations of our marks could bring potential trade name or trademark infringement claims against us. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States, and effective patent, copyright, trademark, and trade secret protection may not be available in such jurisdictions. Our business could be harmed if we are unable to protect or preserve the value of our trademarks, patents, copyrights, trade secrets, or other proprietary rights for any reason, or if we are subject to any claims or customer confusion related to our intellectual property or any failure or inability to protect our proprietary rights.

Litigation or proceedings before the U.S. Patent and Trademark Office or the World Intellectual Property Organization may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets and domain names, or to determine the validity and scope of the proprietary rights of others. Any litigation or adverse priority proceeding or other efforts to protect our intellectual property could result in substantial costs and diversion of resources and could seriously harm our business and operating results. Third parties have in the past, and may in the future, also assert claims against us alleging infringement, misappropriation, or other violations of patent, trademark, or other proprietary rights held by them, whether or not their claims have merit. For example, one of our subsidiaries was sued over alleged copyright and trademark violations based on use of “pop-up” advertising, although this action was settled in June 2004 without any material adverse effects to us. We expect that participants in our markets will be increasingly subject to infringement claims as the number of services and competitors in our industry segment grows. Any such claims, whether they are with or without merit or are determined in our favor, could be time-consuming, result in costly litigation, divert the attention of our management, cause service upgrade delays, and harm our business or operating results. Furthermore, as a result of infringement claims we may be required to enter into costly royalty or licensing agreements, which may not be available on terms that are acceptable to us, or at all. If a third party successfully asserts an infringement claim against us and we are required to pay monetary damages or royalties or we are unable to obtain suitable non-infringing alternatives or license the infringed or similar intellectual property on reasonable terms on a timely basis, our business could be adversely affected.

The third-party licenses on which we rely may not continue to be available to us on commercially reasonable terms. The loss of such licenses could require us to incur greater cost or change our business plans, either of which could harm our business.

We have a history of generating significant losses, and may not be able to sustain profitability.

We have an accumulated deficit of $778.0 million through April 3, 2011. To date, we have had only four profitable quarters, and we may never achieve profitability on a full-year or consistent basis. As a result, our stock price may decline and stockholders may lose all or a part of their investment in our common stock.

Our stock price is likely to continue to fluctuate, which could result in substantial losses for stockholders.

The market price of our common stock has been, and is likely to continue to be, extremely volatile. Our stock price could be subject to wide fluctuations in response to a number of factors, including those described in this annual report, some of which are beyond our control, and these fluctuations could result in substantial losses for stockholders.

In the past, securities class action and derivative litigation has often been brought against a company following periods of volatility in the market price of its securities. We have been named in such lawsuits in the past, including certain putative class action and derivative suits filed against us and certain of our current and former officers and directors in 2004. Although the courts dismissed these lawsuits, we may be the target of similar litigation in the future. Securities litigation could result in substantial costs and divert management' s attention and resources, which could seriously harm our business and operating results and cause the trading price of our stock to decline.

Certain stockholders own a significant amount of our common stock, which could discourage an acquisition of drugstore.com or make removal of incumbent management more difficult.

Amazon.com beneficially owns approximately 12% of our outstanding stock, and is entitled to designate a director to serve on our board of directors, currently Geoffrey R. Entress. Kleiner Perkins Caufield and Byers, or KPCB, owns approximately 9% of our outstanding stock, and T. Rowe Price Associates, Inc. owns approximately 7% of our outstanding stock. Because each owns a significant percentage of our capital stock, any of these stockholders, or more than one of them, could significantly influence all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions. Furthermore, because of these substantial equity stakes in drugstore.com, competitors of these stockholders, or other potential acquirers could decide not to merge with, or acquire, us. In addition, in the case of a potential acquisition of drugstore.com by another party, a substantial equity stake in drugstore.com could prevent the tax-free treatment of an acquisition, making drugstore.com a less attractive acquisition candidate. In addition, if any of our significant stockholders were to sell a substantial quantity of their holdings in a short period of time, our stock price could decline.

At April 3, 2011, we had approximately $638 million of federal net operating loss carry-forwards that will expire beginning in 2018. Internal Revenue Code Section 382 imposes limitations on our ability to utilize net operating losses if we experience an ownership change. An ownership change may result from transactions increasing the ownership of certain stockholders in the stock of a corporation by more than 50 percentage points over a three-year period. The value of the stock at the time of an ownership change is multiplied by the applicable long-term tax exempt interest rate to calculate the annual limitation. Any unused annual limitation may be carried over to later years. Based upon our cumulative historic ownership activity, it likely results in a significant limitation on the utilization of our net operating loss carryforwards. Also, if we were to have an extraordinary amount of shares acquired, for example more than 40.0 million from a new or existing 5% shareholder or if we were to be acquired, then based on our current fair value and the low long-term tax exempt interest rate, utilization of a significant amount of our net operating losses could be further limited.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. (Removed and Reserved).

Item 5. Other Information.

None.

Item 6. Exhibits

Exhibit No.	Exhibit Description
2.1	Agreement and Plan of Merger, dated March 23, 2011 (incorporated by reference to Exhibit 2.1 to drugstore.com, inc.' s Current Report on Form 8-K filed March 24, 2011 (Registration No. 000-26137)).
3.1	Amended and Restated Certificate of Incorporation of drugstore.com, inc. (incorporated by reference to Exhibit 3.2 to drugstore.com, inc.' s Registration Statement on Form S-1 filed February 9, 2000 (Registration No. 333-96441)).
3.2	Amended and Restated Bylaws of drugstore.com, inc. dated January 26, 2009 (incorporated by reference to Exhibit 3.1 to drugstore.com inc.' s Current Report on Form 8-K filed January 30, 2009 (SEC File No. 000-26137)).
31.1	Certification of Dawn G. Lepore, Chairman of Board, President and Chief Executive Officer of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Robert P. Potter, Vice President and Chief Accounting Officer of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Dawn G. Lepore, Chairman of Board, President and Chief Executive Officer of drugstore.com, 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 Robert P. Potter, Vice President and Chief Accounting Officer of drugstore.com, 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.

DRUGSTORE.COM, INC
(Registrant)

By:. /s/ Robert P. Potter

Robert P. Potter
Vice President and Chief Accounting Officer

Date: May 13, 2011

Exhibit 31.1

CERTIFICATIONS

I, Dawn G. Lepore, certify that:

1. I have reviewed this quarterly report on Form 10-Q of the registrant, drugstore.com, inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant’ s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   c) Evaluated the effectiveness of the registrant’ s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
   d) Disclosed in this report any change in the registrant’ s internal control over financial reporting that occurred during the registrant’ s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant’ s internal control over financial reporting; and
5. The registrant’ s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’ s auditors and the audit committee of the registrant’ s board of directors:
   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’ s ability to record, process, summarize and report financial information; and
   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’ s internal control over financial reporting.

May 13, 2011

/s/ Dawn G. Lepore

President, Chief Executive Officer and
Chairman of the Board

Exhibit 31.2

CERTIFICATIONS

I, Robert P. Potter, certify that:

1. I have reviewed this quarterly report on Form 10-Q of the registrant, drugstore.com, inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant' s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   c) Evaluated the effectiveness of the registrant' s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
   d) Disclosed in this report any change in the registrant' s internal control over financial reporting that occurred during the registrant' s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant' s internal control over financial reporting; and
5. The registrant' s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant' s auditors and the audit committee of the registrant' s board of directors:
   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant' s ability to record, process, summarize and report financial information; and
   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant' s internal control over financial reporting.

May 13, 2011

/s/ Robert P. Potter

Vice President and Chief Accounting Officer

Exhibit 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of drugstore.com, inc. (the "Company") for the period ending April 3, 2011, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Dawn G. Lepore, President, Chief Executive Officer and Chairman of the Board of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Dawn G. Lepore

President, Chief Executive Officer and
Chairman of the Board

May 13, 2011

A signed original of this written statement required by Section 906 has been provided to drugstore.com, inc. and will be retained by drugstore.com, inc. and furnished to the Securities and Exchange Commission or its staff upon request.

Exhibit 32.2

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of drugstore.com, inc. (the "Company") for the period ending April 3, 2011, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert P. Potter, Vice President and Chief Accounting Officer, of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Robert P. Potter

Vice President and Chief Accounting Officer

May 13, 2011

A signed original of this written statement required by Section 906 has been provided to drugstore.com, inc. and will be retained by drugstore.com, inc. and furnished to the Securities and Exchange Commission or its staff upon request.